ARTICLES

POLICY FUNCTIONS AS LAW: LEGISLATIVE FORBEARANCE IN CHINA’S ASSET MANAGEMENT COMPANIES†

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ABSTRACT

Since 1979, the People's Republic of China (China) has been involved in an on-going process of economic reform with the goal of transforming from a centrally planned economy to a socialist market economy. As one aspect of this process of transition, China has had to address issues of financial-sector and state-owned-enterprise (SOE) reform. With China's accession to the World Trade Organization in 2003 and its related commitments to foreign competition and financial sector reform, the process of transition has taken on a new urgency. In its process of enterprise and financial reform, China has used a policy of gradualism and legislative forbearance, i.e. a certain ambiguity and flexibility in legislating and interpreting policy through law. This is especially apparent in relation to the intersection of enterprise and financial restructuring through asset management companies designed to address non-performing loans in China's banking and SOE sectors. While this approach to the institutionalization of policy through legislative forbearance is a pragmatic approach to difficult issues, it exposes China's continued development to risk by weakening the progression of the rule of law.

1. INTRODUCTION

On December 11, 2001, the People's Republic of China (China) joined the World Trade Organization (WTO). Since joining the WTO, China's volume of foreign trade has doubled from US $500 billion to US $1 trillion.1 To fully integrate into the global economic system and to reduce trade conflicts and support domestic restructuring and development, China needs its currency, the renminbi (RMB), to be fully convertible.2 When it joined the WTO, China agreed to fully open its banking sector to foreign participation by the end of 2006.3 However, insufficient confidence in China's banking system limits continued capital account liberalization and full convertibility of the RMB.

To meet the challenges of foreign competition and to secure the benefits of financial liberalization and economic growth in

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1. Editor's Desk: Dancing with Wolves, BEIJING REVIEW (Jan. 6, 2005) at 2.


the context of financial and political stability, China has embarked on major banking restructuring, focusing on the performance and financial condition of its state-owned and state-controlled banks, including balance sheet restructuring through recapitalization and the disposal of non-performing loans (NPLs). To enhance its financial condition, China is implementing the 1988 Basel Capital Accord and has committed to implementing the Basel II framework, which requires its banking institutions to maintain, at some point in the future, a certain minimum capital adequacy level.

Crucial to the development of a competitive environment for banking services since China’s WTO accession are its specific commitments stipulating that regulation of China’s banking sector is solely prudential—for example, specific commitments that the regulatory framework for banking contain no economic needs tests or quantitative limits on licenses. Further, since 2002, any existing non-prudential measures restricting the ownership, operation, and judicial form of foreign financial institutions, including licensing and internal branching, are required to be eliminated. With these commitments to prudential regulation of banking in place, China’s state-owned enterprises (SOEs) can no longer rely on direct or indirect state support through loans from government-owned or -controlled commercial banks, but rather have to compete for financing in a commercial, market-based context.

The law and policy approach applied to banking restructuring in China, especially to balance sheet and asset problems such as NPLs, reflects its developing legal system and may be used as a basis for measuring the development of the rule of law in China. This article focuses on one mechanism of banking restructuring: asset management companies (AMCs), their institutional characteristics and roles in China’s banking system, and the legal issues surrounding their operation. Its intention is to address the law and policy issues relating to the disposal of NPLs in China’s banking system.

There are many imperfections in China’s effort to build an effective legal system to support its socialist market economy, as well as many challenges confronting its future development. Indeed, China’s corporate and financial law reforms have to strike

6. Id.
7. Id.
a balance between economic competitiveness and the maintenance of social stability in post-WTO China. Despite this conflict, China's efforts to build an effective legal system cannot be discredited.\(^8\) One cannot ignore the reality that the high growth rates which characterize China's economic development (and hence social stability) have been correlated to its legal development.\(^9\) There are numerous studies which support the notion that the rule of law is positively correlated with economic development.\(^10\) While it's debatable whether successful economic development depends on the rule of law,\(^11\) the Asian financial crisis of the late 1990s, for example, was a result of inadequate economic planning, weak regulatory mechanisms, lack of enforcement of prudential rules, and poor transparency.\(^12\) Therefore, the legal framework, as well as the economic, historical, and political context in which that legal framework operates must be addressed in China's banking reform.\(^13\)

As the end-of-2006 deadline for full liberalization of the banking sector approaches, the pressure to expedite banking reform increases. Given the magnitude of NPLs and the risks of social instability, the measures taken must be immediate and decisive as new problems are revealed. This can hardly be achieved in strict compliance with the rule of law, e.g. through the formal legislative process. As a result, "legislative forbearance," i.e. relaxing the strict rule of law, has been and continues to be the pragmatic approach adopted. However, such relaxation should not be transformed into "rule by law." Rather, the strict observance of legislative formality over policy should be relaxed only when necessary and essential to cure legislative defects in the banking reform. The real issue is whether there is evidence of a genuine undertaking to develop a legal system that fits post-WTO China.

This article first discusses the background of China's banking reform and the role of the AMCs. Through a historical understanding of the causes and implications of NPLs in China, the measures adopted to address them are analyzed. There is no pan-

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11. Peerenboom, supra note 9, at 450.
acea for solving China's NPL problems. While experience from other jurisdictions is helpful, China has its own unique economic, historical, and political environment. Accordingly, the measures adopted to resolve China's NPL problems in its process of transition from central planning to a socialist market economy must proceed through a process of trial and error, particularly because China lacks significant expertise and experience in market-related law and economics.

Second, the legal issues affecting the successful operation of the AMCs will be examined. Their corporate governance, state policy, property rights, and foreign participation, as well as SOE restructuring, are explored. The theme of this article is that policy functions as law. The disposal of NPLs through the use of AMCs illustrates how this feature of the Chinese legal system operates from a practical rather than a jurisprudential perspective.

2. BACKGROUND: AMCS IN CHINA

In addressing NPLs as part of the process of banking restructuring, the Central People's Government (CPG) of China has adopted a series of measures, including recapitalization, debt-equity swaps, mergers, NPL disposals, and closing insolvent banking institutions. This section first discusses banking reform in China leading to the establishment of AMCs. Then, it analyses the AMC concept before discussing legal aspects.

2.1 Banking Reform in China

In December 1993, China's State Council took measures to reform the banking sector in order to enhance the role of financial services in the national economy. As a preliminary objective, these measures were intended to separate state policy banks from state commercial banks since the boundary between them had become blurred under the planned economy system. This decision provided directives to transform the state specialized banks into state commercial banks. Accordingly, China has implemented a three-tier system for its state-owned banks. The first-tier banking institutions are its four largest state-owned commercial banks (SOCBs), i.e. the Agricultural Bank of China (ABC), the Bank of China (BOC), the China Construction Bank (CCB), and the Industrial and Commercial Bank of China.

15. Id.
16. Id. § 3.
As of the end of 2003, these SOCBs accounted for, respectively, some fifty-nine percent of deposits and fifty-five percent of all loans granted in the entire banking system. These four SOCBs dominate China’s banking system. The second-tier banking institutions are the policy banks created to alleviate the burden of the policy and commercial roles of specialized banks. In 1994, the three policy banks were restructured to assume their own financial risks in carrying out specific state policies. The third-tier banking institutions consist of national, regional, and local commercial banks. In addition, there are other banking institutions vested with specific functions for local development.

In China, the fundamental legal structure underlying the banking system is the Constitution of the People’s Republic of China ("PRC Constitution"), which stipulates the leadership of the Chinese Communist Party (CCP) and the socialist path. From 1953 to the late 1970s, the People’s Bank of China (PBOC) was the only de facto banking institution and assumed both central and commercial banking roles. The then-existing SOCBs, restructured from banking institutions that existed before the establishment of the PRC, were merely performing their specialized functions. Although they accepted deposits and channeled money into lending activities, they were primarily public bodies acting as state agencies executing governmental policies in granting credits to SOEs. Through a gradual process they became independent from the PBOC and the Ministry of Finance (MOF) and took over the commercial banking role of the PBOC. In 1984, the State Council formalized the specialized functions of

17. Id. § 3(1).
20. Id.
22. Decision on Financial System Reform, supra note 14, § 3(3).
25. Id., at 20-22.
Before 1983, the funding of SOEs came directly from the state. In 1983, the State Council decided to substitute bank loans in place of state grants. After 1985, loans granted by the SOCBs were the only source of funding for the SOEs, which relied on bank loans as indirect subsidies, e.g. through low interest rates and frequent default on principal and interest. In other words, the SOCBs assumed the state's role in indirectly providing employment and maintaining social stability. It was impossible for them to be regulated under a prudential system since most SOEs made investment decisions in accordance with state policies. Consequently, NPLs have accumulated rapidly in the SOCBs during China's rapid economic growth of the past two decades.

As China continues its transformation from a planned economy to a socialist market economy, the SOCBs now have to perform the role of "real" banking institutions. They have to transform themselves from state agencies to banking institutions performing commercial roles under a prudential regulatory system. In reality, some of the less efficient SOEs are still operating for the sole purpose of maintaining employment in order to maintain social security for their workers and former workers, e.g. housing, medical benefits, unemployment benefits, and pensions. Their poor performance is also partly due to the constraints imposed by state policies, e.g. price controls which curb earnings. It is unlikely that any state agency would allow them to go bankrupt as the state has a statutory duty to arrange for the re-employment of any laid off workers and to guarantee their
basic necessities. Any deviation from this practice may create social discontent and possibly lead to social instability – the paramount concern of the CCP. Therefore, reforming the SOCBs in China goes beyond simply injecting money into the banking system and implementing prudential banking regulations. The social safety net system can no longer depend on state-supported bank loans. In response, China has been reducing subsidies through its fiscal and banking systems, promoting competition, and enhancing corporate governance.

