

# Financial Reform in China: The Problematic Aspects of Protecting Creditor Rights

Berry Fong-Chung Hsu<sup>\*</sup>, Douglas Arner<sup>\*\*</sup> and Qun Wan<sup>\*\*\*</sup>

## *Abstract*

Since 1979, 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 to address issues of financial-sector and state-owned enterprise reform. With its 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 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 paper discusses how this policy is application in addressing the non-performing loan (NPL) problems, a substantial component is related to property rights. In addressing the NPL problems, four asset management companies were created. They are state-owned, non-banking financial institutions with power to manage enterprises. In disposing the vast volume of financial assets (a substantial of which are real estate related), the property right issues under Chinese law have to be addressed. These include the validity of transfer of property (e.g. loans sold by the mortgagees), creditor rights (e.g. problems of transferred mortgages), corporate law concerns (e.g. issues related to creditor rights, equity rights, and real estate), and foreign participation (e.g. foreign ownership of real estate).

---

<sup>\*</sup> B.Sc., LL.M. (Alberta); M.A. (Oregon); Ph.D. (London); C.Eng. (U.K. 1991); Barrister and Solicitor (Supreme Court of Victoria and High Court of New Zealand). Associate Professor, Department of Real Estate and Construction, and Deputy Director, Asian Institute of International Financial Law, University of Hong Kong. [e-mail: [bhsu@hku.hk](mailto:bhsu@hku.hk); fax: (852)-2559-9457; address: Department of Real Estate and Construction, University of Hong Kong, Hong Kong SAR (China)]

<sup>\*\*</sup> B.A. (Drury); J.D. (Southern Methodist); LL.M., Ph.D. (London). Associate Professor; Deputy Director, Asian Institute of International Financial Law; and Director, LL.M. (Corporate & Financial Law) Programme, Faculty of Law, University of Hong Kong.

<sup>\*\*\*</sup> LL.B. (Peking); LL.M.(Zhongshan); Ph.D. (Hong Kong); Legal Practitioner (People's Republic of China). Research Fellow, Asian Institute of International Financial Law, Faculty of Law, University of Hong Kong.

## Introduction

China's AMCs are state-owned, non-banking financial institutions with power to manage enterprises.<sup>1</sup> They are headquartered in Beijing, and their local branch offices are established in areas most adversely affected by NPLs, e.g. Wuhan and Shenyang.<sup>2</sup> 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 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*.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> Members of the supervisory board are also appointed by and report to the State Council.<sup>6</sup> 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.<sup>7</sup> 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

---

<sup>1</sup> Z ALMANAC OF CHINA'S FINANCE AND BANKING 2003 [ZHONGGUO JINRONG NIANJIAN 2003] 74 (2003).

<sup>2</sup> For more information, see: Cinda Overview – Organizational Structure, <http://www.cindamc.com.cn/cindaen/OrganizationalStructure.html>; CHAMC – Corporate Structure, <http://www.chamc.com.cn/English/our%20company/corp.htm>; Zhongguo dongfang zichan guanli gongsi – zuzhi jigou [China Orient AMC – Organization Structure], <http://www.coamc.com.cn/zzjg.aspx>; China Great Wall Asset Management Corp. – Organization Structure, <http://www.gwamcc.com/en/aboutus/index4.asp>.

<sup>3</sup> Jinrong zichan guanli gongsi tiaoli [Financial Asset Management Company Regulations] (promulgated by the State Council, Nov. 10, 2000) (P.R.C.) [hereinafter AMC Regulations] § 9; Guoyou zhongdian jinrong jigou jianshi hui zanxing tiaoli [Provisional Ordinance of the Supervision Committee of State-Owned Key Financial Institutions] (promulgated by the State Council, Mar. 15, 2000) (P.R.C.).

<sup>4</sup> AMC Regulations, *supra* note 3, § 8.

<sup>5</sup> *Id.*

<sup>6</sup> Provisional Ordinance of the Supervision Committee of State-Owned Key Financial Institutions, *supra* note 3.

<sup>7</sup> Huarong wang – zhangcheng zhaiyao [Huarong Web – Excerpt of Corporate Bylaws], <http://www.chamc.com.cn/jianjie/jie3.htm>.

