FINANCIAL HOLDING COMPANY SYSTEM AND RELEVANT LEGISLATION

by

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(Under the Direction of Charles R. T. O'Kelley)

ABSTRACT

Where should China's financial business be going? What would China's financial industry look like? Should it continue the segregation along different financial lines adopted since 1995, or repeal the lines? What kind of model of financial conglomeration should China adopt? These questions are particularly significant especially after China's entry into the World Trade Organization. According to the General Agreement on Trade in Service, China must open up the financial markets in five years. China's financial institutions will be facing international rivals by then. The United States and European Union has adopted the financial holding company and universal bank system respectively. This article will take analysis the advantages and disadvantages of these two systems, and answer questions mentioned above.

INDEX WORDS: Financial Holding Company (FHC), China, U.S., E.U., Universal Bank, Finance Conglomeration, Customer Privacy Protection, Supervision of Finance

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DEDICATION

To BING LEE, my husband

Thank you for all you have done for me.

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CHAPTER I

INTRODUCTION

"By the year 2015, you may not be able to tell what is a financial institution, what is a bank, and what is a nonfinancial institution."[1]

Alan Greenspan, Federal Reserve Board

Where should China's financial business be going? Should it continue the segregation along different financial lines adopted since 1995, or repeal the lines? Under the context of liberalization and globalization of financial industry, more and more countries are demolishing the walls between banking, securities and insurance industry, and permitting financial companies to provide multiple financial services. In the perspective of customers, they can enjoy "one-stop-shop" financial services within a integrated financial institution, just like grocery shopping; efficient and convenient. With respect to financial institutions, they can not only dramatically cut overlapping cost, but also to be put on the same foot in the international finance market to compete with their rivals.

This question is particularly significant now that China has entered into the World Trade Organization (WTO). According to the General Agreement on Trade in Service (GATS), China must open up its financial markets in five years.[2] Chinese financial institutions will be facing international rivals by then. The current financial system and legislation of China can hardly help

[1] Mark E. Nance & Bernd Singhof, *Banking's Influence over Non-Bank Companies After Glass-Steagall: A German Universal Comparison*, **14 Emory Int'l L. Rev. 1305** (2000).
[2] Kuan-Chun Chang, *The Supervision of Financial Conglomerates in China in the Post WTO Era – The Challenges of Risk Concentration and Risk Contagion*, **11 U. Miani Int'l & Comp. L. Rev. 1** (2003).

financial institutions win this competition. China has taken some reform steps, one of which is amending the Commercial Banking Law. In this amendment, China made an opening and left some room to officially establish the system of consolidation. This amendment can be seen as a signal of China's intention to conglomerate financial service industries.

The U.S. promulgated the Gramm-Leach-Bliley Act which created financial holding company (FHC) system to consolidate banking, securities and insurance. The Act sought to achieve three goals, (i) placing the domestic financial firms in a more competitive market to compete with international rivals,[3] (ii) improving financial services to consumers,[4] (iii) enhancing the safety and soundness of the banking industry.[5]

Previously, the European Union (E.U.) established a more flexible model which allowed the universal banking system (UBS), to fuse the financial boundaries among member countries in the E.U. and to foster international competition of financial institutions.

This article will first explore the legal framework of financial business in China in Chapter II, discuss the argument about the necessary of consolidation in financial industries, and then lead to the first sub-conclusion that China needs to take financial conglomeration. In Chapter III and Chapter IV, this article will give an overview to how the U.S. and E.U. establish their own financial systems. After going over the history of financial legislation of the U.S. and the E.U., this author will examine briefly the two financial conglomeration models, respectively in Chapter III and IV. In Chapter V, this article will further analyze the advantages and disadvantages of FHC system and UBS, and introduce a new phenomenon of financial corporation structure in German, which is a combination of existed financial conglomeration

[3] Vincent Di Lorenzo, *Gramm-Leach-Bliley Act Challenges Financial Regulators to Assure safe Transition in Banking Industry*, **72 N.Y. St. B. J. 36** (2000) ("Purpose of the Act").