The monopoly status of the SOCBs and their close links with the national economy mean that bankruptcy is not a possible solution to China’s banking problems because of its tremendous social and economic costs. In the past, the extent of NPLs in the SOCBs was not readily apparent, but a 2002 study found that the then-existing system understated NPLs by an average of fifteen percent. In the same year, some analysts suggested that the total NPLs could be over forty percent of all loans versus twenty-five percent under the then-existing system as reported by the PBOC. Given the concentration of banks, the closure of any SOCB would in all likelihood generate serious bank runs and, potentially, the collapse of the entire banking system and perhaps China’s financial and economic system. Considering the poor profitability of the SOCBs and their weak risk-control systems, it is also not appropriate to seek to address NPL problems solely through growth underpinned by deregulation (“growing out of the problem”), although clearly this does have a role. Transition issues, e.g. social and political stability, as well as sustainable economic growth, suggest that a mild approach is more suitable in China’s peculiar circumstances. With reference to international experience in the management and disposition of NPLs, the AMC concept should be both a feasible and an expeditious way of improving the financial condition of China’s SOCBs.

37. Nehru, supra note 30, at 17.
39. Id.
2.2 THE AMC CONCEPT

China has adapted the AMC concept from the experiences of other jurisdictions, e.g. inter alia, Finland, Japan, Sweden, and the United States. The ultimate objective of an AMC is to resolve its NPL portfolio and to achieve maximum value. To achieve this objective, there are a number of techniques in addressing NPLs through the AMC framework. This objective and the related techniques inevitably involve complicated legal issues. Success in achieving this objective very much depends on the relevant law, legal institutions, and supporting institutional framework. As an example, unless the issues respecting property rights relating to these assets are addressed, it is not an easy task for the banking system to work on commercial principles. In the first auction of an NPL portfolio by Huarong AMC to foreign and domestic purchasers, a consortium led by Morgan Stanley paid RMB10.8 billion for four out of five pools of assets. However, this consortium paid only eight to nine cents on the dollar because of the legal risks arising from uncertain property rights.

According to economists, there are two problems associated with NPLs: the stock problem - that old loans are non-performing; and the flow problem - that new loans may also be non-performing. Consequently, two approaches have been employed to solve NPL problems. Where the entire banking system and perhaps the real economy are suffering systemic problems, the stock solution may be adopted to dispose large volumes of bad debts and restructure distressed banking institutions. This approach includes liquidating distressed banking institutions, disposing of impaired assets, and restoring viable but illiquid banking institutions. When restructuring problematic banking institutions, timely disposal of NPLs is crucial to successful and expeditious bank restructuring.

In non-systemic crisis contexts, the flow approach allows problematic banking institutions to recapitalize over time by ele-

46. Id.
47. Id.
48. Id.
vating operational profits through relaxation of regulatory requirements. This approach to resolution is called financial forbearance. Stock and flow models have been applied by a number of countries in disposing of and managing NPLs, as well as corporate restructuring. According to international experience, either centralized or decentralized structural models are generally adopted in managing and recovering impaired assets. The decentralized solution leaves the NPLs on the books of banking institutions and establishes an internal asset management unit, i.e. a “bad bank,” to dispose of the bad assets. Usually these units are subsidiaries of the distressed banking institutions, and their major task is to manage the transferred problem assets and to recover as much from these assets as possible. The centralized approach requires the transfer of problem assets to a single organization with the sanction of the state because of their quality and scale.

The AMC concept is a workable solution in dealing with NPLs and restructuring impaired banking institutions. According to a recent study, in twenty-six banking crises worldwide, an AMC strategy was adopted in nine cases. This approach has been employed in assisting to resolve problems brought to the surface by the Asian financial crises (1997–1998) in a number of Asian countries, including Indonesia, South Korea and Malaysia. Economists have examined the advantages and disadvantages of these two approaches according to the types of assets

49. Regulatory forbearance is applied to deal with banking problems by lowering capital adequacy requirements, more liberal tax treatments, relaxing loan loss reserves and provisioning requirements, and lenient accounting standards. The prerequisites to employ this approach are that the crisis is temporary and the banks are fundamentally sound. An important assumption is that the banks should gradually recapitalize themselves by improving their profits. See Stijn Claessens, Experiences of Resolution of Banking Crises, in BIS Policy Papers—Strengthening the Banking System in China: Issues and Experience 275 283 (1999), available at http://www.bis.org/publ/plcy07.pdf.

50. World Bank, supra note 45, at 3.

51. SHENG, supra note 45, at 40; IMF, supra note 45, at 7-8; World Bank, supra note 45, at 3-4.

52. World Bank, supra note 45, at 4.


54. Id.

55. Id.

56. World Bank, supra note 45, at 2.

57. In handling huge NPLs after the Asian financial crises, Korea, Malaysia, Thailand and Philippines set up AMCs to accelerate the disposition of mounting bad assets and to help the revival of unviable banks.

involved, the magnitude of the problem, the depth of markets, and the characteristics of debtors contributing to the structural arrangement of AMCs. Regardless of the corporate governance structure of the AMC, a sound legal framework is essential in managing and disposing of assets effectively from their transfer to debt recovery. The AMCs should be vested with legal privileges in ensuring clear title to transferred assets and in lowering transaction costs, e.g. simplifying notification obligations of creditors in transferring assets. The legal framework should include effective bankruptcy, corporate and securities laws, as well as well-trained lawyers and an effective judiciary. To avoid conflicts of interests arising from China's thin secondary debt market and the complex relationship among banking institutions, corporate borrowers, and AMCs, a legal environment drawing foreign investment into the domestic NPL market may expedite the disposal of NPLs and the restructuring of troubled enterprises. However, China's legal infrastructure has yet to be fully developed.

The causes of NPLs depend upon historical, economic, political, and legal factors. Accordingly, vehicles adopted for resolving NPLs should be flexible. AMCs are no exception. In South Korea and the United States, AMCs were employed to dispose of NPLs quickly. In Sweden and Finland, they were employed to restructure disabled corporate borrowers and troubled banking institutions. Studies have shown that AMCs with clearly defined and consistent objectives are more likely to succeed than those with mixed and conflicting goals. AMCs focused on disposing of NPLs quickly tend to be more effective than those with broader objectives such as supporting corporate restructuring. A sound corporate governance structure is crucial for AMCs to

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59. Id.
60. Id. at 11-12.
61. Id.
62. Id.
64. For details of financial crises and resolution mechanism, as well as major features of AMCs including types, governance structure, objectives, funding, management, the process of the asset transfer and disposition, and legal environment in which AMC operates, see World Bank, supra note 45, Annex tables 1-10.
65. Id. at 13-15.
66. Id. at 18-19.
67. IMF, supra note 58, at 5-6.
68. World Bank, supra note 45, at 2-3.
achieve satisfactory performance. Legal mechanisms should be implemented to ensure their independence, transparency, and accountability. Furthermore, AMCs should be free from political pressure, with their own budgets and balance sheets, and have independent legal status. Independent auditing and regular publication of relevant information are required to maintain transparency. From an economic perspective, they should be profit-oriented, and provide incentives that motivate employees and management to achieve their objectives. The legal framework of China’s AMCs should address all of these issues.

2.3 The Development of AMCs in China

As noted above, in 1993, the State Council issued the Decision on Financial System Reform separating policy loans from the state-owned specialized banks with the ultimate aim of transforming them into state-owned commercial banks. Two years later, two pieces of banking legislation, the Law of the People’s Bank of China (“PBOC Law”) and the Commercial Banking Law, were enacted to reinforce the commercialization of the banking sector. However, it was not until the recapitalization scheme in 1998 and the closure of a few distressed financial institutions in 1999 that the CPG made serious attempts to improve the profitability and competitiveness of the SOCBs. Notwithstanding the implementation of the basic legal and regulatory framework to enhance the competitiveness of China’s banking institutions, the most imminent issue to address was the NPL problem. In 1999, the State Council created four AMCs as provisional institutions to address these issues.

69. IMF, supra note 58, at 13.
70. Id. at 13-18.
71. Id. at 13-14.
72. Id. at 14-15.
73. Id. at 18.
74. s. 3, Decision on Financial System Reform, supra note 14.
no legal provision stipulating the corporate life of the AMCs, it is, however, generally considered to be ten years because their issued bonds have a ten-year maturity period. The AMCs are designed to take over the NPL assets of the SOCBs through debt-equity swaps. Each SOCB is assigned an AMC, i.e. Great Wall for ABC, Orient for BOC, Cinda for CCB, and Huarong for ICBC, with nearly RMB1.4 trillion total in NPLs initially transferred.

The AMCs were created halfway through China's three-year SOE rescue program, a program launched in 1997 to rescue inefficient large and medium-sized SOEs through the restructuring of management into modern corporate entities. The AMCs are expected to play an active role in this process. Legally, they were created as part of the banking reforms in commercializing the SOCBs. The reforms include divesting most NPLs from the SOCBs, maximizing the recovery value of the transferred NPLs, relieving the heavy debt burden of SOEs, and improving the governance structure of SOEs through the debt-equity swap scheme. The debt-equity swap scheme is an important strategy in restructuring SOEs by releasing their debt burden and enhancing state supervision over their management. Therefore, the reforms of their ownership structure and their operation focus on policy objectives rather than profit-orientation. Experience from other jurisdictions has shown that most AMCs have multiple objectives because they are often set up in response to systemic banking crises, which often are closely related to corporate performance. Thus, expediting corporate restructuring and promptly disposing of bad assets are often designated as two par-

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78. BIS, supra note 63, at 1.
83. Id. art. 19.
84. World Bank, supra note 45, at 7.
allel objectives of AMCs. This is also true in the case of China. As SOEs still dominate China’s economic landscape, it is inevitable that its AMCs would engage in corporate restructuring and prompt disposal of bad debts since most NPL assets acquired arose from loans obtained by the SOEs.