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 AMC's can only review the qualifications of enterprises and make conversion agreements with SOEs.<sup>8</sup> 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 regularly to ensure the accuracy of its financial statements and the timely disclosure of financial risks to its stakeholders.<sup>9</sup> The periodic reports of AMC's should be published to ensure transparency.<sup>10</sup>

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

## **1. Issues Relating to Rights Respecting Transferred AMC Assets**

The transfer of RMB1.39 billion of NPL assets from the SOCB's to the AMC's 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.<sup>11</sup> Naturally, such a mandatory transfer package also granted the AMC's more legal power in the management and disposal of NPL's. Nevertheless, the legal issues pertaining to the transfer warrant further discussion.

### **1.1 Validity of Transfer**

The most important issue is the validity of loans sold by the SOCB's. In accordance with Chinese contract law, the transfer of NPL assets from the SOCB's to the AMC's is contractual in nature.<sup>12</sup> 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.<sup>13</sup> Under the *Commercial Banking Law*, banking business does not cover the disposal of loan assets.<sup>14</sup> 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,<sup>15</sup> and its legitimacy was further strengthened

---

<sup>8</sup> AMC Regulations, *supra* note 3, § 18.

<sup>9</sup> IMF, *supra* note 60, at 14-15.

<sup>10</sup> *Id.*

<sup>11</sup> AMC Regulations, *supra* note 3

<sup>12</sup> Hetong fa [Law on Contracts] (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) (P.R.C.), art. 79.

<sup>13</sup> *Id.*

<sup>14</sup> Shangye yinhang fa [Law on Commercial Banks] (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, effective July 1, 1995, revised on Dec. 27, 2003, effective Feb. 1, 2004) (P.R.C.), art. 3 (listing the services which can be undertaken by commercial banks).

<sup>15</sup> Cinda AMC Establishment Notice 1999, *supra* note 79; Huarong, Great Wall and Orient AMC Notice 1999, *supra* note 79.

by an administrative regulation issued by the State Council in 2000.<sup>16</sup> 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.

## 1.2 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;<sup>17</sup> otherwise, the debtor is not bound by the transfer.<sup>18</sup> The total number of debtors involved in the RMB1.39 billion asset transfer exceeded two million nationwide.<sup>19</sup> 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.<sup>20</sup> 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.<sup>21</sup> In addition, the notice may be served by notifying the debtor in court during legal proceedings.<sup>22</sup> These special interpretations and rules on serving notice ascertain the rights of the AMCs in the assets transferred. However, as they only apply specifically to AMCs and not to other creditors, there is no equality under the law.

---

<sup>16</sup> See *AMC Regulations*, *supra* note 3.

<sup>17</sup> Law on Contracts, *supra* note 168, art. 80.

<sup>18</sup> *Id.*

<sup>19</sup> Cinda Overview – Business Operation,

<http://www.cindamc.com.cn/cindaen/BusinessOperation.html>; Company Profile, <http://www.chamc.com.cn/English/our%20company/gongsijianjie.htm>; Zhongguo dongfang zichan guanli gongsi – gongsi jianjie [China Orient Asset Management Corp. – Company Introduction], <http://www.coamc.com.cn/ShowAboutInfo.aspx>; ZHONGGUO JINRONG NIANJIAN 2002, *supra* note 82, at 53.

<sup>20</sup> *AMC Regulations*, *supra* note 3, § 13.

<sup>21</sup> Zui gao renmin fayuan guanyu shenli sheji jinrong zichan guanli gongsi shougou, guanli, chuzhi guoyou yinhang buliang daikuan xingcheng de zichan de anjian shiyong falü ruogan wenti de guiding [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.

<sup>22</sup> *Id.*

Questions also arise concerning the validity of transferred mortgages. Chinese contract law allows the transfer of mortgage.<sup>23</sup> Some mortgaged properties, including land-use rights, real estate, forest, transportation vehicles, and equipment, as well as other movables and pledged rights, must be registered as against third parties.<sup>24</sup> The *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.<sup>25</sup> There are, however, a few relevant ministerial regulations. For example, the *Administration of Urban Real Property Mortgage Procedures* of the Ministry of Construction requires amended registration after any variation of the security contract.<sup>26</sup> The AMCs should comply with the same legal requirement in protecting their interests against third parties. In practice, however, the change of mortgagee 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.<sup>27</sup> This means the original registration remains in force, and the burden of the AMCs to re-register the transferred mortgages is waived.

