

A COMPARATIVE ANALYSIS OF APPLICATION OF BANK INSOLVENCY

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Abstract: Because of banks' special nature, it is impractical to apply unmodified general enterprise bankruptcy provisions to banks. To prevent systematic risks and to protect depositors and public interests, bankruptcy laws should provide independent, special regulations to deal with bank insolvency and restructuring. The Article discusses legislation in different countries, particularly China's 2006 Enterprise Bankruptcy Law, which does not contain special insolvency rules, leading to obstacles in bank insolvency practice. China's 2015 Regulation on Deposit Insurance and its drafted Regulation on Financial Institution Insolvency signal that future bank insolvency may be resolved through markets and judicial bankruptcy procedures, initiating a transition to a special insolvency regime.

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I. INTRODUCTION

“Crisis” is a term with which banks¹ have been associated since the day they came into being. In a sense, the history of the banking sector's operations is

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the history of bank insolvency—from the failure of the early Italian Merchant Bank during the 14th century to the crisis of the banking sector that swept across the United States and Europe from 2008 to 2012. At the beginning of the 1980s, banking crises struck both the United States and Europe. Research results published in 1996 by the International Monetary Fund (IMF) indicate that from 1980 to 1996, 75% of the IMF member countries encountered a “significant” crisis in the banking sector. The Asian Financial Crisis in 1997 and the American sub-prime debt crisis in 2008 have contributed to making governments of different countries, international financial organizations, and scholars more concerned with financial issues, prompting them to explore solutions for preventing and resolving banking crises. Certainly, in the circumstances of fierce market competition, banks are no more exempt than any other enterprise from the risk of failure. However, banks are different from general enterprises, because a bank’s failure will have widespread implications for numerous families. More importantly, the failure of one bank may harm depositors’ confidence in other banks. It may even destroy the stability of the entire banking system if not addressed properly. The many banking crises have made governments aware of the necessity of regulation of banks, the purpose of which is to protect the interests of depositors, maintain the stability of financial system, and bolster the national economy. Therefore, numerous countries have enacted banking laws and established rules of “market entry” to ensure that only sufficiently mature institutions with enough capital enter the banking market. Meanwhile, these countries have imposed rules regarding “prudent operation” to ensure the stable operation of the banking business.

As technology advances, economic globalization develops and financial products take on new forms. Stricter requirements are imposed on the banking regulator as its function and power expand. Despite the existence of strict market entry rules and a prudent supervisory system, banks still fail. Unsound management, fraud, undue absorption of risk, and unfavorable market conditions present a critical and even fatal risk of bank failure despite the efforts of banking supervisors. Due to the importance of the banking sector in the economic life of the world, banking supervisors of different countries were initially reluctant to allow banks, especially large banks, to fail. They were instead inclined to bail out banks, which resulted in greater regulation costs and losses in regulatory failure.

One factor that exacerbated the Asian Financial Crisis was the lack of an effective resolution mechanism for bank insolvency. In September 1997, the Basel Committee on Banking Supervision (Basel Committee) issued the *Core Principles for Effective Bank Supervision*.² The Basel Committee noted that the establishment of speedy and orderly withdrawal mechanisms was indispensable in the effective handling of insolvency. Moreover, the Basel Committee found that

Business and Economics, School of Law.

¹ The term “bank” will be defined as a financial intermediary who accepts deposits from the public and lends loans to other persons or companies.

² See Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision (Basel Core Principles)* (Sept. 1997), <https://www.bis.org/publ/bcbasel102.pdf>.

banking supervisors should be responsible for, or at least help to establish, this orderly withdrawal mechanism. Thus, a complete and effective bank supervisory system should include not only measures to rectify irregularities *ex ante* to prevent failure, but also the means to deal effectively with bank insolvency. In other words, the system must provide for courses of action like operational reorganization, financial reorganization, and a liquidation procedure.