In 2000, the State Council promulgated rules regulating AMCs (the “AMC Regulations”). However, the AMCs were under the respective jurisdiction of the PBOC and the MOF, as well as the China Securities Regulatory Commission (CSRC). The China Banking Regulatory Commission (CBRC) was established in April 2003 and assumed the previous PBOC’s functions of regulating banks, AMCs, and trust and investment companies, while maintaining a stable financial system. The PBOC continues its role as China’s central bank, with a new mandate to support financial stability in addition to monetary policy. However, both are arms of the State Council and, therefore, their regulatory functions are certainly affected by political considerations.

3. THE LEGAL FRAMEWORK OF CHINA’S AMCs

The absence of legislative provisions clarifying the actual status of the AMCs, as well as the length of their corporate life, affects their operation. This section discusses the jurisdiction of the AMCs and their regulatory framework. However, much of the regulatory framework of the AMCs relies on state policy rather than legislation. This legislative forbearance may be justified on the basis of flexibility and expediency in disposing of NPLs but risks violating legal principles.

85. AMC Regulations, supra note 82.
86. Id. art. 4.
89. Zhongguo renmin yinhang zhuyao zhize nei she jigou he renyuan bianzhi queding [Decision on the Major Functions, Internal Organizations and Staff of the PBOC] (issued by the People’s Bank of China, Sept. 30, 2003)
90. ZHONGGUO JINRONG NIANJIAN 2002, supra note 80, at 745.
3.1 The Mandates of the AMCs

The AMCs are state-owned, non-banking financial institutions with their own independent legal identities. In managing and disposing of NPLs, AMCs may, under AMC Regulations, engage in: (i) debt collection; (ii) leasing, transferring or restructuring acquired assets; (iii) debt-equity swaps and holding equity stakes in enterprises for a period of time; (iv) issuing bonds and borrowing from financial institutions; (v) listing recommendation and security underwriting; and (vi) financial and legal consultation, project evaluation, as well as other business activities approved by the PBOC and the CSRC. They must maintain their assets and minimize losses. They may purchase NPLs from the SOCBs, subjected to criteria established by the State Council, and manage these assets. Naturally, their corporate governance inherits the traditional problems of all SOEs in China when dealing with complex financial issues in the absence of clear, non-political rules.

The AMCs are mandated to purchase NPL assets according to their book value. As their rates of recovery are more likely to occur at a lower level than book value, they have often been criticized as a failure. When foreign investors are involved, the pressure of “losing state assets” restricts NPL disposition. Therefore, it would be unrealistic to evaluate their performance solely on recovery value. However, loans scheduled to be written off are excluded from this mandate. In any event, the loans are restricted to those created prior to 1996. The rationale is that prior to 1996 most loans created by the SOCBs were policy loans. Since 1996, the SOCBs have had to bear the credit risks of their lending. The MOF infused RMB10 billion into each
AMC as its registered capital. The purchase of NPL assets is financed by loans granted by the PBOC originally designated to the SOCBs and bonds issued to the SOCBs. Although the bonds are not guaranteed by the State, the State, nevertheless, implicitly backs them by fixing the annual interest of these loans at 2.25 percent. Accordingly, the State is indirectly subsidizing SOCBs in writing off their NPLs through the AMC vehicles.

3.2 Legislative Forbearance

To maximize the recovery value of the transferred NPLs, the AMCs are empowered to take drastic measures in management and disposal. As in other jurisdictions, special laws and regulations were made empowering the AMCs to have broader powers in the disposal of NPLs. The subordinate legislation stipulating the status, powers, and liabilities of the AMCs is the AMC Regulations, an administrative regulation enacted by the State Council in 2000 under the PRC Constitution. Its enabling act is a provision of the PRC Banking Regulation Law, which provides that "where the laws [i.e. legislation] and administrative regulations provide otherwise [for] the regulation and supervision of policy banks and asset management companies, these provisions shall prevail." However, according to the PRC Legislation Law, laws trump all subservient administrative regulations codifying state policies. A fortiori, the PRC Banking Regulation Law, enacted by the Standing Committee of the National People's Congress (NPC), cannot prevail over the PRC Legislation Law, which is a "fundamental law" enacted by the full NPC.

In practice, various policies issued by different state agencies, as well as judicial interpretations issued by the Supreme People's Court, constitute the core regulatory framework of the AMCs. To facilitate the transfer of NPLs from the SOCBs to the AMCs and the recovery process, extensive powers are granted to the AMCs. Notwithstanding the above, there is hardly any legal support in China for legislative forbearance. However, the idea

103. AMC Regulations, supra note 82, art. 5.
104. Id. art. 14.
105. BIS, supra note 63, at 6-7. It was also confirmed indirectly by officials of the People's Bank of China in a journalist reception. See Zhongguo Jinrong Nianjian 2001 [Almanac of China's Finance and Banking 2001]
106. AMC Regulations, supra note 82, art. 10.
107. IMF, supra note 58, at 11-12.
108. PRC Constitution, art. 89(1).
109. PRC Banking Regulation Law, supra note 88, art. 48.
111. Id. art. 7.
of “policy functioning as law” is an important feature of the Chinese legal system in its transformation from a planned economy to a socialist market economy.\(^{112}\) The very fact that China is now progressing towards a socialist market economy, as a state policy, is a clear violation of the PRC Constitution, which stipulates that “the state shall practice economic planning on the basis of socialist public ownership.”\(^ {113}\) When constructing the institutional framework, policies often prevail over formal arrangements, e.g. laws and regulations.\(^ {114}\) This also applies to China’s AMCs. In March 1999, the Working Report of the CPG recommended “gradually setting up the AMCs to dispose [of] current NPLs and implementing strict responsibility for the quality of new loans.”\(^ {115}\) Thereafter, Cinda AMC was established and a series of policy documents were promulgated defining the status and jurisdiction of the AMCs.\(^ {116}\) The Decisions of Reform and Development of SOEs\(^ {117}\) approved by the Central Committee of the CCP in September 1999 confirmed the establishment of the first AMC. One month later, another three AMCs were approved.\(^ {118}\) Although the NPC had proposed that the NPL problem should be resolved through the AMC concept, its activation was nevertheless signaled by the CCP.

In practice, policy steers China’s economic and political reform. Policy is the foundation of law, and law is the institutionalization of policy.\(^ {119}\) In other words, laws merely implement the policies of the CCP.\(^ {120}\) As the CCP’s policies have been changing during this transitional period, China’s legal system has had to take an ad hoc and piecemeal approach.\(^ {121}\) Therefore, the legal framework regulating AMCs in this evolving system consists of regulations, rules, decisions, and orders made under various ad

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\(^{113}\) PRC Constitution, art. 15.


\(^{115}\) Second Plenary Session of the Ninth National People’s Congress, *supra* note 42.


\(^{117}\) Guanyu guoyou qiye gaige he fazhan ruogan zhongda wenti de jueding [Decisions on Some Important Issues of Reform and Development of State-Owned Enterprises] (promulgated by the Central Committee of the China Communist Party, Sept. 22, 1999) (P.R.C.) [hereinafter Decisions of Reform and Development of SOEs].

\(^{118}\) Huarong, Great Wall and Orient AMC Notice 1999, *supra* note 77.

\(^{119}\) Chen, *supra* note 114, at 256.

\(^{120}\) Chen, *supra* note 112, at 256.

\(^{121}\) Id.
hoc policies, which lack clarity, certainty, universality, and stability.122

China’s legislative hierarchy includes laws (as legislation is called), administrative, local, and autonomous regulations and special rules.123 The NPC and its Standing Committee are empowered to enact laws.124 The State Council may make administrative regulations under the PRC Constitution or empowering laws.125 The NPC and its Standing Committee may invest the State Council with power to make administrative regulations within the scope of their legislative power.126 The State Council may then recommend the NPC and its Standing Committee to enact these regulations into laws whenever practicable.127 Therefore, China’s legislative system has incorporated an experiential feature designed to meet the needs of a rapidly changing and developing economy. However, the differing interests of various state-level government departments and local governments have resulted in inconsistency in these administrative regulations.128 Legislative competition among government agencies to seek rents by issuing regulations, orders, and complex procedures further complicates the matter.129

The legal framework regulating AMCs in China is a complex and evolving system, composed of administrative regulations made by the State Council and two judicial interpretations of the Supreme People’s Court, as well as a number of administrative orders, decisions, and opinions made by various departments and commissions of the State Council.130 These administrative regulations and orders are specifically tailored for the AMCs. Moreover, a few non-AMC-specific regulations are also applicable to the AMCs. For example, the Provisional Rules on SOE Reorganization131 provides a basic framework for the entry of foreign

122. Id.
123. PRC Legislation Law, supra note 110, art. 2.
124. Id. art. 7.
125. Id. art. 56; PRC Constitution, art. 89.
126. PRC Legislation Law, supra note 110, art. 56.
127. Id.
128. Zhang, supra note 114.
129. Id.
130. E.g., Provisional Rules on Drawing Foreign Capital into the Asset Restructuring and Disposal by Financial Asset Management Companies, Circular of the General Office of the State Council on Transmitting the Opinions on Exerting Further Efforts in the Work of Debt-Equity Swap of State-owned Enterprises of the State Economic and Trade Commission, the Ministry of Finance, and the People’s Bank of China, Measures on the Asset Disposition of Financial Asset Management Company, etc. Further references are provided in appropriate footnotes of this article where they are discussed.
131. Liyong waizi gaizu guoyou qiye zanxing guiding [Provisional Rules on Reorganization of SOEs by Using Foreign Funds] (promulgated by the State Economic
capital for restructuring SOEs. Although the legal framework regulating the AMCs heavily relies on administrative regulations and orders, there is no law harmonizing and rationalizing them. As these regulations and orders are made by different government departments with differing mandates, conflicts inevitably arise. This is not conducive to attracting foreign capital to China’s NPL market.132

The special laws and policies, under which the AMCs operate, are not yet fully enforceable. The policy-dominated regulatory framework means that the AMCs may not enjoy the certainty of legal support and are vulnerable to outside interference. On the other hand, policies have the advantage of flexibility and expediency. Indeed, the Decisions of Reform and Development of SOEs, made by the Central Committee of CCP as a practical guideline, allows non-listed SOEs to transfer their state-allocated land-use rights upon approval.133 The granting fees, paid by the assignee of the land-use rights to the assignor enterprise, may then be used to increase its capital, reduce debts, or undertake structural adjustment.134 This policy is beneficial to the AMCs because some of the land-use rights owned by them, originating from NPLs, are allocated without paying fees to the state. The mortgage of allocated land-use rights must be approved by the local land department;135 however, some local governments only allow the transfer of land-use rights when such rights are granted rather than allocated and when all the granting fees are paid under the PRC Urban Real Estate Management Law.

