6. Country Report 2

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Prof. Dong:

Ladies and gentlemen, good afternoon. The title of my speech is "Legal Framework for Consumer Protection in Chinese Financial Service." Now, I will explain this title in three respects. The first part is the strata separating business policy and controlling policy. In the Chinese legal framework there are certain kinds of financial transaction productions. Any new financial transaction must be submitted to the government for approval. With regard to the consumer, he can loan from bank mortgaged with estate, he can get collective influence from banks I think which is a very important instrument. He can apply to banks for credit cards, a consumer can buy securities by ways of securities companies in which he becomes an investor. He can buy trusts or benefits from trusts or investment companies and the raised money will be loaned to the merchants. He can buy kinds of insurance products from insurance companies, but the consumer or public cannot sell any financial products to the others.

Generally speaking, Chinese Commercial Bank Act, Securities Law and Insurance Act provide a strata separating business policy and controlling policy. That means only the approved bank can operate a deposit business and loan the money to the merchant. Only the approved securities company can do the business of investment banking, securities broker dealing but it can not do the business of deposit. Only the approved trust investment company can do the business or raising money from the public and loan it to the merchant. Only the approved insurance company can sell its insurance products to the public, but it cannot do the business of deposit.

Recently, Chinese Supreme People's Court provides by ways of judicial interpretation act, natural person and normal merchant can do the civil loan with each other, but the loan interest in controlled. So at present, most of the enterprises or companies prefer to make a managing credit contract instead of civil loan contract. In practice the government encourages financial institute to make new financial products. But in Chinese society, because of the bad commercial credibility and the large populations, the financial products are seldom, such as credit card, bond and so on.

The second part is the new Company Law and the securities law. The two new acts have been amended this year in the light of the European Community Council Directive and the Chinese legal experience. They are very important to the commercial society and to the public in the financial market. According to Articles 20 of the Company Law, when the shareholders of a company abuse of their power, it will lead to the application of piercing the corporate veil. That means the company's corporate entity will be denied and its shareholders have to assume the responsibility to the creditors.

According to the Article 16, 21, 148, 149, 123, 150 of the Act, the transaction between the related bodies will be limited. Such transactions must be decided by the non-related shareholders or the independent directors of the company.

According to the Articles 34, 98 of the Company Law, any shareholders of the company have the right to inquire about and copy the corporation by-laws, shareholder meeting records, director meeting records, corporate account books. In the old Company Law, there were only principle regulations; in practice most companies denied the rights of shareholders on the pretext of the corporate secrets.

According to the Articles 152, 153 of the Company Law, any shareholder can bring a suit against the other shareholder, against the company and against corporate senior managers, by means of independent action and deriving action.

According to the Articles 20, 26, and 31 of Securities Law, any company that wants to issue any kind of securities, must disclose its all kinds of situation by a true, exact and complete way. False representation in public offer is prohibited. If there is occurrence of false representation, all intermediate institutes and the company must assume the responsibility to the public according to civil law, administrative law and criminal law.

According to the Articles 77, 203 of the Securities Law, the manipulating act of the securities market is prohibited. If an institute manipulates the securities price, and resulting in the fluctuations of the market, it will undertake the responsibilities in administrative law, criminal law and civil law. But the suiting consumers must prove their losses and the cause relations, which is very difficult. To make up such a defect, the new Securities Law provides a new principle of the spot transaction and the futures transaction. And the new financial futures market has been set up in Shanghai, which will provide the transaction service of the market index futures, bond future, options and so on. Most Chinese scholars think the principle and the hedge transaction will avoid the manipulation of the individual company shares, which is popular in Chinese financial market.

The new Securities Law provides the rules to prohibit the security company to deceive the consumers, including the diverting act of the security companies. Besides, the new Security Law provides to set up the fund of protecting investors. The fund will be engaged to remedy the losses of harmed investors.

The third part is development of Chinese Financial Legal System. Generally speaking, Chinese financial legal system is in its initial stage and it develops slowly. Most financial laws take the form of the special acts. The civil law and commercial law are now developing. In practice, the financial transactions are not popular besides the deposit. So the legislators pay little attention to the protection of the consumers, but the safety of the transactions.

Nowadays, Chinese banks supply a few kinds of consumer loans. Because the Consumer Bank Act only provides principle rules and there are seldom forced regulations in the Act, the transaction parties depend on the contract. The interest clauses and the responsibility clause of the contract are always unfavorable which responds a grievance of the consumer. For example the banks have the right to raise the loan interest rate in accordance with the regulation of the People’s Bank of China.