In free market economies, the failure of any single entity is a natural phenomenon born of the pure competition of the marketplace. However, because bank failures seriously impact the economy wholly, legislators of different countries treat bank failure more carefully than failure in other sectors. A special resolution system is adopted for bank insolvency, typified by such special legal systems in the United States, the U.K., Canada, Italy, and Russia. Even in European countries with general insolvency laws, addressing the special issue of bank failure has drawn great attention. The common rules of financial market development are that an effective bank supervisory system must be accompanied by a sound, efficient, and transparent market withdrawal mechanism.

Since the 1990s, with the increasing financial system reform and due to the payment risk incurred by unsound assets, Chinese financial institutions, especially small-sized and mid-sized ones, were on the brink of insolvency. Although China has clear provisions regarding bank insolvency in the *Law of PRC on Commercial Banks*, banking supervisors have imposed administrative closure on an extremely limited number of banks. Therefore, there is not even one case in which the court system declared a bank insolvent.

Generally speaking, the measures China employs to address bank insolvency are extremely restricted, with a high level of administrative intervention. More significantly, China's market withdrawal mechanism lacks a formal legal framework. Additionally, when a bank fails, the allocation of responsibility for the loss is extremely unreasonable. The government ultimately bears most losses caused by failing banks. These factors make bank insolvency costly in China. The unreasonable loss allocation of bank insolvency not only distorts the mechanism of market competition, but it also produces moral risk.

Considering the special nature of banks, insolvency laws for banks in China should use special regimes, including banking reorganization and liquidation. It is impractical to govern commercial banks under general enterprise bankruptcy provisions without any modifications.

II. WHY BANK INSOLVENCY SHOULD APPLY SPECIAL RULES

A. Bank Insolvency Legislation in Different Countries

In the United Kingdom (U.K.), Germany, France, and most European countries, banks, as commercial corporations, are subject to general bankruptcy

laws or company laws. For example, in the U.K. the general corporate bankruptcy code governs banks like any other entity.³

The reasons for applying general bankruptcy laws to banks⁴ are, first, in insolvency proceedings, differences between economic entities fade during the calculation of bankruptcy assets, the confirmation of claims, the application of the priority to claims, and liquidating assets. Second, the establishment of deposit insurance helps to secure depositors' interests, preventing bank insolvency from causing severe damage to the public. In this circumstance, it is appropriate to apply general corporate bankruptcy rules to banks, making it less necessary to adopt special rules for bank insolvency. Third, the proceedings of general bankruptcy laws can also resolve a bank's insolvency rapidly, even when there is insider abuse.

However, from a legal perspective the process of bank insolvency is extremely complex. In many ways bank reorganizations or liquidations are much more complicated than other enterprises. Especially when banks have a large number of small depositors, the general insolvency law is not enough. Therefore, many countries develop special rules for bank failures, which are different from those of other enterprises.

After the 2008 financial crisis, the U.K. amended its legislation on banking, establishing a special resolution regime for bank insolvency. The first part of the Banking Act 2009 of England makes provisions for a special resolution regime for problematic banks regarding the authority responsible for banks' insolvency resolution. The Act also includes three types of stabilizing options including transfer to a private sector purchaser (Section 11), transfer to bridge bank (Section 12), and transfer to a temporary public ownership bank (Section 13), as well as insolvency and transfer procedures. In this special resolution regime, the Bank of England, the Treasury, and Financial Services Authority perform the responsibility in a coordinated fashion.⁵

B. Why Should Banks Apply a Special Resolution Regime?

Due to the special nature of banks, other countries such as the United States, Canada, Italy, South Korea, and Russia have adopted special rules for insolvent banks, which are exempt from the general bankruptcy law. Bank insolvency law includes both the liquidation mechanism and the rehabilitation of an insolvent bank to avoid failure.

³ The Insolvency Act of 1986 applies to insolvent banks. Insolvency Act 1986, c. 45, (U.K.). The banking supervisor is the Bank of England, which was replaced by the Financial Services Authority (FSA) in 2000.

⁴ For a detailed account of reasons of supporting general application of bankruptcy laws, see EVA H.G. HÜPKES, *THE LEGAL ASPECTS OF BANK INSOLVENCY: A COMPARATIVE ANALYSIS OF WESTERN EUROPE, THE UNITED STATES AND CANADA* 17-19 (2000).