[4] *Id.*

[5] *Id.*

models. This author will also explore which model is more optimal for China under current situation. The second sub-conclusion of this article is that FHC system is more promising for China. And the new phenomenon in Germany may give China some inspiration that China should not simply transplant the FHC system, but need to make some revision. Chapter VI will analyze three potential problems of establishing FHC system, privacy protection, safety and soundness of the financial industry, and supervision. It will compare the U.S. supervision system and that in different countries.

CHAPTER II

THE LEGAL FRAMEWORK OF FINANCIAL INDUSTRY IN CHINA

A. The Development of Financial Legislation in China

The period of real development in the financial industry and financial legislation is only about thirty years since 1978. Before that, banks were not even a profit-generating entity, but controlled and owned by the government,[6] and securities and insurance industry barely existed.

Pre-1978 period. Prior to 1978, banks in China were more like government bureaus than real financial entities.[7] Until the market liberation in 1978, their main responsibilities were allocating capital under the planned economy scheme[8], and implementing money policy[9].

China's "Glass-Steagall". Aimed to establish market economy and make banks operated like real banks[10], a wave of legislation passed in China in the field of financial services since 1995.[11] The first was the People's Republic of China Commercial Banking Law[12] which outlined the structure and operation of commercial banks.[13] Article 43[14] established the separation of commercial banking from other investment activities,[15] a Glass-Steagall like provision, which

[6] Andrew Xuefeng Qian, *Transforming China's Traditional Banking Systems Under the New National Banking Laws*, **25 Ga. J. Int'l & Comp. L. 479** (1996).
[7] Li Guo, *Financial Holding Company or Universal Bank? A Comparative Note on the Latest Amendment to China's Commercial Bank Law Art. 43*, **121 Banking L. J. 883**, 885 (2004).
[8] *Id.*
[9] Qian, *supra* note 6, at 479.
[10] "Real bank" means, according to the People's Republic of China Commercial Banking Law, that commercial banks should be operated under the principles of efficiency, safety and liquidity. They should not rely on the government like before, but on self-operation, self-risk management, self-responsibility for profits or losses, and self-restraint. Their operation should be independent and free from any interference of any work units or individuals. See Qian, *supra* note 6, at 488.
[11] Guo, *supra* note 7, at 885; see also Amy Chunyan Wu, *PRC's Commercial Banking System: Is Universal Banking A Better Model*, **37 Colum. J. Transnat'l L. 623**, (1999).
[12] See Commercial Banking Law of the People's Republic of China (adopted May 10, 1995).
[13] Wu, *supra* note 11, at 623.
[14] See Commercial Banking Law of the People's Republic of China, art. 43.
[15] Guo, *supra* note 7, at 885.

was reiterated and stressed in the People's Republic of China Security Law[16] and the People's Republic of China Insurance Law[17]:

> "Commercial banks *must not engage in trust investments or stock business* and *must not invest in immovable property* not for their own use, within the People's Republic of China. Commercial banks must not invest in non-banking financial institutions or enterprises within the People's Republic of China. The State Council shall formulate separate implementing procedures for commercial banks which have invested in non-banking financial institutions or enterprises prior to the implementation of this law."[18] (Emphasis added)

After promulgation, Article 43 was interpreted to demand commercial banks wind down the securities and trust activities of their subsidiaries or sell their brokerage subsidiaries.[19] The statutory of Article 43 and its interpretation is reminiscent of Glass-Steagall in the Banking Act of 1933 of U.S..[20] Interestingly, the U.S. was the only major country maintaining segregation according to the financial business lines at the time.[21]