### 1.3 Company Law Concerns

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.<sup>28</sup> Equity shareholdings account for twenty-one percent of the NPLs.<sup>29</sup>

---

<sup>23</sup> Law on Contracts, *supra* note 168, art. 81.

<sup>24</sup> Danbao fa [Security Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995) (P.R.C.), arts. 41, 42, 78, 79.

<sup>25</sup> *See generally id.*; 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.).

<sup>26</sup> 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.

<sup>27</sup> 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, *supra* note 178, art. 8.

<sup>28</sup> 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.

<sup>29</sup> Gao, *supra* note 99.

The shareholder rights of the AMCs in SOCBs arose from the debt-equity swap scheme.<sup>30</sup> 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.<sup>31</sup>

To avoid the adverse effects of the provisions of the PRC Company Law on AMCs, the *AMC Regulations* allow SOEs to buy back their shareholdings from the AMCs.<sup>32</sup> 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.<sup>33</sup> It is especially complicated for a joint-stock enterprise, which must have at least two but not more than fifty shareholders.<sup>34</sup> 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, hence, increases its debt ratio.<sup>35</sup> 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.<sup>36</sup> 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.<sup>37</sup> 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.<sup>38</sup>

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

---

<sup>30</sup> AMC Regulations, *supra* note 3, § 16.

<sup>31</sup> *Id.* § 21.

<sup>32</sup> *Id.*

<sup>33</sup> Gongsi fa [Company Law] (promulgated by the Standing Comm. Nat'l People's Cong. Dec. 29, 1993, revised Dec. 25, 1999, revised Oct. 27, 2005) (P.R.C.), art. 103.

<sup>34</sup> *Id.* art. 20.

<sup>35</sup> Zhai zhuan gu gongzuo jinzhhan qingkuang [Working Progress in Debt-Equity Swap Scheme], [http://www.setc.gov.cn/cyzc/setc\\_cyzc\\_main140.htm](http://www.setc.gov.cn/cyzc/setc_cyzc_main140.htm).

<sup>36</sup> GUOQI ZHAIWU CHONGZU [THE DEBT WORK-OUT FOR SOES IN CHINA] 131 (Fangsheng Zhou ed., 2003).

<sup>37</sup> Guowuyuan bangongting zhuanfa guojia jingmao wei, caizheng bu, renmin yinhang guanyu jin yi bu zuo hao guoyou qiye zhai quan zhuan gu quan gongzuo de yijian [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] (promulgated by the General Office of the State Council, Feb. 23, 2003) (P.R.C.), § 3(15).

<sup>38</sup> AMC Regulations, *supra* note 3, § 21.

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.<sup>39</sup> Second, since the shares held by the AMCs in SOEs are state-owned shares,<sup>40</sup> 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,<sup>41</sup> 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.<sup>42</sup> In addition, the selling price of state-owned shares cannot be lower than the par value of each share.<sup>43</sup> 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.<sup>44</sup> The extent of this requires further enactment. Commercial banks are not normally allowed to make investments in Chinese enterprises.<sup>45</sup> Because the scope of their business is restricted by law, securities and insurance companies cannot purchase the equity holdings of the AMCs.<sup>46</sup> Other private investors face great difficulties entering into the NPL market because of insufficient

---

<sup>39</sup> Company Law, *supra* note 189, art. 147.

<sup>40</sup> Gufen youxian gongsi guoyou guquan guanli zanxing banfa [Provisional Measures for Management of State Share of Stock Limited Companies] (promulgated by the Management Bureau of State-owned Assets and the State Commission of Institutional Reform, Nov. 3, 1994) (P.R.C.), art. 2.

<sup>41</sup> Gufen youxian gongsi guoyou gu gu dong xing shi guquan xingwei guifan yijian [Opinions on Behavior Model Concerning State Shareholders of Stock Limited Companies in Exerting Shares] (promulgated by the Management Bureau of State-owned Assets and State Commission of Institutional Reform, Mar. 24, 1997) (P.R.C.), art. 15.

<sup>42</sup> 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.

<sup>43</sup> Opinions on Behavior Model Concerning State Shareholders of Stock Limited Companies in Exerting Shares, *supra* note 198, art. 17.