⁵ See Banking Act 2009, c. 1, §§ 1, 11-13, sch. 5 (Eng.).

The United States provides a prime example of such a special regime. In the mid-1920s, banks increasingly began to fail. At the same time, the collapse of the stock market in 1929 was an outright disaster for the banking industry. Due to complete loss of confidence in the banks, the financial system reached the brink of collapse and depositors suffered from great losses. The Glass–Steagall Act of 1933 created the Federal Deposit Insurance Corporation (FDIC) to provide deposit insurance to guarantee the safety of deposits of member banks.⁶ It also gave the FDIC the power to regulate and supervise state non-member banks.⁷ Thus, when banks fail, the Comptroller, rather than the courts, has the power to declare insolvency, to terminate the bank’s charter, and to direct the actions of the receiver. The FDIC often acts as the sole receiver of the insured institutions.

At present, most countries have already adopted, or are prepared to adopt, special rules for bank insolvency for the four reasons outlined below.

1. Important Functions of Banks in an Economy

The banking industry is often the center of an economic system. The primary business is closely bound up with the public interest. A bank’s survival depends on the deposits of individuals and enterprises as well as loans to households, business firms, and governments.⁸ However, lending banks are often less aware than other types of lenders of their borrowers’ willingness and ability to perform. In addition, any implication that a bank is in distress is likely to lead to a bank run, which could be devastating to small depositors.⁹ Banks are also often crucial members of the payment and settlement systems. The accountings of clients’ funds are generally carried forward through a bank. Thus a bank’s insolvency may make the whole payment and settlement system collapse. In turn, this will threaten other banks. Evidence¹⁰ demonstrates that the consequences of

⁶ For a detailed account of the creation of the Federal Deposit Insurance Corporation, see FED. DEPOSIT INS. CORP., *THE FIRST FIFTY YEARS* (1984).

⁷ The U.S. banking regulatory system is very complicated because it includes four federal regulators: (1) the Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks; (2) the Federal Reserve Banks (FRB) regulate and supervise bank holding companies and state-chartered banks that are members of the Federal Reserve System; (3) the FDIC regulates and supervises state-chartered banks that are not members of the Federal Reserve System; and (4) the Office of Thrift Supervision (OTS) charters, regulates, and supervises federal savings associations.

⁸ See generally Raymond Fisman & Inessa Love, *Financial Dependence and Growth Revisited*, 5 J. EUR. ECON. ASS’N 470, 470-79 (2007).

⁹ Since the subprime mortgage crisis, legislatures on various levels have introduced bank resolution rules that aim to serve general public interest, rather than the interests of individual banks or individual creditors. See also generally Amendments to the Act on Financial Supervision and the Bankruptcy Act and any other powers in connection with the introduction additional powers to intervene with financial institutions in difficulty, Oct. 26, 2011, Stb. 2011, 1-2, 4 (Neth.).

¹⁰ Evidence can be seen in many researchers’ articles. See, e.g., Jeremy Crimmel &

bank failures on the real economy are far more serious than the failures of other companies.¹¹

2. Bankruptcy Regime

In general bankruptcy, liquidation seeks to solve collective action problems of creditors and to allocate the debtor's property among creditors in a fair and reasonable way. The greatest purpose of the general insolvency law is thus to make a fair repayment of all creditors. In comparison, the goal of bank insolvency law is to protect the public interest and the soundness of the financial system.¹² Due to the unique nature of banks, the liquidation proceedings display some differences, such as in the initiation of bankruptcy or the special protection of payment systems.

Conciliation was introduced to avoid upsetting the liquidation process. The conciliation system is one in which the negotiations between creditors and debtors require majority agreement on the repayment of the credit and the debt under the approval of a court. The main content of such an agreement includes debt relief and extension in exchange for the guarantee of repayment. Courts have limited authority to intervene, but a court cannot force the creditors to accept the agreement. Therefore, the conciliation system can only help to avoid the bankruptcy of the debtor—it cannot actively rescue their operation.