China government adopted the "Glass-Steagall" like provision to prevent commercial bank funds from flowing into the securities market.[22] Known as "hot money", these funds poured into the fledgling securities market of China, searching for high, short-term profit, and then left as quickly, resulting in a vulnerable price of securities market.[23] Being in the deposit beyond loans situation from 1980s, Commercial banks had every reason to put funds into securities market

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[16] See The Security Law of the People's Republic of China art., 6 (promulgated on 29th Dec. 1998, effective from 1st July 1999, modified on 27th Oct. 2005); see also Guo, *supra* note 7, at 885-886 ("Securities business shall be engaged in and administered as a business separate from the banking business, trust business and insurance business. Securities companies shall be established separately from banks, trust companies and insurance companies").

[17] See The Insurance Law of the People's Republic of China art., 6 (promulgated on 30th June 1995, effective from 1st October 1995); also see Guo, *supra* note 7, at 885-886 ("only insurance companies formed in accordance with [Insurance Law] may engaged in the commercial insurance business and prohibited any other entity or individual from doing so").

[18] **I.A. Tokley** & **Tina Ravn**, **Banking Law in China**, 181 (Sweet & Maxwell 1997).

[19] Wu, s*upra* note 11, at 623.

[20] *Id.* at 625.

[21] *Id*. at 626.

[22] *Id.* at 627.

[23] *Id*.

while interest of loans was the principal source of their profit.[24] Loans by commercial banks were blamed as the major source of these speculative funds.[25]

Intention of Conglomeration. It is not incidental that more and more countries have pulled down their Glass-Steagall walls.[26] Not only could conglomeration make financial entities more profitable to pursue multiple services within an integrated corporate group, but also provide customers multiple financial services.[27] China has started to reconsider its separation policy, and made "a delicate but significant modification". An amendment of Article 43 was passed on December 27, 2003.[28]

"Commercial banks shall not be permitted to engage in trust investments and stock operations and shall not be permitted to invest in immovable property within the territory of the People's Republic of China that is not for their own use, *except other provided by the State*." (Emphasis added)[29]

This legislative revision did not do anything about the financial system in practical perspective, but showed that lawmakers are thinking about whether or not China should follow the conglomeration trend. By such "minor but significant change"[30], China gave itself a chance to repeal the "Glass-Steagall" provision and consolidate banking, securities and insurance if and when appropriate.

B. Follow the Conglomeration Trend in Financial Area

There are no existing statutory laws defined "financial conglomerates".[31] The Tripartitie Group of Bank, Securities and Insurance Regulators described "financial conglomerates" as "any group of companies under common control whose exclusive or predominant activities consist of

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[24] Guo, *supra* note 7, at 887.
[25] *Id*.
[26] Chang, *supra* note 2, at 5.
[27] *Id*.
[28] Guo, *supra* note 7, at 887-888.
[29] *Id.*
[30] *Id.*
[31] Chang, *supra* note 2, at 2.

providing significant services in at least two different financial sectors (banking, securities, insurance)." [32] According to this description, "financial conglomeration" relates to a group of enterprises, and it is formed by different types of financial institutions.[33]

Although many countries have founded consolidation system in financial industry, the argument never stopped about whether the conglomeration is affecting finance positively or not. Take U.S. for example, the proponents of the Gramm-Leach-Bliley Act (GLBA) believe the lines among different financial sectors should be broken. Financial conglomeration can synergize banking, securities and insurance, provide customers full-scale financial services and boost the stabilization of diversified financial institutions.[34]

The consolidated financial firms can enjoy more efficiency from the consolidation that is not available when the services are provided separately. For example, the FHCs can share the joint and common facilities, personnel, knowledge and brand name. They can market their products and services as a whole. They can efficiently use the financial expertise found inside the FHCs. And the diversification of the financial firms can provide more smoothing income stream, which is an important benefit for the stabilization of the financial firms.[35]

The opponents think that (i) so far there is little evidence showing that large financial conglomerated firms performed better than smaller or specialized ones, (ii) it is possible that the financial conglomeration could significantly threat the safety and soundness of financial industry, (iii) the current regulation of financial industry is not adequate to prevent potential risks.[36]