<sup>44</sup> Quanguo renmin daibiao dahui changwu weiyuan hui guanyu xiugai “Zhonghua Renmin Gongheguo shangye yinhang fa” de jue ding [Decision of the Standing Committee of the National People’s Congress on Revising the Law of People’s Republic of China on Commercial Banks] (promulgated by the Standing Comm. Nat’l People’s Cong., Dec., 27, 2003) (P.R.C.), art. 13.

<sup>45</sup> Law on Commercial Banks, *supra* note 170, art. 43.

<sup>46</sup> Law on Securities, *supra* note 151, arts. 129, 130.

funds and policy discrimination.<sup>47</sup> 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.<sup>48</sup> 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 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.<sup>49</sup>

## 2. 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.<sup>50</sup> 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.<sup>51</sup> 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.<sup>52</sup>

---

<sup>47</sup> Ruoyu Li, Si da zichan gongsi xiang waizi chushou buliang zichan yinfa jianrui zhiyi [Critical Challenge on AMCs' Selling NPLs to Foreign Capital], BEIJING CHENBAO [BEIJING MORNING POST], Nov. 24, 2004, available at <http://finance.sina.com.cn/g/20041124/11411177640.shtml>.

<sup>48</sup> Company Law, *supra* note 189, art. 153.

<sup>49</sup> 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, § 3(20).

<sup>50</sup> Provisional Rules on Reorganization of SOEs by Using Foreign Funds, *supra* note 133.

<sup>51</sup> Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, *supra* note 184.

<sup>52</sup> David D. Liu, *Foreign Investment in NPL Assets: Is China's Legal Environment Up to the Task?*, CHINA L. AND PRACTICE, May 2003, at 27-28.

Under the *Provisional Rules of Attracting Foreign Capital*,<sup>53</sup> issued by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC – now the Ministry of Commerce) in 2001, the AMC's are empowered to sell or transfer their creditor rights to foreign investors.<sup>54</sup> Debts purchased by foreign purchasers become foreign debts.<sup>55</sup> In China, the borrowing, use, and repayment of foreign debt and contingent foreign debts are under strict state supervision.<sup>56</sup> All foreign debts, external guarantees, utilization of foreign debt, and repayment must comply with the provisions of relevant laws and administrative regulations and measures.<sup>57</sup> 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 AMC's 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.<sup>58</sup> This provides specific rules regulating the registration, approval, and guarantee of foreign debts, as well as remittance of proceeds.<sup>59</sup>

Under the *Provisional Rules of Attracting Foreign Capital*, the AMC's may dispose of their shares in non-listed SOEs.<sup>60</sup> However, it is silent as to whether or not the AMC's 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,<sup>61</sup> 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.<sup>62</sup> As noted above, banking, finance companies, trust

---

<sup>53</sup> Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, *supra* note 184.

<sup>54</sup> *Id.* art. 5(3).

<sup>55</sup> Wai zhai guanli zanxing banfa [Provisional Measures for Management of Foreign Debts] (promulgated by the State Development and Planning Comm'n, Ministry of Finance, and State Administration of Foreign Exchange, Jan. 8, 2003, effective Mar. 1, 2003) (P.R.C.), art. 2.

<sup>56</sup> *Id.* art. 8.

<sup>57</sup> *Id.*

<sup>58</sup> 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 AMC's] (promulgated by the State Administration of Foreign Exchange, Dec. 17, 2004, effective Jan. 1, 2005) (P.R.C.).

<sup>59</sup> *Id.*

<sup>60</sup> Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, *supra* note 184, art. 6.

<sup>61</sup> Company Law, *supra* note 189, art. 147.

<sup>62</sup> Waishang touzi changye zhidao mulu [Catalogue of Industries for Guiding Foreign Investment] (promulgated by the State Development and Reform Commission and the

and investment companies are still considered restricted industries, making them less accessible to foreign participation.<sup>63</sup>

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 *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.<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup> Nonetheless, the scope of foreign investment is still restricted by the national industrial policies.<sup>67</sup>

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.<sup>68</sup> 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.<sup>69</sup> 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 representative assembly.<sup>70</sup> 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.<sup>71</sup> 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

---

Ministry of Commerce, Nov. 30, 2004) (P.R.C.); Zhidao waishang touzi fangxiang guiding [Regulations on Guiding Foreign Investment Direction] (promulgated by the State Council, Feb. 11, 2002, effective Apr. 1, 2002) (P.R.C.), art. 4.