But it is often impossible for banks to apply for conciliation. Banks have vast numbers of creditors, including depositors, many of whom live overseas. Simply bringing together such large creditors to hold a creditors' meeting would itself be a Herculean task, not to mention the difficulty in voting on the resolution of any agreement. In addition, because credit is the foundation of survival for banks, it is impossible for banks in the midst of a credit crisis to obtain deposits and other funds from the financial market. That means banks, once in the conciliation process, may lose the opportunity to return to normal operation and any capability to fulfill the agreement.

The corporate reorganization system contains major intervention measures to avoid failure of the bankrupt company, while protecting the interests of its creditors.¹³ Compared to the conciliation system, the reorganization system works better for banks in crisis, but still presents some obstacles. Because

Elyas Elyasiani, *The Association Between Bank Concentration and the Real Economy*, Financial Management Association, 38 (Jan. 12, 2015), http://www.fma.org/Orlando/Papers/Crimmel_Elyasiani_FMA_2015.pdf.

¹¹ HÜPKES, *supra* note 4, at 20.

¹² Mathias Dewatripont & Jean-Charles Rochet, *The Treatment of Distressed Banks*, 13 FIN. STABILITY REV. 65, 66 (2009).

¹³ The corporate reorganization regime is first stipulated by Chapter 11 of the United States' Bankruptcy Act, and the same rescue regimes have been introduced to the U.K. and Australia in the past 20 years. *See* 11 U.S.C. §§ 1101-1174 (2015).

banking relies on public confidence, a bank's assets will quickly lose value once the reorganization program has been announced. The bank may then no longer be able to afford to run normally. Moreover, there may not be enough time to convene a meeting of a large number of creditors to discuss the reorganization plan with the permission of the court. The result is delay and cost increases. Therefore, it is almost impossible to achieve the goal of rescuing insolvent banks through a reorganization regime.

3. Supervisory Requirement

Banking is a highly regulated industry, which distinguishes its insolvency regime from that of other companies. Strict licensing requirements and prudential regulation are the crucial factors to prevent banking problems. Prudential regulations manage risk by requiring banks to maintain a certain capital adequacy ratio to ensure they have sufficient funds to absorb unexpected losses. Prudential regulations are not intended to prevent bank failures, but rather to protect the interests of depositors and the banking system as a whole. Once a bank fails, the banking supervisor has the power to be involved in the whole process and to appoint a receiver or conservator to take over the bank, and may either sell to other financial institutions, or quickly liquidate the bank to minimize the negative impact. It is up to the banking supervisor to determine when a bank is insolvent but not illiquid, which means it needs intervention and regulatory measures.

4. Standard of Insolvency

The insolvency standard determines whether and when a debtor is insolvent and triggers the insolvency proceedings. According to most bankruptcy laws, this determination is based on either one of two tests. The first, the cash flow test, measures liquidity: Can the debtor pay its debts when they are due? An insolvent company that fails this test is unable to clean off its debt with its existing property, credit, or technical capacity and thus cannot pay its debts as they come due. The second is the balance sheet test: does company's balance sheet show liabilities in excess of assets? Unlike the cash flow test, the focus of the balance sheet test is in the debtor's own funded debt ratio. Hence, it does not consider the factors of credit, debt capacity, or debt maturity when calculating of the amount of debts. In a sense, the balance sheet test is stricter than the cash flow test because its purpose is to prevent the company from inappropriately expanding its debt, which may damage the interests of creditors and the order of the market economy. When a company's balance sheet shows over-indebtedness, it may pose a threat to the interests of creditors and exacerbate the insecurity of the market circulation order because its property and assets are the guarantee and foundation

of the repayment of its creditors. Both of these tests can be used for banks' failures.

But for banks, there is also a third test for "regulatory insolvency." When the banking supervisor finds that a bank does not meet certain regulatory requirements, regulators can determine the bank is insolvent. The authority will then take appropriate regulatory measures immediately. The main reason for this extra test is very simple. If the supervisory authorities must wait until the bank becomes insolvent to take appropriate measures, it exacerbates the adverse effects of bank insolvency, and it will also result in missing the opportune timing for effective and successful reorganization. Regulatory insolvency thus ensures the banking supervisor's early intervention, and minimizes the losses of bank insolvency. The United States has adopted this third test.¹⁴

III. BANK INSOLVENCY REGIME IN CHINA

A. The 2006 Enterprise Bankruptcy Law of China

In China, a bank is subject to the general insolvency law as well as special rules in the commercial banks law.¹⁵ In response to defects and problems of the bankruptcy legislation in recent years, China has modernized its regime with the 2006 Law of the People's Republic of China on Enterprise Bankruptcy.¹⁶

¹⁴ See 12 U.S.C. §1831o (1970). There are five categories for measuring the adequacy of a bank's capital in the United States, including "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." § 1831o(e)(h).