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[32] *Id.*
[33] *Id.*
[34] Bernard Shull & Lawrence J. White, *The Right Corporate Structure for Expanded Bank Activities*, **115 Banking L.J. 446**, 464 (1998).
[35] *Id.*
[36] Arthur E. Wilmarth, Jr. *The transformation of The U.S. Financial Services Industry, 1975-2000: Competition, consolidation, and Increased Risks*, **2002 U. Ill. L. Rev. 215**, 437-75 (2002).

Specifically, in objectors' views, managers of big FHCs have the intention to build an empire to fit into the "Too Big To Fail" (TBTF) status.[37] They are likely to take excessive risks in financial activities at the expense of the safety and soundness of the finance.[38] As a result, risks in banking sector, of federal safety net, and in whole economy will increase.

First, risks in banking sector will increase. Large banks pursued rapid growth in risky financial business tied to the capital markets, so they failed at a higher rate than small banks during 1971-1991.[39] These high risk financial activities seemed to make diversified financial firms more vulnerable to sudden downturn in the capital markets, not more stable.[40]

Second, risks of federal safety net[41] for banking will increase. When nonbank subsidiaries suffered in financial markets, the bank in the same FHC that has powerful reputational interests will have excessive incentives to rescue nonbank subsidiaries. Because customers can hardly tell whose financial services they are enjoying in a FHC, especially when the FHC tries to create a unified brand for the whole group.[42] Similarly, federal regulators will also be likely to protect nonbank affiliates in a FHC, because they don't want banking industry to be affected so that the whole economy is affected.[43] Thus, the mechanism which was designed to protect banking industry will extend to other sectors of finance with much higher risks.[44]

Third, consolidation risks in the whole financial services industry increased. Consolidating

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[37] *Id*. at 215.
[38] *Id.*
[39] *Id.*
[40] *Id.* at 445.
[41] Federal safety net is generally referred to the Federal Deposit Insurance Corporation (FDIC) deposit insurance, FRB payments system guarantees for banks and the FRB's authority to act as lender of last resort (LOLR) for both banks and nonbank firms. The Federal safety net paid nearly $200 billions to resolve the failures of 3000 banks and thrift institutions. See **Harding de C. Williams**, **Federal Banking Law and Regulations – A Hand Book for Lawyers**, 35-44 (2006); see also Wilmarth, Jr., *supra* note 36, at 224-25.
[42] Wilmarth, Jr. *supra* note 36, at 446-47.
[43] *Id.* at 446-50.
[44] *Id*.

different financial sectors means breaking the barriers separating banks, securities and insurance.[45] One of the main functions of these barriers is to insulate each sector from the other's problem so that one can act as an alternative finance source for the other to recover from the financial losses.[46] The opponents took the record of Japan during 1990 as an example. In 1990s, two of twenty largest banks, two major securities firms and three large insurance companies failed in Japan.[47] In addition, several big banks were on the edge of insolvent.[48] The financial industry stuck in a prolonged slump after that, because the banks were unable to provide credit, and the whole economy in Japan also suffered.[49] Analysts attributed this, in large part, to the massive exposures of the banking to the real estate market and the stock market.[50] As a result, when the real estate market and stock market collapsed at the same time, there were no other alternative financial resources available.[51]

In the U.S., the federal banking regulators implemented so-called "source of strength" doctrine, holding companies and their affiliates are required to cross-guaranteed.[52] Many analysts doubt this doctrine as the "firewall controversy",[53] although this requirement aimed at establishing a second line of defense against adverse transactions with affiliates.[54]

As discussed previously with regard to "hot money", there were obviously reasons that China separated commercial banking and investment business. Not all of these reasons have disappeared. However, after China joined the WTO, Chinese financial entities is facing more and