The Law of the People’s Courts stipulates that “the Supreme People’s Court gives interpretation on questions concerning the specific application of laws and decrees in adjudicating cases.”136 This in effect empowers the Supreme People’s Court to make judicial interpretations. It is also provided in the Resolution on Strengthening the Work of Law Interpretation, approved by the

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132. Yan Du, Waihui ju xin zheng shijie buliang zichan waimai shenpi nanti [Trying to Solve the Problems in Approving the Sale of NPLs to Foreign Investors], 21 SHIJI JINGHI BAODAO [21ST CENT. BUS. HERALD], Jan. 8, 2004).
133. Decisions of Reform and Development of SOEs, supra note 119, § 7(4).
134. Id.
135. Chengzhen guoyou tudi shiyong quan churang he zhuanrang zanxing tiaoli [Provisional Rules of the Assignment and Transfer of the Right to the Use of State-Owned Land in Urban Area], (promulgated by the State Council, May 19, 1990) (P.R.C.), arts. 44, 45.
Standing Committee of the NPC in 1981, that the Supreme People's Court may interpret laws in adjudicating cases. However, the power to enact laws is the exclusive jurisdiction of the NPC and its Standing Committee, and the role of the court, which has no legislative power, is to interpret laws. Moreover, "legislative interpretation," which happens when a provision in a law or decree requires further definition of its limits or supplementary stipulations, is entrusted to the Standing Committee of the NPC. Legislative interpretation has the same binding force as legislation. Under the PRC Constitution, the Standing Committee has final interpretive power subject to the veto of the full NPC. The court cannot make new law under the guise of judicial interpretation.

As in common law countries, the line between legislative interpretation of the Standing Committee and judiciary's interpretive function is often blurred. In China, the court usually exercises its power actively in interpreting laws. Although the court can only exercise judicial power under the PRC Constitution in adjudicating cases before it, it often declares new rules or regulations in adjudicating cases. It may be argued that the court exceeds its jurisdiction and such practice is not conducive to the rule of law. Two judicial interpretations given by the Supreme People's Court in 2000 and 2001, however, have cleared most of the AMCs' legal barriers. These judicial interpretations would circumvent the intention of the laws in certain issues such as notice of obligation to creditors, change of registration of mortgaged rights, and maximum amount of mortgages. These will be discussed later in this article.

138. PRC Constitution, art. 58; PRC Legislation Law, supra note 110, art. 7.
139. PRC Constitution, art. 123; Art. 33, Organic Law of the People's Courts, supra note 136, art. 33.
140. Resolution on Strengthening the Work of Law Interpretation, supra note 137, ¶ 1; PRC Constitution, art. 67(4); PRC Legislation Law, supra note 110, art. 42.
141. Id. art. 47.
142. PRC Constitution, arts. 64, 67(1), 67(4), 67(11).
144. Under the PRC Constitution, the Supreme People's Court is the highest judicial organ, but its interpretive role is not mentioned. PRC Constitution, art. 127. See: LIU, supra note 147, at 78; Organic Law of the People's Courts, supra note 136, art. 33; Resolution on Strengthening the Work of Law Interpretation, supra note 137, ¶ 2.
145. LIU, supra note 143, at 78, 90. Liu points out that since 1978 the Standing Committee has rarely exercised its power to interpret legislation.
146. Id. at 89-91.
The problem of the AMCs is aggravated by the policy-based transfer of NPLs. First, since most transferred NPLs arose from policy loans, the restructuring of these assets by AMCs would face intervention from parties with vested interests. Second, the SOEs, which are the root of the NPLs, were established under the planned economy system and have to provide a social security to employees and retired employees. The titles of the NPL transferred assets are encumbered by socio-economic obligations, such as housing, medical benefits, pensions and other social security measures for current and retired workers. These encumbrances adversely affect asset prices. The successful operation of such a program very much depends on how it is implemented under the relevant policies and law. It is important to note, however, that China's legal infrastructure is still developing.

3.3 The Regulatory Framework of the AMCs

Regulatory authority over China's AMC is divided among a number of agencies, i.e. CBRC, CSRC, MOF, and PBOC, each of which has its own respective mandates and powers. All of these agencies are represented on the AMCs' supervisory boards. Since their interests in the AMCs are different, their regulatory policies toward the AMCs often conflict. As the only shareholder of the four AMCs, the MOF takes charge of the development of the AMCs and ultimately would have to bear their losses under the reasonable assumption that they eventually incur substantial financial losses. The PBOC is more interested

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147. In the first auction of NPL portfolio by Huarong AMC to foreign and domestic investors, it was reported that the consortium led by Morgan Stanley paid only eight to nine cents for a dollar. See: Chan, supra note 44.

148. The CBRC is a banking regulatory authority under the State Council, responsible for the regulation and supervision of banking institutions in China and their business operations: (Banking Regulation Law, art. 2); The PBOC formulate and implement monetary policy, prevent and mitigate financial risks, and maintain financial stability (PBOC Law, art. 2); The CSRC is mainly responsible for centralized and unified supervision and administration of the national securities market (Securities Law, art. 7); The MoF takes charge of setting up and enforcing development strategies and policies of finance and taxation, macro-economic policies and the distribution of revenue between central and local as well as the state and SOEs, etc. available at http://www.mof.gov.cn/news/20050301_1842_4634.htm.


150. AMC Regulations, supra note 82, § 32.
in their loan recovery. The CBRC enforces the relevant laws and regulations respecting the AMCs, and it has a duty to control financial risks and maintain stability in the banking system.\textsuperscript{151} The CSRC, as the major regulator supervising the securities business in China, oversees the securities activities of the AMCs. Since members of senior management of the AMCs are appointed by the state,\textsuperscript{152} it is doubtful that the various state agencies could deal with them impartially without preferential treatment.

If the above regulatory agencies were to be merged into one super-agency, the overlapping of supervisory costs as well as effort could be avoided. One solution is to establish a central body that supervises the CBRC, CSRC, MOF, and PBOC in coordinating the regulatory framework of the financial sector. This may, however, not be politically acceptable. One regulatory objective is to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the financial sector. In avoiding differing interpretation of policies and laws by different state agencies, regulations from different state agencies, e.g. CBRC, CSRC, MOF, and PBOC, should be harmonized and rationalized. Like any piece of law, it is the substance, i.e. the enforcement mechanism, rather than the form that counts. The root of the problems in regulating the financial sector rests with the conflicting roles in enforcing the regulations rather than with the banking law and policies.

4. PROBLEMATIC ASPECTS OF CHINA’S AMCS AND LEGISLATIVE FORBEARANCE

4.1 CORPORATE GOVERNANCE OF AMCs

China’s AMCs are state-owned, non-banking financial institutions with power to manage enterprises.\textsuperscript{153} They are headquartered in Beijing, and their local branch offices are established in areas most adversely affected by NPLs, e.g. Wuhan and Shenyang.\textsuperscript{154} Although each AMC corresponds to a SOCB, there is no equity link between them. Therefore, each AMC is independent from its corresponding SOCB. To strengthen state supervision

\textsuperscript{151} PRC Banking Regulation Law, \textit{supra} note 88, art. 1.
\textsuperscript{152} AMC Regulations, \textit{supra} note 82, § 8.
\textsuperscript{153} \textit{ZHONGGUO JINRONG NIANJIAN 2003}, \textit{supra} note 40, at 74.
over the business operations of the AMCs, a supervisory board has been established in each AMC under the *AMC Regulations* and the *Provisional Ordinance of the Supervisory Board in Key State-owned Financial Institutions*.\(^\text{155}\) There is no modern corporate governance structure in these AMCs. Each has a supervisory board, and its management includes a chief executive and several deputy chief executives.\(^\text{156}\) An independent board of directors has yet to be appointed for each AMC. The chief executive, appointed directly by the State Council, is responsible for the management and business operation of the AMC.\(^\text{157}\) Members of the supervisory board are also appointed by and report to the State Council.\(^\text{158}\) They look after the AMC's finances and supervise the chief executive and principal managers with the ultimate purpose of protecting state property and interests.\(^\text{159}\) The head office takes charge of the entire business of each AMC, and the local branches have no independent legal status and run their business without the authorization of the headquarters. However, effective governance mechanisms are essential in keeping their profit-orientation free of political interference, since they are state-owned enterprises funded by the MOF.