<sup>63</sup> Catalogue of Industries for Guiding Foreign Investment, *supra* note 218, § 7(1).

<sup>64</sup> Provisional Rules on Reorganization of SOEs by Using Foreign Funds, *supra* note 133.

<sup>65</sup> *Id.* art. 2.

<sup>66</sup> *Id.* art. 5.

<sup>67</sup> *Id.* art. 6.

<sup>68</sup> *Id.* art. 7.

<sup>69</sup> Chan, *supra* note 46.

<sup>70</sup> Provisional Rules on Reorganization of SOEs by Using Foreign Funds, *supra* note 133, art. 8.

<sup>71</sup> *Id.*

rights to choose whether to continue the employment contract.<sup>72</sup> The employment contract of employees retained must be renewed or altered.<sup>73</sup> Those employees whose contracts are terminated are entitled to compensation.<sup>74</sup> 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.<sup>75</sup> 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.<sup>76</sup> The procedure of applying for the approval of the restructuring is rather complicated and time-consuming.<sup>77</sup>

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.<sup>78</sup> However, the transfer is restricted to those listed in the Catalogue of Foreign Investment Industries.<sup>79</sup> The requirements for controlling or relatively controlling shareholding to be a Chinese party remain unchanged after the transfer.<sup>80</sup> The transfer must be open to public bidding following prescribed procedures.<sup>81</sup> After the transfer, the listed enterprises shall carry on the original policies and will not enjoy the treatments available to foreign invested enterprises.<sup>82</sup>

The AMC's are empowered to establish foreign invested enterprises with foreign capital by transferring share rights and real property holdings.<sup>83</sup> Since 2002, when Huarong AMC established two joint-venture AMC's to dispose of NPLs—one with a Morgan Stanley-led consortium and the other with Goldman Sachs<sup>84</sup> – several joint-

---

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* art. 9.

<sup>78</sup> Guanyu xiang waishang zhuanrang shangshi gongsi guoyou gu he faren gu youguan wenti de tongzhi [Notice of the Related Issues on Transfer of the State-owned Shares and the Legal Person Owned Shares in the Listed Companies to Foreign Investors] (promulgated by the China Securities Regulatory Commission, Ministry of Finance, and the State Economic and Trade Commission, Nov. 1, 2002) (P.R.C.).

<sup>79</sup> *Id.* § 2.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* §§ 3, 4.

<sup>82</sup> *Id.* § 9.

<sup>83</sup> Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, *supra* note 184, art. 6.

<sup>84</sup> Press Release, Huarong guoji zhaobiao sheli zhong wai hezuo zichan guanli gongsi huode pizhun [Huarong Gets Approval on the Establishment of Joint AMC], *available at* <http://finance.sina.com.cn/roll/20021203/0824285413.shtml>.

venture AMC has received approval in the subsequent international bidding.<sup>85</sup> Creditor rights, however, are not considered an eligible investment under Chinese company law.<sup>86</sup> 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.<sup>87</sup> 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.<sup>88</sup> 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.<sup>89</sup> This impairs their role in disposing of NPLs.<sup>90</sup> 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 assets.<sup>91</sup> 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.

### 3. 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,

---

<sup>85</sup> Weiling Li, *Huarong: zhong wai hezuo chuzhi zichan xiangmu ju huo pi* [*Huarong: Joint Projects in Disposing Assets Get Approved*], GUOJI JINRONG BAO [INT'L FIN. NEWS.], Dec. 13, 2004.

<sup>86</sup> Company Law, *supra* note 189, art. 24.

<sup>87</sup> Provisional Rules of Attracting Foreign Capital into Asset Restructuring and Disposition of Asset Management Companies, *supra* note 184, art. 6.

<sup>88</sup> Press Release, *supra* note 240.

<sup>89</sup> *Id.* The Morgan Consortium won the bid in November 2001, and the joint-venture AMC received approval in November 2002. The final transfer of assets was made in February 2003. See Runfeng Hu, *Buliang zichan chuzhi de neiwai qiusuo* [*Internal and External Discovery*], LIAOWANG DONGFANG ZHOUKAN [ORIENTAL OUTLOOK], May 30, 2004.

<sup>90</sup> 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.").