The insurance practice depends on the insurance contract of the two parties too. The Insurance Act provides a few principle rules, and the new insurance standard contract between insurance company and the consumer must be supplied to the China Insurance Regulatory Commission for approval. In legal practice, there are a lot of unfair standard clauses in the insurance contract. For example, the limitation to the insurance accident, the limitation to the insurance compensations. Chinese Consumer Association used to provide many such advises to all kinds of insurance companies.

In the securities practice, the security attorney contract, that means the broker dealing contract, is limited a lot by the Security Law. For example, the limitation of the promise from security company, the prohibition of the diverting. Because the transactions in the Internet are popular, the securities company has little chance to tort the investors.

Generally speaking, the disputes in Chinese financial transaction are normal by ways of suit to court, but the consumers have no advantages. Of course, in many transactions the consumers can bring up an offence against institutes to the China Banking Regulatory Commission, China Insurance Regulatory Commission and the China Security Regulatory Commission. In security transactions the fund of protecting investors may play an important role. In accordance with Chinese legal system, if the transaction objects of a financial transaction are criminal, and then gain some benefits through the illegal activities, the benefits will belong to the state. That is all, thank you very much.

Prof. Tong:

Thank you for the introduction. My name is Tong, and I am from Matsuyama University. I would like to thank the organizer for the kind invitation, this is a great honor for me. Let me speak in Japanese.

As I have listened to the discussions, most of the people present are legal experts. I do not have a legal background, but Professor Dong right now has reported already, so let me supplement what he has already told us. I am going to talk about financial assets of the Chinese households.

Professor Dong already reported on the point, but there are only limited number of types of financial assets. For example, derivatives are prohibited in the Chinese market. The slide shows the balances of deposit savings, including postal savings and bank deposits. As of 2005 the outstanding amount is roughly 14 trillion renminbi.

This is the deposit savings compared with the GDP. The left hand scale represents the deposit balance, while the right hand scale shows the ratio to the GDP. If you look at the white part on the left-hand scale, this is the GDP. As you can see, the percentage of the deposits to GDP is very high, quite close to 90%. This white portion represents the urban areas, while the red portion represents the rural areas.

This is the deposit balance. The Chinese households, other than savings and deposits, do have equities, fixed income securities, and other financial products, but we do not have statistics for these balances, or perhaps they are not disclosed, although I am not sure. This is the data released in June 2002 by the statistics office of the Chinese Government, and shows the average financial asset balance of the urban household and its composition. As you can see, deposit accounts for some 70% of the financial assets of the urban families. Equities account for around 11%, government bonds, 4%, and there are also premiums paid for insurance with depository nature, including public insurance. There are also housing funds which, if you are employed by a good company in the urban area, is compulsory. There are other marketable securities, but they are very small and negligible.

Although we do not have data for the balance of financial assets, China has been releasing the flow-of-funds table from 1992, and this represents increases in financial assets compiled from the table by assembling financial transactions data.

In the household, every year the money flows, first of all, to deposits. The red part on the slice is the deposit. The lower part shows the cash; people keep cash at hand. The yellow part is bonds, and as you can see, bonds account for a very small percentage This is insurance. The black shows equities. This is how the breakdown of financial assets of the Chinese households has changed over time.

This is the same information shown in terms of percentage. If you look here, amongst the financial transactions in the household, the deposits always have a very large percentage. In particular, if you compare the latest figures with those in 1992, now the deposits are larger than it 1992. The yellow part is the bonds, and the ratio of the bonds is smaller than in 1992. Equities have also decreased.

This is also the same data. The latest data available is for 2003, and every year some 72% of transactions is for deposits. In 1992 the figure was only about 60%.

The reason behind is first of all households' borrowings from banks. Currently the households have access to bank borrowings and as you can see from the graph, the figures jumped in 1997/1998. Until 1996 the borrowings were not large, but from 1997 loans for real estate or durable goods became accessible, in order to stimulate domestic demand. Up until 1997, consumer loans were not permitted. These figures are for the urban households, and include the self-employed borrowing money from banks or credit associations to set up a business. This has been expanding rapidly. As of 2003, the outstanding balance was some 700 billion yen, and should be much larger for 2005. In particular, most of these loans are for housing, which is a serious issue at the moment. Of course, if you want to take out housing loans from the banks, then you will have to place deposits.

Now this is about the stocks. As you can see from this graph, the white bars represent the market capitalization. The market capitalization peaked out in 2000 and it has been declining since, because of the depressed stock market. The red bars represent the number of stocks outstanding. The number of shares outstanding has been increasing, but the market capitalization has been decreasing. All the figures show year-to-year declines in the market capitalization. That is because of the depressed stock market, and, most probably the Japanese media have covered a lot, but there were a number of scandals, and investors are leaving the stock market.