The AMCs' independence, transparency, and accountability have yet to be improved. As the AMCs were established as state agencies to handle the legacy of the SOCBs and SOEs, they are vulnerable to political pressure. The parallel objectives of expediting corporate restructuring and promptly disposing of NPL assets are often conflicting and leave room for state interference. For example, in the debt-equity swap scheme, the State Economic and Trade Commission (SETC) is empowered to select the enterprises capable of taking part in the scheme, and the AMCs can only review the qualifications of enterprises and make conversion agreements with SOEs.\(^\text{160}\) Inevitably, the SETC has to consider state policy in the selection process. Transparency pertaining to their operation and performance is important to enhance accountability and to protect them from outside intervention. International experience suggests that the financial report of an AMC should be audited by an independent auditor regu-
larly to ensure the accuracy of its financial statements and the timely disclosure of financial risks to its stakeholders.\textsuperscript{161} The periodic reports of AMCs should be published to ensure transparency.\textsuperscript{162}

However, the requirements to disclose financial information on AMCs still remain inadequate. There is no comprehensive regulation regulating the disclosure of business information by the AMCs. The AMCs, furthermore, are financial institutions without the requisite human resources.

### 4.2 Issues Relating to Rights Respecting Transferred AMC Assets

The transfer of RMB1.39 billion of NPL assets from the SOCBs to the AMCs in 1999 was the largest disposal of financial assets in China’s history. This was also the first time that the CPG addressed the NPL issue seriously.\textsuperscript{163} Naturally, such a mandatory transfer package also granted the AMCs more legal power in the management and disposal of NPLs. Nevertheless, the legal issues pertaining to the transfer warrant further discussion.

#### 4.2.1 Validity of Transfer

The most important issue is the validity of loans sold by the SOCBs. In accordance with Chinese contract law, the transfer of NPL assets from the SOCBs to the AMCs is contractual in nature.\textsuperscript{164} A creditor may transfer its contractual right to a third party depending on the nature of the contract, the agreement itself, and the provisions of laws.\textsuperscript{165} Under the Commercial Banking Law, banking business does not cover the disposal of loan assets.\textsuperscript{166} Because banking is a highly regulated business, there is doubt about the legality of such disposals. To avoid doubt, the transfer of RMB1.39 billion NPL assets was approved by the State Council,\textsuperscript{167} and its legitimacy was further strengthened by an administrative regulation issued by the State Council in
However, the validity of subsequent transfers of NPL assets by the AMCs to third party investors remains uncertain. The AMC Regulations only affirm the validity of the assets transferred from the SOCBs to the AMCs but falls short of addressing subsequent disposals by the AMCs to other investors.

4.2.2 Creditor Rights

The second issue is the transfer of creditor rights, as well as ancillary rights attached thereto. Under Chinese contract law, the creditor has an obligation to serve notice on the debtor regarding the transfer of contractual rights; otherwise, the debtor is not bound by the transfer. The total number of debtors involved in the RMB1.39 billion asset transfer exceeded two million nationwide. It would have been seemingly impossible to notify all debtors in order to fulfill the legal obligation.

The AMC Regulations, however, state that where AMCs acquire original creditor rights, debtors, guarantors, and other related contracting parties must perform their obligations in accordance with original contracts. Still, it is doubtful whether such a decree of the State Council can circumvent the requirement of a legislative provision of the NPC. To avoid doubt the Supreme People’s Court issued two judicial interpretations in 2001 and 2002 simplifying transfer procedures and securing the rights of AMCs. Under these interpretations, a transferor SOCB is deemed to have served its notice by publishing it in leading national or provincial newspapers. In addition, the notice may be served by notifying the debtor in court during legal proceedings. These special interpretations and rules on serving notice ascertain the rights of the AMCs in the assets transferred. How-

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168. See AMC Regulations, supra note 82.
169. Law on Contracts, supra note 164, art. 80.
170. Id.
172. AMC Regulations, supra note 82, § 13.
173. Zui gao renmin fayuan guanyu shenli sheji jinrong zichan guanli gongsi shouguo, guanli, chuzhi guoyou yinhang buliang daikuan xingcheng de zichan de anjian de gui [Regulations Concerning Laws Involving the Rulings of the Supreme People’s Court on Legal Cases With Respect to Financial Asset Management Companies’ Assets Formed by the Acquisition, Management, and Disposal of State-Owned Banks’ Non-Performing Loans] (promulgated by the Supreme People’s Court, Apr. 11, 2001) (P.R.C.), art. 6.
174. Id.
ever, as they only apply specifically to AMCs and not to other creditors, there is no equality under the law.

Questions also arise concerning the validity of transferred mortgages. Chinese contract law allows the transfer of mortgage.\textsuperscript{175} Some mortgaged properties, including land-use rights, real estate, forest, transportation vehicles, and equipment, as well as other moveables and pledged rights, must be registered as against third parties.\textsuperscript{176} The \textit{Security Law} and its judicial interpretations by the Supreme People's Court in 2000 do not mention re-registration requirements arising from either the amendment of a security contract or the assignment of both the principal and ancillary security contracts.\textsuperscript{177} There are, however, a few relevant ministerial regulations. For example, the \textit{Administration of Urban Real Property Mortgage Procedures} of the Ministry of Construction requires amended registration after any variation of the security contract.\textsuperscript{178} The AMCs should comply with the same legal requirement in protecting their interests against third parties. In practice, however, the change of mortgage requires the assistance of the mortgagor, who often prefers not to cooperate in order to avoid its contracting obligations. There are transaction costs attached to compliance with this legal requirement.

To protect the interests of the AMCs, the Supreme People's Court issued an interpretation in 2001 providing the AMCs with immediate mortgagee rights. It stated that the registration of mortgaged rights attached to the assets acquired by the AMCs from the SOCBs is still valid upon the assignment of the principal creditor rights.\textsuperscript{179} This means the original registration remains in force, and the burden of the AMCs to re-register the transferred mortgages is waived.

\textsuperscript{175} Law on Contracts, \textit{supra} note 164, art. 81.


\textsuperscript{177} See generally id.; \textit{Zui gao renmin fayuan guanyu shiyong "Zhonghua Renmin Gongheguo danbao fa" ruogan wenti de jieshi} [Judicial Interpretations by the Supreme People's Court on Applying the Security Law] (promulgated by the Supreme People's Court, Dec. 8, 2000) (P.R.C.).

\textsuperscript{178} Chengshi fangdichan diya guanli banfa [Administration of Urban Real Property Mortgage Procedures] (promulgated by the Ministry of Construction, May 9, 1997, effective June 1, 1997, revised Aug. 15, 2001) (P.R.C.), art. 35.

\textsuperscript{179} Regulations Concerning Laws Involving the Rulings of the Supreme People's Court on Legal Cases With Respect to Financial Asset Management Companies' Assets Formed by the Acquisition, Management, and Disposal of State-Owned Banks' Non-Performing Loans, \textit{supra} note 173, art. 8.
The third issue is the relevant provisions in Chinese company law. The NPL assets acquired by the AMCs can be classified variously as creditor rights, equity rights, and real property.\textsuperscript{180} Equity shareholdings account for twenty-one percent of the NPLs.\textsuperscript{181} The shareholder rights of the AMCs in SOCBs arose from the debt-equity swap scheme.\textsuperscript{182} This scheme enables the AMCs to recover their debts by helping to revive failed enterprises through alleviating their debt burden. Under the debt-equity swap scheme, debts owed by the SOEs to the SOCBs were converted into shareholdings held by the AMCs. Accordingly, the SOEs save paying interest thereon and have their debt ratio reduced. Under the legal framework, the AMCs may dispose of their interests in the SOEs by selling their shareholdings to the SOEs through share buy-backs, to third parties, or publicly listing the shares through stock exchanges.\textsuperscript{183}

To avoid the adverse effects of the provisions of the PRC Company Law on AMCs, the \textit{AMC Regulations} allow SOEs to buy back their shareholdings from the AMCs.\textsuperscript{184} As the AMCs have to pay interest on their bonds, they may have to realize their shareholdings in the SOEs to meet this obligation. Share buy-back by the enterprise was once employed as the most significant channel since there are a lot of legal barriers both for private investors to purchase state-owned shares and for most SOEs to go public. However, the provisions of Chinese company law make buy-back of shares by SOEs difficult. Since an enterprise's capital is reduced after buying back its shares, the shareholders' general meeting must approve such transaction.\textsuperscript{185} It is especially complicated for a joint-stock enterprise, which must have at least two but not more than fifty shareholders.\textsuperscript{186} If the shareholders of the enterprise fall outside this legal requirement, the validity of such a transaction is in doubt. In reality, a number of SOEs have complained that share buyback reduces its capital base and,

\textsuperscript{180} Jinrong zichan guanli gongsi xishou waizi canyu zichan chongzu yu chuzhi de zanxing guiding, [Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies] (promulgated by the Ministry of Foreign Trade and Economic Cooperation and the Ministry of Finance, Oct. 26, 2001) (P.R.C.), art. 5.
\textsuperscript{181} Gao, \textit{supra} note 97.
\textsuperscript{182} \textit{AMC Regulations}, \textit{supra} note 82, § 16.
\textsuperscript{183} \textit{Id.} § 21.
\textsuperscript{184} \textit{Id.}
\textsuperscript{186} \textit{Id.} art. 20.
hence, increases its debt ratio.\textsuperscript{187} To protect the interest of the AMCs in recovery of debts, share buyback is a prerequisite step in almost ninety percent of the debt-equity swap contracts.\textsuperscript{188} Since share buyback could not be enforced in most debt-equity swap cases, it was abolished by an administrative order of the State Council in 2003.\textsuperscript{189} There is also a risk that the shareholdings of such SOEs are not diversified. However, an AMC can always transfer its shareholdings in a SOE to other investors.\textsuperscript{190}

The transfer of shares held by the AMCs faces several legal limitations. First, in the scheme of debt-equity conversion, an AMC becomes the sponsor shareholder of the newly established joint-stock enterprise. According to Chinese company law, the shares held by the sponsor of a joint-stock enterprise cannot be transferred within three years from the date of incorporation.\textsuperscript{191} Second, since the shares held by the AMCs in SOEs are state-owned shares,\textsuperscript{192} their liquidity is subject to policy restrictions. Although the state-owned shareholders may transfer their shares to other enterprises and natural persons in and outside China,\textsuperscript{193} how and at what price these shares are sold have to follow prescribed procedures. State-owned shares can only be sold by agreement, which must be approved by relevant state agencies.\textsuperscript{194} In addition, the selling price of state-owned shares cannot

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\textsuperscript{188} GUOQI ZHAIWU CHONGZU [THE DEBT WORK-OUT FOR SOEs IN CHINA] 131 (Fangsheng Zhou ed., 2003).