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[45] *Id.* at 451.
[46] *Id.*
[47] *Id.* at 451- 52.
[48] *Id.*
[49] *Id.*
[50] *Id.* at 453.
[51] *Id.*
[52] **William A. Lovett**, **Banking and Financial Institutions Law**, 164 -65, (Thomson West 2005) (1997).
[53] *Id.* The firewall of interaffiliate transactions is generally known as Section 23 (A) and (B) of Federal Reserve Act, imposing quantitative limitations and collateral requirement.
[54] *Id.*

more competition in the international finance market.[55] How to boost the competitiveness of financial institutions will become the highest priority. Actually, one of the main purposes of both the U.S. and the E.U. consolidated the financial sectors is to increase competitive of their financial institutions in the international finance market.

The brief background of international finance market is financial modernization, which rejects the direct supply of finance services and structure of firms by legal rules, but prefers competitiveness.[56] Blurred boundaries, conglomeration and functional despecialization are the characteristics of financial modernization.[57]

Blurred Boundaries. Gordon Brown, Britain's finance minister, said when pronouncing the decision to conglomerate finance services, "[i]t is clear that the distinctions between different types of financial institutions, which are banks, securities firms, and insurance companies, are becoming increasingly blurred."[58] More and more financial entities provide similar or even the same services.[59] Many countries blurred lines between banking, securities and insurance. The have undertaken radical reforms to respond.[60]

Conglomeration and Functional Despecialization. Conglomeration and functional despecialization are two, seemingly overlapping, but actually distinct, consequences of the blurred boundaries among different categories in financial business.[61] New types of financial entities are emerging. They combine two or more areas in banking, securities and insurance,

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[55] Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, **38 Tex. Intl'l L.J. 317**, 319 (2003).
[56] *Id*.
[57] *Id.* at 321-22.
[58] Chancellor of the Exchequer Gordon Brown, Speech to the House of Commons, **294 Parl. Deb., H.C.** (6th ser.) (1997) 510.
[59] Schooner & Taylor, *supra* note 55, at 321.
[60] Such as the United Kingdom, the United States, Australia, Japan and so on; see also Schooner & Taylor, *supra* note 55, at 321-322.
[61] Schooner & Taylor, *supra* note 55, at 321.

using standard contracts and the unbundling to deal with risks they have not faced before conglomeration.[62]

The blurring of boundaries, the conglomeration and functional despecialization are stealthily, but unassailably, happening.[63] In China, the Everbright Group has two banks, two securities firms, and one life insurance company. Other cases include the China Internantional Trust and Investment Corporation Group and Ping An Insurance Group.[64] The Chinese government has already noticed these changes, and considered about repealing the segregation in financial services, and has already made an opening in legislation.

The trend of conglomeration of financial services is undeniable. China is also, as a matter of fact, going through this conglomeration quietly. It is reasonable to concern the safety and soundness of financial industry if China decides to establish consolidated financial industry. China will adopt financial consolidation in the near future, because first, the consolidating trend has been emerging. Second, China's financial institutions need a new system and legislation to compete in the global financial marketplace.

[62] *Id.*
[63] Guo, *supra* note 7, at 898.
[64] *Id.*

CHAPTER III

THE LEGAL FRAMEWORK OF FINANCIAL INDUSTRY IN THE U. S.

After observing the necessary of conglomeration in financial industry in China, the next question will be what kind of financial corporate structure would be more suitable for China. In this and the next Chapter, an overview of how the U.S. and the E.U. adopted the corporate structure they are using will be made. From the history of their development of financial legislation, it is obvious that the U.S. and the E.U. have different viewpoints about financial consolidation. The E.U. viewed the conglomeration as a benefit for the financial industry to develop toward good directions. While the U.S. was more prudent in financial legislative reform, they took very cautious steps to complete the process of consolidation.[65]