¹⁵ Law of the People's Republic of China on Commercial Banks (2003 Amendment), Article 71:

Where a commercial bank is unable to pay the debts due, it may be adjudicated bankrupt by the people's courts according to law with the consent of the banking regulatory organ of the State Council. In this process, the people's courts shall organize the banking regulatory organ of the State Council and other relevant departments and personnel to form a liquidation group to make liquidation. In the bankruptcy liquidation of a commercial bank, the bank shall, after paying the liquidation expenses, the wages of the employees, and labor insurance fees, pay in priority the principals and interests of individual savings deposits.

Law of the People's Republic of China on Commercial Banks (promulgated by Order No. 47 of the President of the People's Republic of China, May 10, 1995) (amended by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003), art. 71, 2003 P.R.C. LAWS.

¹⁶ Enterprise Bankruptcy Law of the People's Republic of China (promulgated by

In enacting the 2006 Enterprise Bankruptcy Law, legislators faced the question of which entities to include. The scope of the law was one of the major problems encountered in its drafting because of the differences of opinions. Some opposed the inclusion of commercial banks and other financial institutions because of their peculiarities and potential for public unrest if improperly handled. Those in support of their inclusion argued that: (1) financial regulatory authorities in recent years have dealt with many financial institutions in distress, accumulating rich experience in disposing of insolvent financial institutions; (2) individual depositors can still be paid off despite the declaration of the financial insolvency, preventing social unrest; and (3) inclusion meets the practical needs of bankruptcy for problem financial institutions because further losses will result if an already-distressed financial institution is not declared bankrupt. Xiaoling Wu, Deputy Governor of the People's Bank of China, pointed out that those financial institutions with serious problems must be disposed of as soon as possible. Thus, they should go bankrupt in accordance with the insolvency standards.¹⁷

To accommodate these different opinions, the drafting group tried two different approaches: (1) commercial banks, insurance companies, and other financial institutions shall not be governed by the 2006 Enterprise Bankruptcy Law; and (2) when a financial institution goes into bankruptcy, the State Council may formulate detailed measures for implementation of the bankruptcy law.¹⁸ The latter formulation is the compromise that became the final legal text.¹⁹ In order to resolve the needs of commercial banks, insurance

the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) 2006 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ.

¹⁷ XiaoLing Wu, *The Early Treatment of Problematic Financial Institutions*, LIBERATION DAILY, July 10, 2004.

¹⁸ Item 6, Part 3, Instructions regarding the Law of the People's Republic of China on Enterprise Bankruptcy (draft), (promulgated by Nat'l People's Cong of the PRC on 21 June, 2004):

It is generally reasonable for bankruptcy of financial institutions like commercial banks and insurance companies to be governed by the Enterprise Bankruptcy Law. However, these financial institutions are special. For example, their assets include self-owned and client-owned assets; meanwhile, their bankruptcy involves numerous people and social stability, and the initiation of bankruptcy proceedings should be approved by the supervisor. Moreover, other special requirements are needed regarding the detailed procedures of receiver and creditor's meeting, etc. To accommodate and harmonize the laws, Article 163 of the draft prescribes that "when financial institutions like commercial banks and insurance companies go bankrupt, detailed measures shall be formulated by the State Council in accordance with this law and other relevant laws."

<http://law.lawtime.cn/lifadongtai/2509.html> (last visited Jan. 3, 2016).