<sup>91</sup> Chuanzhen Wu, *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*], NANFANG ZHOUMO [SOUTHERN WEEKEND] (Jan. 27, 2005).

and to restructure the SOEs into modern corporations.<sup>92</sup> 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.<sup>93</sup> 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.<sup>94</sup> The AMCs can only review the qualifications of SOEs and make conversion agreements with them.<sup>95</sup> The ultimate decision must be approved by the State Council after consulting the SETC, MOF and PBOC.<sup>96</sup> 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 economy; and (ii) the SOE has quality products with market competitiveness, better management capability, and an sufficient compensation relief for laid-off workers.<sup>97</sup> All participating SOEs must establish a modern corporate system under relevant laws and regulations,<sup>98</sup> and they must be restructured into joint-stock enterprises.<sup>99</sup> The converted equity holdings are the capital contributions of the AMCs, and the restructured assets form the share capital of the SOEs. The aggregated

---

<sup>92</sup> Guanyu zhai zhuan gu qiye guifan caozuo he qianghua guanli de tongzhi [Notification by State Economic and Trade Commission Concerning the Regulation, Operation and Management Consolidation of Debt-to-Equity Swapped Enterprises] (promulgated by the State Economic and Trade Commission, Nov. 6, 2000) (P.R.C.); 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.

<sup>93</sup> Law on Commercial Banks, *supra* note 170, art. 43.

<sup>94</sup> AMC Regulations, *supra* note 84, § 18.

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> Cong shi ge fangmian jiedu zhai zhuan gu [Understanding Debt-Equity Swap Scheme in Ten Aspects], Oct. 25, 1999, [http://www.setc.gov.cn/cyzc/setc\\_cyzc\\_main16.htm](http://www.setc.gov.cn/cyzc/setc_cyzc_main16.htm). See also, ZHONGGUO JINRONG NIANJIAN 2001, *supra* note 107, at 49.

<sup>98</sup> Notification by State Economic and Trade Commission Concerning the Regulation, Operation and Management Consolidation of Debt-to-Equity Swapped Enterprises, *supra* note 248, ¶ 4; 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.

<sup>99</sup> *Id.*

amount of equity each AMC owns in an SOE is not restricted by their net asset value.<sup>100</sup> 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.<sup>101</sup> 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.<sup>102</sup> 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<sup>103</sup> from around seventy percent in the early 1990s.<sup>104</sup> 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.<sup>105</sup> This would result in increasing their debt ratio and is not conducive to diversifying their shareholders.

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.<sup>106</sup> Severing the non-performing or non-profitable assets of the SOEs and then transferring them into new companies is an option in restructuring SOEs.<sup>107</sup> Although both official documents and conversion contracts stipulate that local governments must support the relief of social burdens from the SOEs,<sup>108</sup> the financial difficulties of local governments have postponed most of their commitments.<sup>109</sup> After the debt-equity swap, the SOEs are obliged to implement efficient corporate governance

---

<sup>100</sup> AMC Regulations, *supra* note 84, § 16.

<sup>101</sup> ZHONGGUO JINRONG NIANJIAN 2001, *supra* note 107, at 49.

<sup>102</sup> 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(6).

<sup>103</sup> ZHONGGUO JINRONG NIANJIAN 2001, *supra* note 107, at 49.

<sup>104</sup> THE DEBT WORK-OUT FOR SOES IN CHINA, *supra* note 192, at 8-9.

<sup>105</sup> Guojia jing mao wei chanye zhengce si [Industrial Policy Department of the State Economic and Trade Commission]. Zhai zhuan gu gongzuo jinzhan qingquang [Working Progress in Debt-Equity Swap Scheme], May 30, 2001, [http://www.setc.gov.cn/cyzc/setc\\_cyzc\\_main140.htm](http://www.setc.gov.cn/cyzc/setc_cyzc_main140.htm).

<sup>106</sup> China Center for Economic Research, *Working Paper: Zhongguo de guoyou qiye yu jinrong tizhi gaige [Reforms of China's State-owned Enterprises and Financial Structure]*, 16, No. C2003027 (Oct. 6, 2003) (prepared by Yifu Lin & Zhiyun Li), available at <http://www.ccer.edu.cn/download/2649-1.pdf>.