\textsuperscript{190} AMC Regulations, supra note 82, § 21.

\textsuperscript{191} Company Law, supra note 185, art. 147.


\textsuperscript{194} Caizheng bu guanyu gufen youxian gongsi guoyou guquan guanli gongzuo youguan wenti de tongzhi [Notification by the Ministry of Finance on Management of State Shares of Stock Limited Companies] (promulgated by the Ministry of Finance, May 19, 2000) (P.R.C.), § 1.
\end{flushright}
be lower than the par value of each share. The lengthy and complicated approval procedures create uncertainty and increase transaction costs in disposing of these shares, and selling prices based on impractical assessment rather than market discipline tend to limit freedom of bargaining.

A thin, secondary debt market with limited players makes it more difficult for the AMCs to dispose of their NPL assets at a reasonable price. Although the revised Commercial Banking Law opens the door for commercial banks to invest in enterprises within China, this is still an exception. The extent of this requires further enactment. Commercial banks are not normally allowed to make investments in Chinese enterprises. Because the scope of their business is restricted by law, securities and insurance companies cannot purchase the equity holdings of the AMCs. Other private investors face great difficulties entering into the NPL market because of insufficient funds and policy discrimination. Foreign participation also encounters serious legal restrictions, and this will be discussed in detail in the subsequent section.

Listing SOEs through the stock exchanges enables the AMCs to dispose of their shareholdings and promotes share diversification in the SOEs. In addition to the requirements of share capital and the diversification of shareholders, an enterprise applying to list its shares must have been in operation for three or more years and must have made profits for the past three consecutive years. Obviously, the SOEs in which the AMCs hold shares do not normally meet these requirements. Accordingly, the AMCs will take a longer time to dispose of their NPL assets through the stock exchanges. Furthermore, even if the restructured SOE could be listed, state-owned shares and state corporate shares are not tradable in China’s stock markets, and their transfer can only be made by agreement. Thus, the

195. Opinions on Behavior Model Concerning State Shareholders of Stock Limited Companies in Exerting Shares, supra note 193, art. 17.
197. Law on Commercial Banks, supra note 166, art. 43.
200. Company Law, supra note 185, art. 153.
SOE shares held by the AMCs are not very liquid. Moreover, state approval is required to list or to transfer shares of large SOEs relating to national development.  

4.3 Foreign Participation

In the late 1970s, China began its open door policy. Since then, the legal framework for foreign investment has continued to improve. In 2003, the Interim Provisions on Restructuring State-owned Enterprises with Foreign Investment was issued by the SETC and provides a basic framework for foreign capital to enter into the strategic restructuring of SOEs. The profound relationship among the interested parties in China, e.g. AMCs, SOCBs and SOEs, calls for participation of independent outside investors to resolve NPLs. Foreign partners are more likely to deal at arms length with these parties. In addition, they bring in new financial resources, management skills, and experience in assisting the AMCs to resolve NPLs and in developing a secondary debt market.

The legal framework for involving foreign capital in addressing NPL problems began to take shape in 2001 when the Provisional Rules on Drawing Foreign Capital into the Asset Restructuring and Disposal by Financial Asset Management Companies was enacted as an administrative regulation. It expressly states that all AMCs may receive foreign capital in resolving NPLs. However, it only offers limited guidance to foreign investors. The related legal and regulatory problems have yet to be dealt with.

Under the Provisional Rules of Attracting Foreign Capital, issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC – now the Ministry of Commerce) in 2001, the AMCs are empowered to sell or transfer their creditor rights to foreign investors. Debts purchased by foreign purchasers be-

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202. Provisional Rules on Reorganization of SOEs by Using Foreign Funds, supra note 131.

203. Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, supra note 180.


205. Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, supra note 180.

206. Id. art. 5(3).
come foreign debts.\textsuperscript{207} In China, the borrowing, use, and repayment of foreign debt and contingent foreign debts are under strict state supervision.\textsuperscript{208} All foreign debts, external guarantees, utilization of foreign debt, and repayment must comply with the provisions of relevant laws and administrative regulations and measures.\textsuperscript{209} However, in the absence of comprehensive laws and regulations on the transfer of debts from domestic creditors to foreign investors, the integration of debts sold by the AMCs to foreign investors into a uniform management system of foreign debt is a challenging issue. In 2004, the State Administration of Foreign Exchange (SAFE) issued a notification concerning the management of foreign debts arising from NPLs.\textsuperscript{210} This provides specific rules regulating the registration, approval, and guarantee of foreign debts, as well as remittance of proceeds.\textsuperscript{211}

Under the\textit{ Provisional Rules of Attracting Foreign Capital}, the AMCs may dispose of their shares in non-listed SOEs.\textsuperscript{212} However, it is silent as to whether or not the AMCs can sell their shares in listed SOEs. In China, there are different rules on transfer of shares between listed and non-listed enterprises. In addition to the restriction that an enterprise sponsor cannot transfer their shares within three years of the date of incorporation,\textsuperscript{213} there is an industrial restriction on foreign investment. Although market access for foreign investors has been expanded after China's WTO accession, some industries continue to remain off-limits to foreign capital. The two major documents of the State perspective on access of foreign capital classified industries as encouraged, restricted, and prohibited industries.\textsuperscript{214} As noted above, banking, finance companies, trust and investment compa-

\begin{itemize}
\item \textsuperscript{208} Id. art. 8.
\item \textsuperscript{209} Id.
\item \textsuperscript{210} Guojia waihui guanli ju guanyu jinrong zichan guanli gongsi liyong waizi chuzhi buliang zichan youguan waihui guanli wenti de tongzhi [Notification of the Foreign Exchange Administration Involving Using Foreign Capital to Dispose of NPLs by AMCs] (promulgated by the State Administration of Foreign Exchange, Dec. 17, 2004, effective Jan. 1, 2005) (P.R.C.).
\item \textsuperscript{211} Id.
\item \textsuperscript{212} Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, \textit{supra} note 180, art. 6.
\item \textsuperscript{213} Company Law, \textit{supra} note 185, art. 147.
\end{itemize}
nies are still considered restricted industries, making them less accessible to foreign participation.\textsuperscript{215}

In the new round of SOE reform, which commenced at the beginning of this century, the strategy of increasing foreign participation in the restructuring of SOEs has received wide support. Under the \textit{Provisional Rules on SOE Reorganization}, a basic framework for the entry of foreign capital into the strategic restructuring of SOEs began to operate on January 1, 2003.\textsuperscript{216} Except for financial companies and listed enterprises, foreign funds may be used to restructure SOEs and enterprise with state-owned shares into foreign-funded enterprises.\textsuperscript{217} According to the provisional rules, an AMC may transfer its creditor rights in a SOE to a selected foreign investor, and the transferred SOE may then be restructured into a foreign-funded enterprise, or an AMC may sell all or part of the state-owned shares they are holding to selected foreign investors. Selected foreign investors must meet the following conditions: (i) the management qualifications and technical skills required by the restructured enterprise; (ii) good business credit standing and management skills; and (iii) good financial standing and economic strength.\textsuperscript{218} Nonetheless, the scope of foreign investment is still restricted by the national industrial policies.\textsuperscript{219}

The transfer of creditor rights must be approved by holders of state-owned property rights of the restructured enterprise, and the transfer of state-owned share rights of an enterprise must be approved at the shareholders’ general meeting.\textsuperscript{220} Arrangements for redundant employees of transferred SOEs are still problematic for foreign investors. Since the priority of China’s current policy is to maintain social stability, additional burdens are placed on foreign funds; consequently, this policy to maintain stability adversely influences the selling price of the assets that the AMCs hope to sell.\textsuperscript{221} The restructuring parties, including the holders of state-owned property rights, the creditors of the state-owned enterprises that assign their credits, the enterprises that sell their assets, and the restructured enterprise must come up with a proper settlement plan before employees may be restructured, and the plan must be approved by the employee represen-

\begin{itemize}
\item \textsuperscript{215} \textit{Id.}
\item \textsuperscript{216} \textit{Provisional Rules on Reorganization of SOEs by Using Foreign Funds, supra note 131.}
\item \textsuperscript{217} \textit{Id. art. 2.}
\item \textsuperscript{218} \textit{Id. art. 5.}
\item \textsuperscript{219} \textit{Id. art. 6.}
\item \textsuperscript{220} \textit{Id. art. 7.}
\item \textsuperscript{221} Chan, \textit{supra note 44.}
\end{itemize}
The restructured enterprise must use its existing resources to meet expenses, such as delayed salaries for the employees, un-rebated funds, and overdue social security premiums. The enterprise and the employees are entitled to a bilateral choice, i.e. the enterprise as employer and the workers as employees have their respective rights to choose whether to continue the employment contract. The employment contract of employees retained must be renewed or altered. Those employees whose contracts are terminated are entitled to compensation. For employees that are transferred to social security organizations, the social security premiums thereof shall be paid as one lump sum in full as prescribed by law. The money for those payments is deducted from the net assets of the enterprise before its restructuring or as a priority payment from the proceeds of the disposed state-owned assets. The procedure of applying for the approval of the restructuring is rather complicated and time-consuming.