¹⁹ Article 134 states:

companies, and other financial institutions in bankruptcy and to maintain the harmonization of law, the procedure of the 2006 Enterprise Bankruptcy Law should apply to the bankruptcy of financial institutions in general. However, there are special problems for financial institutions, such as a large number of creditors, especially small depositors that are closely connected with social stability and require special provisions formulated by the State Council in the initiation of insolvency proceedings at an administrator and creditors' meeting, and so on. Because the Financial Institution Bankruptcy Ordinance is still in the process of drafting, there are no specific provisions that can be used in practice.

The China Banking Regulatory Commission (CBRC) is China's banking supervisor that is responsible for: formulating supervisory rules and regulations governing the banking institutions; authorizing the establishment, changes, termination, and business scope of the banking institutions; supervising and enforcing prudential supervision; taking enforcement actions against rule-breaking behaviors; and providing proposals on the resolution of problem deposit-taking institutions in consultation with relevant regulatory authorities. The CBRC, in supervising and intervening in the procedures of bank insolvency, has access to all the banking information necessary to adequately monitor the bank's health. The CBRC initiates regulatory proceedings as early as possible.²⁰

Where a commercial bank, securities company, insurance company or any other financial institution is under the circumstances as specified in Article 2 of this Law, the financial regulatory authority under the State Council may lodge an application with the people's court for reorganization or bankruptcy liquidation of the financial institution. Where the financial regulatory authority under the State Council adopts, according to law, such measures as take-over and trusteeship with respect to a financial institution that operates at grave risks, it may apply with the people's court for suspending the proceedings for civil action or execution, wherein the said financial institution is the defendant or the party against whom a judgment or order is being executed.

Where a financial institution goes into bankruptcy, the State Council may, according to the provisions of this Law and other laws, formulate the measures for effecting bankruptcy.

Enterprise Bankruptcy Law of the People's Republic of China, art. 134.

²⁰ Article 38 states:

When financial institutions in the banking sector has already encountered, or may encounter credit crisis, seriously harming the lawful rights and interests of depositors and other clients, the banking supervisor (the CBRC) of the State Council may impose takeover or restructuring of the institution. Takeover and restructuring shall be

China began to carry out economic reform in 1978.²¹ But the focus was on general enterprise. Reform of the most important enterprises relating to the national economy—banking—is lagging behind. Market competition is insufficient and disorderly, requiring still larger reform efforts. Due to the special nature of banks, bank insolvency should not be governed by China's general enterprise bankruptcy law, but rather by specially designed rules.

Article 71 of the *Law of People's Republic of China on Commercial Banks* (Law on Commercial Banks) provides that the People's Court declare banks insolvent, with the CBRC's consent.²² After the declaration of insolvency, the People's Court must coordinate with the CRBC to form a liquidation group to undertake liquidation. This indicates the procedural specificity of bank insolvency, that the court needs to consult the CBRC to determine whether a bank will be insolvent, and thus liquidated. It would appear that China does have special laws for China's bank insolvency. The Law on Commercial Banks applies first as the special rules, and the corresponding provisions in 2006 Law on Enterprise Bankruptcy shall be applied to all other issues. The fact is that the Chinese government tends to resolve bank insolvency through administrative measures rather than market withdrawal mechanism, which is mainly attributable to concerns about financial instability. Also, in China it is difficult for the public to accept bankruptcy or insolvency, which also helps to explain why it took so long to enact the 2006 Enterprise Bankruptcy Law.

B. Administrative Revocation

In practice, not a single commercial bank in China has been liquidated following insolvency procedures. The compulsory liquidation imposed on commercial banks is a liquidation process through administrative revocation or closure.²³ The main legal source for liquidation through revocation is the

implemented in accordance with relevant laws and regulations of the State Council.

Law on Supervision on the Banking Sector of People's Republic of China, art. 38.

²¹ Reform and opening-up is a fundamental economic policy of China. During the Third Plenary Session of China's 11th CPC Central Committee, it was decided by Deng Xiaoping that the reform and opening-up policy would be implemented. Reform started in the countryside in Anhui Province, China. After the adoption of reform and opening-up, China began to establish its socialist market economy.

²² Law of People's Republic of China on Commercial Banks (promulgated by Order No. 47 of the President of the People's Republic of China, May 10, 1995) (amended by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003), art. 71, 2003 P.R.C. LAWS.