This is similar information. This shows the monetary value of the stock transactions and the size of new issues. This is the size of transactions. It also peaked out in 2000 and after that the trading volume has continued to go down. The red shows the new issues. It also peaked in 2000 and equities can no longer be issued now.

For the reason, please look at the composition of the financial assets in the financial sector. Lending accounts for the largest part followed by bonds. The ratio of bonds is rising among the financial assets owned by financial institutions.

The green part is the foreign reserve, which is expanding rapidly.

What I am trying to emphasize is that, although the lending remains high in terms of the percentage, the bonds are increasing sharply. What might be the reason? Because the financial institutions have a very serious problem of non-performing. In the bond market, there are strict regulations and therefore very few companies issue corporate bonds, and most of the bonds are government bonds and bank debentures. In particular the government bonds have been issued in a very large scale since 1997, in order for the government to stimulate the domestic demand. Bonds are now investment vehicles for banks instead of loans. Banks are in many cases lead managers in government bond issues, and before selling to the retail investors, they will purchase and own the bonds. Under the Banking Act of China, the banks are not permitted to own shares. In order to manage assets safely, they turn to bonds, and the rests foreign reserves and others.

The red part is the size of the government bond issues and the red part is the size purchased by financial institutions. At this moment about 70% of the government bonds are purchased by the financial institutions—they do not really want to sell to retail investors—and the yellow part is the year-on-year growth rate.

In China, assets are invested as a means of social security or social insurance rather than in financial products. Thank you for your attention.

Question:

Thank you very much both of the presenters. I would like to ask first Dr. Dong about your presentation. You have mentioned the Chinese system is very similar to the traditional Japanese system; deposits are the majority and insurance is second, and capital market is very thin. You mentioned that regulating those financial systems are separate legal system and one is banking and insurance, and then the rest of the regulations. Is there any directions, any ways to consolidate financial investors' protection just as Korea has presented or Japan is now trying? That is the first question.

Second question is Dr. Tong's presentation. It seems to be that government bond market is growing in China, but most of the bonds are held by financial institutions which is very similar to traditional Japanese. But in the Japanese case, we used to have a syndicated group, in other words government are allocating bonds to various financial institutions and mainly there were 10-year government bonds. So I am wondering if in the Chinese case, is there such a kind of sales method of bonds or is it just voluntary for banks to buy government bonds? That is my question.

Prof. Dong:

Up to now in China we have very strict separation between the business policy and the controlling policy. But recently some scholars and experts suggest that maybe we should learn from Germany and Japan and combine these two policies. But this is just a suggestion at this moment.

Also some experts suggest that maybe it is OK to allow to set up the so-called financial holding companies. Under the holding companies, there can be banks, securities companies, as well as insurance companies. Currently in China we have only two companies so structured.

As for the future legislation in the financial framework, we may adopt market-oriented policies instead of the current bank-oriented policies. For the time being, I believe the strict separation between the business policy and the controlling policy will remain unchanged.

Prof. Tong:

It is true that looking at China, maybe our situation now is similar to the situation in Japan back in the 1960s. You talked about an underwriting syndicate for the government bonds in Japan. We do not have one in China. There are, at present, no securities companies offering services for issuing government bonds, so the government will rely on nationally-owned commercial banks, such as the Agriculture Bank and Industry and Commerce Bank of China.

From 1997 on, the interest rate has been lowered many times. In the declining interest rate environment, in terms of asset value, it is better to invest in government bonds. That is why banks choose to hold government bonds themselves, instead of selling over the counter. Of course the government would like to see more retail holding of government bonds and try to guide the banks so that some 30% or so of the total bonds should be sold to general investors. Then, there will be queues of elderly people throughout the night trying to buy government bonds from banks. I myself have seen such queues. But the situation is somewhat mitigated now. In Japan, it is said that the zero interest-rate policy will be lifted soon. Interest rates are also being raised in Europe and the US. The Chinese economy is now overheated, and it is expected that the interest rate in China will also rise. As such, it is now a little bit easier to buy government bonds in China. Banks still prefer to buy government bonds to lending money to the troubled state-run companies, even if the asset value may decline somewhat.

Question:

First I would like to ask my question toward Prof. Dong. In your presentation in paragraph 2.3, you say that in your company law previously they would actually bar corporate information from being disclosed as a result of the pretext of corporate secrets. And in the new law you say that the shareholders have a right to inquire. Now I was wondering whether inquire would still give rise to corporations actually using the previous excuse which was corporate secrets to not disclose information. And also, whether there is actually in fact a much stronger obligation for corporations to disclose in certain circumstances. Also in your presentation in paragraph 3.2 you mention there are a lot of unfair standards clauses within the insurance contracts. I was wondering if there are a variety of ways in which you probably deal with this. I was actually quite interested in this as well.