To utilize foreign capital, techniques, and management and to improve the corporate governance of listed companies, a 2002 joint notice of the CSRC, MOF, and SETC provides that shares in a joint-stock enterprise, whether or not they are state-owned, may be assigned to foreign investors. However, the transfer is restricted to those listed in the Catalogue of Foreign Investment Industries. The requirements for controlling or relatively controlling shareholding to be a Chinese party remain unchanged after the transfer. The transfer must be open to public bidding following prescribed procedures. After the transfer, the listed enterprises shall carry on the original policies and will not enjoy the treatments available to foreign invested enterprises.

222. Provisional Rules on Reorganization of SOEs by Using Foreign Funds, supra note 131, art. 8.
223. Id.
224. Id.
225. Id.
226. Id.
227. Id.
228. Id.
229. Id. art. 9.
231. Id. § 2.
232. Id.
233. Id. §§ 3, 4.
234. Id. § 9.
The AMCs are empowered to establish foreign invested enterprises with foreign capital by transferring share rights and real property holdings. Since 2002, when Huarong AMC established two joint-venture AMCs to dispose of NPLs—one with a Morgan Stanley-led consortium and the other with Goldman Sachs—several joint-venture AMCs have received approval in the subsequent international bidding. Creditor rights, however, are not considered an eligible investment under Chinese company law. Accordingly, foreign investors are reluctant to purchase creditor rights from the AMCs in establishing joint-venture AMCs. This creates difficulty because the majority of NPLs held by the AMCs are creditor rights. The major function of joint-venture AMCs is to manage, restructure, and dispose of NPLs, and the parties share the liabilities and proceeds according to the contracts. Joint investment fund enterprises may also be set up by the AMCs and foreign partners to diversify the disposal of NPLs. The joint-venture AMCs may make subcontracts or set up trusteeship of their asset portfolios with overseas institutions in order to expedite disposal of NPLs. The regulatory hurdles relating to the transfer of state-owned assets to foreign companies, including the time-consuming procedures for government approval, increase transaction costs for foreign investors to enter into China's secondary bad debt market. This impairs their role in disposing of NPLs. In addition, the valuation and pricing of NPLs are problematic because the original transfer is at book value, which may not be an accurate valuation of NPL

235. Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, supra note 180, art. 6.
238. Company Law, supra note 185, art. 24.
239. Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, supra note 180, art. 6.
240. Press Release, supra note 239.
242. Karen Richardson, Chinese Banks’ Bad Loans Draw More Scrutiny, WALL ST. J. Jan. 15, 2004), at A12 (reporting that, “A second international auction by Huarong, held last month, fell far short of expectations. Out of 22 pools of debt at the auction, only three received bids that met the minimum reserve prices set by Huarong.”).
assets.\textsuperscript{243} This may be remedied by allowing more investors into the market and implementing transparent and fair procedures to determine the asset value. The absence of legislative forbearance in alleviating the legal barriers of foreign participation indicates that China is still cautious about foreign investors.

4.4 \textbf{Restructuring State-owned Enterprises}

The introduction of the AMC concept is intended to enhance the recovery of NPLs, to reduce financial risks, to balance the books of large and medium-sized SOEs, and to restructure the SOEs into modern corporations.\textsuperscript{244} The dismantling of insider influence in the SOEs and the diversification of their shareholdings are important tasks of the AMCs. The debt-equity swap scheme is an important new strategy in relieving the SOEs’ debt burden and enhancing state supervision over their management. Under a policy of strict separation of financial business in China’s financial markets, banking institutions cannot hold shares in enterprises.\textsuperscript{245} Therefore, they can hardly exert any influence as creditors on the operation of the SOEs. Although the debt-equity swap scheme enables the AMCs to restructure non-performing SOEs, it is the SETC that selects the participating SOEs.\textsuperscript{246} The AMCs can only review the qualifications of SOEs and make conversion agreements with them.\textsuperscript{247} The ultimate decision must be approved by the State Council after consulting the SETC, MOF and PBOC.\textsuperscript{248} The SETC inevitably has to consider state policy demands rather than the commercial interests of the AMCs in its selection process. The two criteria set up to select SOEs are whether: (i) the loans arose before 1995, [maybe a stupid question, but—going back to earlier parts of this article—did the planned economy end in 1995 or 1996?] and the high debt ratio was mainly caused by the lack of capital, the float of foreign exchange rates, or enterprise expansion during the planned econ-

\begin{thebibliography}{99}
\bibitem{wu2005} Chuanzhen Wu, \textit{Zhongguo wan yi buliang zichan chuzhi neimu, zi sheng chu da liang huise di dai} [Grey Area in Disposing of Trillions of China’s NPLs], \textit{Nanfang Zhoumo} [Southern Weekend] (Jan. 27, 2005).
\bibitem{law2003} Law on Commercial Banks, \textit{supra} note 166, art. 43.
\bibitem{amcregulations} AMC Regulations, \textit{supra} note 82, § 18.
\bibitem{id2} \textit{Id}.
\bibitem{id3} \textit{Id}.
\end{thebibliography}
omy; and (ii) the SOE has quality products with market competitiveness, better management capability, and an sufficient compensation relief for laid-off workers. All participating SOEs must establish a modern corporate system under relevant laws and regulations, and they must be restructured into joint-stock enterprises. The converted equity holdings are the capital contributions of the AMCs, and the restructured assets form the share capital of the SOEs. The aggregated amount of equity each AMC owns in an SOE is not restricted by their net asset value. The AMCs assume the market risks of their shareholdings.

After negotiations with the SOEs, local governments, and relevant government departments, the SETC selected 601 SOEs of which 508 SOEs joined the debt-equity swap scheme with debt conversion amounting to RMB405 billion. This covered twenty-nine percent of all NPL assets acquired by the AMCs. On April 1, 2000, the NPLs of these SOEs that participated in the scheme became share capital of the joint-stock enterprises. These selected SOEs do not have any obligation to pay interest on these NPLs. According to a State Statistic Bureau survey, such interest amounted to RMB3.7 billion; accordingly, the debt-equity ratio of these SOEs decreased to below forty-six percent from around seventy percent in the early 1990s. However, it was estimated that nearly ninety percent of debt-equity swap contracts impose a duty on the SOE to buy back their shares within a fixed time. This would result in increasing their debt ratio and is not conducive to diversifying their shareholders.


251. Id.

252. AMC Regulations, supra note 82, § 16.


255. ZHONGGUO JINRONG NIANJIAN 2001, supra note 249, at 49.

256. THE DEBT WORK-OUT FOR SOEs IN CHINA, supra note 188, at 8-9.

257. Guojia jing mao wei chanye zhengce si [Industrial Policy Department of the State Economic and Trade Commission]. Zhai zhuang gu gongzuo jinzhan qingquang
Most of the non-profitable assets of the SOEs arise from their social policy burden, including nurseries, schools, and health and social services for the employees and their dependents.\(^{258}\) Severing the non-performing or non-profitable assets of the SOEs and then transferring them into new companies is an option in restructuring SOEs.\(^{259}\) Although both official documents and conversion contracts stipulate that local governments must support the relief of social burdens from the SOEs,\(^{260}\) the financial difficulties of local governments have postponed most of their commitments.\(^{261}\) After the debt-equity swap, the SOEs are obliged to implement efficient corporate governance structures, while the AMCs exert their shareholder rights.\(^{262}\) Under the guidelines of SETC, this would include the division of rights and duties among the shareholders’ general meeting, the board of directors, the board of supervisors, and the management.\(^{263}\) The AMCs exert their influence over the SOEs by their seats on boards of directors and boards of supervisors.\(^{264}\) Accordingly, they may supervise major decisions of SOEs but cannot interfere with daily business functions. Although the AMCs have the power to employ or dismiss senior management staff and to supervise the management through the two governing boards, under Chinese company law their role is limited because the principle that “cadres should be subject to party control” is still a significant requirement in selecting managers.\(^{265}\) Therefore, in some cases, the AMCs cannot choose the management even if

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\(^{259}\) Notification by State Economic and Trade Commission Concerning the Regulation, Operation and Management Consolidation of Debt-to-Equity Swapped Enterprises, supra note 244, § 3(2).

\(^{260}\) Id. ¶ 6(1).

\(^{261}\) Industrial Policy Department of the State Economic and Trade Commission, supra note 257.

\(^{262}\) AMC Regulations, supra note 82, §§ 19, 20; Circular of the General Office of the State Council on Transmitting the Opinions on Exerting Further Efforts in the Work of Debt-Equity Swap of State-owned Enterprises of the State Economic and Trade Commission, the Ministry of Finance, and the People’s Bank of China, supra note 193, § 1.

\(^{263}\) Id.

\(^{264}\) AMC Regulations, supra note 82, § 20.

they control 100 percent of the shares. Moreover, the AMCs do not have the resources to sit in on every governing board of every SOE. As the AMCs are more interested in recovering their stakes in the SOEs as soon as possible, they are not concerned with the long-term interests of the SOEs.

Settlements for laid-off workers have been a delicate issue for local governments and enterprises, as well as for all parties involved in the restructuring of SOEs. A few documents require that when the property rights of an SOE are transferred to an outside investor, the employee representative assembly of the enterprise concerned must be consulted if the legitimate rights and interests of the staff are affected. The relocation of employees and other matters are subject to the approval of the employee representative assembly. The employee relocation program relating to the transfer enterprise concerned must also be examined by the Ministry of Labor and Social Security. However, these conditions put a greater burden on investors, and worker unrest often prevents the normal running of an enterprise and may even force the government to invalidate the property right transfer agreement. Since the staff and workers of SOEs with legally protected rights are called "masters," their unrest against the restructuring of SOEs, when their welfare and interests are adversely affected, has some legitimacy. The local governments often settle such unrest by sacrificing the interests of outside investors to maintain social stability. This obviously violates the rule of law and discourages outside investors from rescuing the SOEs.