²³ Here, revocation and closure mean exactly the same thing. However, due to the

Regulation on Revocation of Financial Institutions enacted in 2001 by the State Council (2001 Revocation Regulation).²⁴

The 2001 Revocation Regulation provides the procedure for revocation, the duties of the liquidation group, and the relationship between credits and debts. The CBRC organizes the liquidation group. The liquidation group is composed of relevant departments, including the CBRC, the Ministry of Finance, the National Audit Office, and the local government. The CBRC designates or consents to the leadership and membership of the group. The liquidation group may commission liquidation matters to a financial institution (Custodian Institution) designated by the People's Bank of China, paid for out of the liquidation fee. The Custodian Institution shall not assume any liabilities of the financial institution, advance any funds, or bear the responsibility for the disposal of the institution's personnel. The statute provides only a list of the Custodian Institution's *negative* obligations rather than a definition of "custodian" itself.

The liquidation group shall, within ten days of its establishment, notify the creditors in writing that they must declare their rights. The group must also announce this within 60 days at least three times in a newspaper. The creditors, upon receipt of the notifying document, or within 90 days since the first announcement if they received no notice, must declare their rights to the liquidation group. The liquidation group may then decide to exempt small-sum depositors from declaration, and the group shall confirm and register the creditors according to the financial books and relevant proof.

The liquidated assets of the financial institution shall be used primarily to pay the principal and interest of individual depositors, after which the remaining assets shall repay debts owed to other legal persons and organizations. Thus, the remaining assets are distributed in accordance in proportion to the capital contribution or stockholding of the stockholders.

As China's reform of the financial system advances, the risks hidden in the country's financial sector loom large. The following financial institutions have failed: Hainan Development Bank (HDB) in June 1998; China Rural Development Trust Investment Co. Ltd. in 1997; China New Technology Venture Capital Co. Ltd. in 1998; Guangdong International Trust Investment Co. Ltd. in 1998; 21 urban credit cooperatives in 1997 and 1998 (5 in Hainan Province, 13 in Guangxi Province, 1 in Qinghai Province, and 2 in Guangdong Province); and 18 rural credit cooperatives in 1998 (in Enping, Guangdong Province).²⁵ Of these financial institutions, only the HDB is a commercial bank.

official expression used in *Regulation on Revocation of Financial Institutions*, revocation is a more professional expression.

²⁴ Regulation on the Closure of Financial Institutions (promulgated by Order No. 324 of the State Council of the People's Republic of China, 23 November, 2001, effective Dec. 15, 2001), XIN FAGUI HUIBIAN (China).

²⁵ ZHOU ZHONGFEI & ZHENG HUI, PRINCIPLES OF BANKING LAW 159-160 (Citic Press Group ed. 2004).

The HDB operated for less than three years before it was closed down, illustrating the risks of China's financial sector as it is currently regulated.²⁶ On June 21, the State Council and the People's Bank of China decided to close the HDB, designating the Industrial and Commercial Bank of China (ICBC) as the custodian. The process of rescuing the HDB reflects the government's undue administrative intervention and the unreasonably high cost of bailout, distorting market competition and incurring moral risk.

C. The Three Features of China's Approach to Bank Insolvency

China's approach to the issue of bank insolvency has the following features. The banking supervisor's regulatory power dominates the process. In all the measures including bank assistance, mergers and acquisitions, and liquidation through revocation, the banking supervisor plays a decisive role.²⁷

True, China's bank insolvency system is focused on a supervising authority. However, it differs from other countries, as the legal environment is different. Although it is authorized by law for the government to intervene in the process of bank insolvency, the authorization is not adequately clear and concrete; also, compared with other countries, the level of competition in China's banking sector is insufficient and the systems of deposit insurance are different. For example, both China and other countries ensure the safety of personal savings deposit to a certain degree. However, those other countries have deposit insurance. The source of the deposit insurance fund is the insured banks themselves and insurance fees, not public funds. China did not have a deposit insurance system. According to Article 71 of the *Law on Commercial Banks*, personal savings deposits enjoy the top priority of repayment, which is not a promise to repay the full amount deposited.²⁸ As a matter of fact, in consideration of preventing financial panic and instability, the Chinese government adopted a "hidden guarantee;" namely, it will ultimately bear all the losses and consequences of bank insolvency, although this is not explicitly stipulated in any law.²⁹ However, this practice might lead to severe

²⁶ See SONG QINGHUA, ON THE BANKING CRISIS 310-15 (2000).