My other question is to Prof. Tong. You mentioned that the Chinese government implemented a policy of increasing internal demand in 1997. I was not too sure from what you mentioned whether this reflected on consumer loans actually increasing instead of this being reflected in decreases in savings instead. Thank you.

Prof. Dong:

In the newly amended Company Law we put a lot of emphasis on the protection of the shareholder rights and interests. In the past theoretically shareholders had the right to inquire at the shareholders' general meetings or obtain a copy of minutes, but the company was able to reject the requests. Now, if they reject the requests, the shareholders can file a suit against the company.

As for your question regarding 3.2, I already listed some reasons. One of the reasons is that in China the commercial credibility is not so good, and we have a large population. The legislature therefore underlined the security of the transactions rather than the fairness of the transactions. I read in an article that of complaints filed by consumers last year, 40% were related to the securities and banking businesses. The Chinese legislation, as I just mentioned, is still in its initial stage of development, and we would like to learn a lot from the Japanese legal system. It is necessary for us to set up some regulation to ban the financial institutions from levying unreasonable costs to the consumers. Thank you for your attention.

Prof. Tong:

Thank you for your question. I am sorry for the inadequacy of my explanation. Back in 1997, I said that measures were taken to stimulate domestic demand in China. That was right after the Southeast Asian financial crisis. In terms of the development model for China, we depended on external demand. Then came the crisis, and China predicted that the financial crisis would stay for a few years. That is why the decision was made to stimulate domestic demand. As a new type of demand, China stimulated consumption demand, and as a means to do so, consumers were allowed to have access to housing loans, automobile loans, durables loans, and so forth. Such loan businesses were permitted. Did I answer your question?

Question:

I have two questions. The first is about postal savings. You talked that savings and deposits account for 70% of the total financial assets of the household, but what is the proportion of postal savings? I personally worked with the Statistical Bureau of China at around 1997 or 1998, and studied the situation of Chinese households right after the large-scale shock in 1996. I conducted an on-site survey as well. At the time, as I remember, most Chinese people were using postal savings. But then the real estate boom came, and I just wonder if there has been a shift to bank deposits for drawing down housing loans.

The second question is about life insurance. After the insurance law was enacted for the life insurance as well, many ordinary people are shifting to children's insurance or endowment insurance policies. But I see anticipated rate of return on insurance premiums set at as high as 7-9%, and I am worried that there will be cases of insurance companies going bankrupt. Have any measures been taken by Chinese authorities for consumer protections in this regard?

Prof. Tong:

Well, from the legal point of view, I do not know how much protection is given to the consumers. With regard the savings and deposits, I would say that about 10% are postal savings, and the proportion is on the decline. And about life insurance bought by consumers, I think the situation is as you have just described. In terms of the mentality of the Chinese people, they are not buying life insurance policies for later in life or for the family. If you look at the subscribers, many are children. I always ask why children should buy insurance policies. Are you trying to make money from death of your children? It should be that the parents buy insurance policies for the benefit of children so that when the parents die, the benefit goes to their children.

In the case of China, insurances are investment-type. The sales people will emphasize advantages to attract many people not knowledgeable about financial matters. So, as mentioned by Prof. Dong, about 40% of complaints are for banks and insurance companies. I think half or so of the complaints are for insurance companies.

Insurance companies are all fully state-owned as of now. There have been no bankruptcies of insurance companies in China so far. But I do predict that a major issue will arise in the insurance industry going forward.

Prof. Dong:

I would like to answer your second question. When an insurance company goes bankrupt in China, we have a re-insurance company. This is a system to protect consumers. I would like to say again that in China currently, the legislators pay little attention to the protection of the consumers, but more on the safety of the transactions. So the cost is more favorable to the bank or the insurance company than to the consumers. Also there are a limit on the guaranteed amount. Many costs of insurance companies are not reasonable. I would say that currently in China there is very little possibility of insurance companies going bankrupt.

Question:

Yes, thank you. Just a brief question regarding the presentation of Prof. Dong Ansheng in his paragraph 1.3. You mentioned in this paragraph two types of contracts—a managing contract and a civil loan contract. Would you clarify the differences and concepts of these two contracts? Thank you.

Prof. Dong:

In China basically, we do not allow companies or individuals to loan money to each other. A managing credit contract means that if you operate a company or an enterprise and you need to have some money to run your business, then you borrow the money. That is what we refer to as the managing credit loan. For the Chinese enterprise, the civil loan is illegal, but they can get a managing credit contract. Before a company goes public, it needs to switch all its loans to the managing credit loans. From my point of view, this regulation is very unfair and very unreasonable. I think this law will be modified in the future.