266. THE DEBT WORK-OUT FOR SOES IN CHINA, supra note 188, at 130; Xie & Li, supra note 180, at 167; Tianyong Zhou, Zhai zhuang gu de liucheng jili yu yunxing fengxian [Procedural Principles and Running Risks of Debt-Equity Swap Scheme], JINGJI YANJIU [J. ECON. RESEARCH], 2000, at 27.

267. Qiye guoyou chanquan zhuangrang guanli zanxing banfa [Interim Measures for the Management of the Transfer of the State-owned Property Right of Enterprises] (promulgated by the State-owned Assets Supervisory and Regulatory Comm’n & Ministry of Finance, Dec. 31, 2003) Under these measures, the settlement of employees was set as the priority in enterprise restructuring, therefore it is problematic for both for local governments and outside investors.

268. Id.

269. Id.

270. Id. arts. 28, 29.


273. Wang, supra note 271, at 70.
The debt-equity swap scheme was evaluated in 2004, four years after its introduction.\textsuperscript{274} The \textit{Opinions on Promoting and Regulating State-Owned Enterprises' Debt-Equity Swap} was issued intending to correct irregularities and strengthen supervision.\textsuperscript{275} To address the irregularities of the scheme,\textsuperscript{276} it requires accelerated follow-up work in the registration of new companies established from debt-to-equity swaps and sets the deadline for registering new companies.\textsuperscript{277} Such new companies are required to adopt modern corporate governance.\textsuperscript{278} With the exception of the industries prohibited or restricted by the State, the shareholdings of the AMCs are encouraged to be publicly sold to domestic and foreign investors on a commercial basis.\textsuperscript{279} The issues of resettling employees, guaranteeing their lawful rights and interests, and maintaining social stability are still a priority.\textsuperscript{280} Therefore, the roles of the AMCs in restructuring SOE under the debt-equity swap scheme are still challenging.

5. CONCLUSION

The situation in China is quite different from other transitional economies. Its economic reform is progressing faster than its legal development because legislative innovation requires time to adapt. The rule of law is an objective, but a balance has to be struck between the pursuit of this ideal and the urgent need to enhance the quality of life in post-WTO China and meet the challenge of globalization.

Strict adherence to the rule of law has to be carried out by humans, and humans are never perfect; but, any deviation from the rule of law should be exercised with utmost caution and should be restricted, e.g. not applicable in criminal justice where

\begin{itemize}
  \item \textsuperscript{274} Guanyu dui zhai zhuan gu qiye jinxing quanmian qingli jiancha de tongzhi [\textit{Notice on Clearing and Inspecting the Enterprises in the Debt-Equity Swap Scheme}] (promulgated by the State-owned Assets Supervisory and Regulatory Commission, Oct. 29, 2004).
  \item \textsuperscript{275} Guo wu yuan bangong ting zhuanfa cai zheng bu deng bumen guanyu tujin he guifan guoyou qiye zhai quan zhan gu quan gongzuo yijian de tongzhi [\textit{Notice of the General Office of the State Council on Transmitting the Opinions of the Ministry of Finance and Other Departments on Promoting and Regulating State-owned Enterprises' Debt-Equity Swap}] (promulgated by the General Office of State Council, Dec. 30, 2004).
  \item \textsuperscript{276} Zhixiong Ke & Shengke Wang, \textit{Guo wei fachu “ti jian biao” zhai zhuan gu san cha lukou mingyun dai jue} [\textit{SASAC Inspection to Look into Debt-Equity Swap}], 21 SHIJINGJI BAODAO [\textit{21ST CENT. BUS. HERALD}], Nov. 29, 2004.
  \item \textsuperscript{277} Notice of the General Office of the State Council on Transmitting the Opinions of the Ministry of Finance and Other Departments on Promoting and Regulating State-owned Enterprises' Debt-to-equity Swap, \textit{supra} note 189, \S\ 1.
  \item \textsuperscript{278} \textit{Id.} \S\ 3.
  \item \textsuperscript{279} \textit{Id.} \S\ 4(1).
  \item \textsuperscript{280} \textit{Id.} \S\ 4(3).
\end{itemize}
the rights of the citizens are in jeopardy. In banking reform, legislative forbearance insofar as necessary in ascertaining the legitimate property rights of the creditors should be allowed in addressing fraud and procedural defects that cannot be promptly addressed by the legislative process. In China, banking reform, which supports its economic development, should have priority over legal and political development, because maintaining social stability is a prerequisite to successful implementations of the rule of law and democracy. The following sections illustrate how legal inflexibility is circumvented by administrative policies in enabling the AMCs to achieve their objective of disposing of NPLs.

The privileges given to the SOCBs in disposing of their NPLs creates unfair market competition for viable and well-managed banking institutions. For banking reform to be successful, the AMCs should be given privileges that challenge fair market principles. However, as China is still a developing economy, efforts to reform its banking system under a rule-based framework is imperfect. Its law and policy, as well as its judicial process, have yet to become internationally acceptable. Nevertheless, the above discussion has shown the sincere efforts of China to fully implement its banking reform commitments. According to the public choice theory, China’s ruling elite could use banking reform to accelerate domestic reforms, as people acting in their self-interest have no motivation to support the reforms. China could exploit banking reform to enhance its legal infrastructure and eliminate protection of vested interest groups. In this process, administrative polices would be employed to address legislative defects and omissions. The above discussions have shown the merits of such legislative forbearance. However, a balance has to be struck in undertaking urgent banking reform through legislative forbearance and strict adherence to the rule of law.

The social environment is not favorable to disposing of NPL assets, for reasons including debt evasion and default by enterprises. Every legal framework has its limit. The transaction costs in addressing these issues often outweigh the benefits of strict legal enforcement. China’s banking reform, nevertheless, would result in eliminating many vested interests, since SOEs would no longer rely to such an extent on the SOCBs for funding and foreign and domestic investors would be forced to play by identical rules. The upshot of using banking reform to restructure SOEs would be to limit state intervention in the markets and enhance transparency in governance. It is, however, too optimistic

to expect the AMCs to play an active role in transforming SOEs into modern companies because their operational and financial risks – e.g. management of SOEs, their human resource constraints, and their financing capability, as well as the emphasis on the short-term goal of cash recovery – have yet to be addressed. All these require an experienced and skilled work force which China is developing.

However, regardless of the benefits in banking reform derived from legislative forbearance, the ultimate objective is to eventually enact all the policies into laws. Without the rule of law, China’s economic development can only be short-lived. Legislative forbearance should only be de facto tolerated in this crucial period of transition.

Market discipline is being introduced to China’s AMCs. In addition to the RMB1.4 trillion NPL purchase, the four AMCs have taken over other NPL assets from the SOCBs. More importantly, the transfer is based on market competition rather than state direction. In 2004, Cinda AMC won the bid by defeating the other three AMCs in selling NPLs. Following the recapitalization of US$45 billion into the BOC and the CCB at the end of 2003, Cinda AMC and Orient AMC were entrusted to take over and dispose of RMB197 billion of NPL assets written off from the balance sheets of CCB and BOC. This deal is significant in that the transfer was not made at the book value of the assets but rather at the price determined by the MOF. This indicates that the AMCs will continue to play a significant role in the resolution of China’s NPLs.

After four years of operation, it is now time to assess the effects of legislative forbearance in regulating AMCs to China’s banking reform. In January 2005, the CRBC released statistics reporting that the NPL ratio of the major commercial banks including the four SOCBs and the twelve joint-stock banks for the past year has been reduced by 4.6 percent, i.e. by RMB394.6 billion, to 13.2 percent, i.e. RMB1.718 trillion. This is the third consecutive year of reported declines in NPL ratio.

\[\text{284. Li Zhenhua, 1970 yi yinhang buliang zichan zai bo li, yang hang yin jian hui xian juexin [The PBC and the CSRC Demonstrate Their Resolution in Transferring RMB197 Billion NPLs], 21 SHIJU JINGJI BAODAO [21ST CENT. BUS. HERALD], May 22, 2004.} \]
\[\text{286. Id.} \]
The development of the AMCs, however, is still facing many challenges. According to a report of China’s National Audit Office (NAO), substantial irregularities exist at the four AMCs: the NPL disposal process was opaque with insider dealing; asset valuation has often been gratuitous; and there are incidents of artificial bidding and auctions. 287 This followed a CBRC news release reporting that the AMCs have been constantly violating laws and regulations. 288 The NAO confirmed that a total of RMB6.7 billion was involved in these cases. 289 Stricter regulations have been put into operation in the past year to strengthen the supervision of the transfer, disposition, and management of NPLs. Accordingly, more stringent responsibilities are imposed on the AMCs and their management. 290 Although detailed procedures and responsibilities have been implemented to reduce the risk of selling NPLs below their value, 291 their initial transfer at book value makes it rather difficult to undertake proper valuation and asset pricing.

The wider ramifications that arise in the disposal of NPLs, such as the reorganization of employees and the social welfare of retired and laid-off workers, have made timely development of the bad debt market more difficult. In December 2004, the Ministry of Labor and Social Security announced that laid-off workers from SOEs will be covered by unemployment insurance. 292 This should enhance the value of the NPL assets.

As discussed, the legal framework regulating China’s AMCs is a developing system. To address the irregularities at the AMCs, the legal, policy and market environment must be enhanced. On the positive side, the CBRC has taken measures to strengthen

291. Id.
corporate governance and to improve the market infrastructure for the disposal of NPLs.\footnote{Yin jian hui jiaqiang buliang zichan chuzhi guanli, duo xiang jinrong zichan guanli gongsi youguan fagui jiang chutai [CBRC Strengthening Supervision over AMCs, and Some Regulations Are Going to Come Out], ZHENGQUAN SHIBAO [Securities Daily], Dec. 30, 2004.}