²⁷ China's practice in resolution of insolvent financial institutions, including Hainan Development Bank, and urban and rural credit cooperatives showed that the Chinese Banking Supervisor (the People's Bank of China before 2003, and the China Banking Regulatory Commission thereafter) made all important decisions in revocation proceedings.

²⁸ Law of the People's Republic of China on Commercial Banks (promulgated by Order No. 47 of the President of the People's Republic of China, May 10, 1995) (amended by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003), art. 71, 2003 P.R.C. LAWS.

²⁹ *Id.*

moral risks³⁰ and does not impose clear and strict legal restriction on the supervisor, who may use bailout to save insolvent financial institutions from bankruptcy. This not only distorts the order of competition, it also unreasonably allocates losses and increases the possibility of excessive risk-taking.

The market's self-adjustment mechanism makes it difficult to integrate financial resources without the interference of a supervisor. This mindset formed over the long period of planned economy in China and enabled administrative intervention to play a dominant role, and the public became accustomed to the government resolving bank insolvency through administrative measures. This answers the question regarding why the practice has not been subject to legal challenge from the public.

On May 1, 2015, China's new Regulation on Deposit Insurance entered into force, meaning that China has initially established a legal market withdrawal mechanism for insolvent banks.³¹ The introduction of deposit insurance has dispelled the concerns of the Chinese government about the negative impact from bank insolvency on financial stability. Thus, it is justifiable to believe that the issue of bank insolvency will be resolved through a market withdrawal mechanism instead of bailout gradually.

IV. CONCLUSION

Banks play a crucial role in the economic systems of all developed and developing countries. However, no country can be immune from bank failures. Banks must be subject to market forces and must be allowed to fail under the market economy. In spite of that, banks fulfill special functions that make them distinguishable from other enterprises: banks provide a sort of public service; banks hold highly liquid liabilities in the form of deposits; and banks constitute the transmission component of monetary policy and national economy. Because of these characteristic functions of banks and the damaging effect of bank failures, most countries and regions take actions against banks that are insolvent or are about to become insolvent very prudentially and set up the legal and institutional framework of bank insolvency, which give prominence to the special rules or provisions for banks.

As the formation of each country's legislative model has a unique foundation and background, the key is to select the most appropriate

³⁰ Moral risk means that managers of banks expect that due to concerns of financial stability, banks will be bailed out, and consequences of their risk-taking activities will be eventually borne by the government, so management takes more risks in bank operations.

³¹ Regulation on Deposit Insurance (promulgated by Order No. 660 of the State Council of the People's Republic of China, 17 February, 2015, effective May 1, 2015) XIN FAGUI HUIBIAN (China).

model according to each country's specific circumstances and needs. What can be confirmed is that insolvency of banks, in light of its distinctive nature, calls for a special resolution regime for bank insolvency in lieu of corporate bankruptcy law.

China is currently drafting the Financial Institution Bankruptcy Ordinance, and it is expected that there will be more cases of bank insolvency resolved through judicial liquidation procedures instead of administrative revocation.³²



³² According to Shang Fulin, the President of the CBRC, the market withdrawal system for financial institutions shall be improved in China. A China-specific legal system of resolution and insolvency for financial institutions shall be established, and effective coordination between administrative revocation and judicial bankruptcy is necessary in China's 13th 5-Year Plan. The draft of this regulation has not yet been announced for public consultation; however, the President represents to a certain extent the official inclination towards legislative reform on financial insolvency in the future. Shan Fulin on Thirteenth Five Banking Sector Reform: Building Suitable Insolvency Law, CHINA FINANCE MAGAZINE (Jan. 3, 2016), <http://finance.sina.com.cn/china/20160103/154624107351.shtml>.