<sup>107</sup> Notification by State Economic and Trade Commission Concerning the Regulation, Operation and Management Consolidation of Debt-to-Equity Swapped Enterprises, *supra* note 248, ¶ 3(2).

<sup>108</sup> *Id.* ¶ 6(1).

<sup>109</sup> Industrial Policy Department of the State Economic and Trade Commission, *supra* note 261.

structures, while the AMC's exert their shareholder rights.<sup>110</sup> 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.<sup>111</sup> The AMC's exert their influence over the SOE's by their seats on boards of directors and boards of supervisors.<sup>112</sup> Accordingly, they may supervise major decisions of SOE's but cannot interfere with daily business functions. Although the AMC's 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.<sup>113</sup> Therefore, in some cases, the AMC's cannot choose the management even if they control 100 percent of the shares.<sup>114</sup> Moreover, the AMC's do not have the resources to sit in on every governing board of every SOE. As the AMC's are more interested in recovering their stakes in the SOE's as soon as possible, they are not concerned with the long-term interests of the SOE's.

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 SOE's.<sup>115</sup> 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.<sup>116</sup> The relocation of employees and other matters are subject to the approval of the employee representative assembly.<sup>117</sup> The employee relocation program relating to the transfer enterprise

---

<sup>110</sup> AMC Regulations, *supra* note 84, §§ 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.

<sup>111</sup> *Id.*

<sup>112</sup> AMC Regulations, *supra* note 84, § 20.

<sup>113</sup> 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(7).

<sup>114</sup> THE DEBT WORK-OUT FOR SOES IN CHINA, *supra* note 192, at 130; Xie & Li, *supra* note 180, at 167; Tianyong Zhou, *Zhai zhuan 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.

<sup>115</sup> Qiye guoyou chanquan zhuanrang 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.

<sup>116</sup> Interim Measures for the Management of the Transfer, *supra* note 271, art. 11.

<sup>117</sup> *Id.*

concerned must also be examined by the Ministry of Labor and Social Security.<sup>118</sup> 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.<sup>119</sup> Since the staff and workers of SOEs with legally protected rights are called “masters,”<sup>120</sup> 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.<sup>121</sup> This obviously violates the rule of law and discourages outside investors from rescuing the SOEs.

The debt-equity swap scheme was evaluated in 2004, four years after its introduction.<sup>122</sup> The *Opinions on Promoting and Regulating State-Owned Enterprises’ Debt-Equity Swap* was issued intending to correct irregularities and strengthen supervision.<sup>123</sup> To address the irregularities of the scheme,<sup>124</sup> 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.<sup>125</sup> Such new companies are required to adopt modern corporate governance.<sup>126</sup> 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.<sup>127</sup> The issues of resettling employees, guaranteeing their lawful rights and interests, and maintaining

---

<sup>118</sup> *Id.* arts. 28, 29.

<sup>119</sup> Jun Wang, *Guo qi suoyouquan zhuanrang de falü he xianshi* [*The Privatization of State-Owned Enterprises in China: The Laws and Reality*], YUE DAN MIN SHANG FA YANJIU [CROSS-STRAIT L. REV.], Jan. 1, 2005, at 54, 61-62.

<sup>120</sup> Quan min suo you zhi gongye qiye fa [Law on Industrial Enterprises Owned by the Whole People] (promulgated by the Nat’l People’s Cong., Apr. 13, 1988, effective Aug. 1, 1988), art. 9.

<sup>121</sup> Wang, *supra* note 275, at 70.

<sup>122</sup> Guanyu dui zhai zhuan gu qiye jinxing quanmian qingli jiancha de tongzhi [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).

<sup>123</sup> Guo wu yuan bangong ting zhuanfa cai zheng bu deng bumen guanyu tuijin he guifan guoyou qiye zhai quan zhuan gu quan gongzuo yijian de tongzhi [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] (promulgated by the General Office of State Council, Dec. 30, 2004).

<sup>124</sup> Zhixiong Ke & Shengke Wang, *Guo zi wei fachu “ti jian biao” zhai zhuan gu san cha lukou mingyun dai jue* [*SASAC Inspection to Look into Debt-Equity Swap*], 21 SHIJI JINGJI BAODAO [21<sup>ST</sup> CENT. BUS. HERALD], Nov. 29, 2004.

<sup>125</sup> 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, *supra* note 279, § 1.

<sup>126</sup> *Id.* § 3.

<sup>127</sup> *Id.* § 4(1).

social stability are still a priority.<sup>128</sup> Therefore, the roles of the AMCs in restructuring SOE under the debt-equity swap scheme are still challenging.

#### 4. 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 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 policies 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.<sup>129</sup> 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.

---

<sup>128</sup> *Id.* § 4(3).

<sup>129</sup> Press Release, China Banking Regulatory Commission, CBRC Held a Supervisory Working Conference to Strengthen NPL Disposal, Dec. 29, 2004, *available at* [http://www.cbrc.gov.cn/mod\\_en00/jsp/en004002.jsp?infoID=1100&type=1](http://www.cbrc.gov.cn/mod_en00/jsp/en004002.jsp?infoID=1100&type=1).

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.<sup>130</sup> 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.<sup>131</sup> 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.<sup>132</sup> 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.<sup>133</sup> This is the third consecutive year of reported declines in NPL ratio.<sup>134</sup>

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

---

<sup>130</sup> *Cinda Pondering Massive NPL Sale*, CHINA DAILY, Feb. 1, 2005, available at [http://news.xinhuanet.com/english/2005-02/01/content\\_2533107.htm](http://news.xinhuanet.com/english/2005-02/01/content_2533107.htm).

<sup>131</sup> *AMCs Entrusted with Massive NPL Disposal*, CHINA DAILY, May 17, 2004, available at [http://news.xinhuanet.com/english/2004-05/17/content\\_1473160.htm](http://news.xinhuanet.com/english/2004-05/17/content_1473160.htm).

<sup>132</sup> 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 SHIJI JINGJI BAODAO [21<sup>ST</sup> CENT. BUS. HERALD], May 22, 2004.

<sup>133</sup> Press Release, China Banking Regulatory Commission, CBRC Released the NPL Statistics for 2004, Jan. 13, 2005, available at

[http://www.cbrc.gov.cn/mod\\_en00/jsp/en004002.jsp?infoID=1138&type=1](http://www.cbrc.gov.cn/mod_en00/jsp/en004002.jsp?infoID=1138&type=1).

<sup>134</sup> *Id.*

auctions.<sup>135</sup> This followed a CBRC news release reporting that the AMCs have been constantly violating laws and regulations.<sup>136</sup> The NAO confirmed that a total of RMB6.7 billion was involved in these cases.<sup>137</sup> 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.<sup>138</sup> Although detailed procedures and responsibilities have been implemented to reduce the risk of selling NPLs below their value,<sup>139</sup> 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.<sup>140</sup> 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 corporate governance and to improve the market infrastructure for the disposal of NPLs.<sup>141</sup>

---

<sup>135</sup> Bei Hu, *Bank Chief Seen Heading Huarong; Likely Posting Comes Amid Increasing Criticism of State-Owned Asset Managers*, S. CHINA MORNING POST, Jan. 3, 2005, at 3.

<sup>136</sup> China Banking Regulatory Commission, *supra* note 285.

<sup>137</sup> *Audit Finds Four AMCs Violating Regulations*, PEOPLE'S DAILY, Jan. 21, 2005, available at [http://english.people.com.cn/200501/21/eng20050121\\_171487.html](http://english.people.com.cn/200501/21/eng20050121_171487.html).

<sup>138</sup> Cai zheng bu, renmin yinhang, yin jian hui guanyu jiaqiang guoyou shangye yinhang buliang daikuan boli guocheng zhong zeren zhui jiu gongzuo de tongzhi [Notification on Identifying Responsibility in Transferring NPLs from State-Owned Commercial Banks] (promulgated by the Ministry of Finance, People's Bank of China, and the China Banking Regulatory Comm'n, Oct. 22, 2004); Jinrong zichan guanli gongsi zichan chuzhi guanli banfa [Measures on the Asset Disposition of Financial Asset Management Company] (promulgated by the Ministry of Finance, Apr. 30, 2004).

<sup>139</sup> *Id.*

<sup>140</sup> Fu Jing, *SOE Reforms Expected to End Within 3 Years*, CHINA DAILY, Dec. 21, 2004, available at [http://www.chinadaily.com.cn/english/doc/2004-12/21/content\\_401796.htm](http://www.chinadaily.com.cn/english/doc/2004-12/21/content_401796.htm).

<sup>141</sup> *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.