Based on the different standpoints, the E.U. took UBS approach which involves both commercial banking activities (such as deposit-taking, lending, mortgage credit, trade financing, money-transmission services, guarantees and commitments, leasing, and factoring etc.) and transactions in securities.[66] It allows not only banks to own equity interests both in banking and nonbanking corporations, but also allows non-banking corporations to own up to 100% equity interests in a bank.[67]

The U.S., on the contrary, adopted FHC system. Banks can not pursue securities and insurance business directly, but through other subsidiaries in a group, because in lawmakers' eye, such nonbanking activities will be manageable in a holding company framework.[68]

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[65] George S. Zavvos, *Banking Integration and 1992: Legal Issues and Policy Implications*, **31 Harv. Int'l L. J. 463**, 481-82 (1990).
[66] *Id.* at 480.
[67] Nance & Singhof, *supra* note 1, at 1349-50.
[68] Constance Z. Wagner, *Structuring the Financial Service Conglomerates of the Future: Does the Choice of Corporate Form to House New Financial Activities of National Banks Matter?* **19 Ann. Rev. Banking L. 329**, 404 (2000).

A. The Development of Financial Legislation in the U. S.

The development of financial legislation of the U.S. began in 1863. This article will concentrate on the way the U.S. has moved from separation to consolidation and back to separation again.

The Glass-Steagall Act. The famous Glass-Steagall Act is the popular name of Section 16, 20, 21 and 32 of the Banking Act of 1933.[69] It is usually described as creating a "Legal Maginot Line" between commercial banking and investment banking.[70] Based on the assumption that the risky and speculative nature of investment banking made it undesirable to commingle investment bank activities with commercial banks responsible for public savings,[71] the Glass-Steagall Act prohibited commercial banks from engaging in certain securities activities.[72]

Section 16 and 21 were about direct operations of commercial banks, prohibiting deposit taking institutions from engaging in the business of issuing, underwriting, selling, or distributing, stock, bonds, debentures, notes or other securities.[73] Section 20 and 32 dealt with commercial affiliations.[74] Under Section 20 and 32, banks were not allowed to affiliate with a company "engaged principally" in certain enumerated activities with respect to securities underwriting and

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[69] Laura J. Cox, *The Impact of the Citicorp – Travelers Group Merger on Financial Modernization And The Repeal of Glass – Steagall,* **23 Nova L. Rev. 899**, 906 (1999).
[70] Jonathan R. Macey, *Symposium: Modernization of Financial Institutions The business of Banking: Before and After Gramm-Leach-Bliley,* **25 J. Corp. L. 691**, 716 (2000) (Calling Glass-Steagall Act "Legal Maginot Line" is suitable, because it had been breached by regulators broader interpretation long before the Banking Holding Company Act was passed).
[71] Guo, *supra* note 7 at 889.
[72] Williams, *supra* note 41, at 11 (It is interesting to notice that commercial banks are allowed to provide many financial services, including certain aspects of investment related activities, such as investment advisory services, brokerage activities, securities underwriting, mutual fund activities, investment and trading activities, asset securitization and so on. Besides, commercial banks are not prohibited from underwriting and dealing in securities outside of U.S.); generally see Cox, *supra* note 69, at 906-10.
[73] Cox, *supra* note 69 at 906-10.
[74] *Id.*

distribution,[75] or to link directorships or employee relationship with such company.[76] The words "engaged principally" are worthy to notice. It is through broader interpretation of section 20 by the Federal regulators that the restrictions of separating different financial sectors got loosen.[77]

The Glass-Steagall reflected three U.S. government concerns. The first concern was excessive concentration of economic power.[78] A bank would become too powerful in economy if it controlled enterprises other than banking.[79] Second, bankers would have had incentives to extend credit to the affiliates when they suffered great loss, or would be lopsided to the affiliates on terms.[80] Third, because of the conflicts of interest in multicapacity financial groups,[81] a bank might be hostile to the competitors of its affiliates engaging in the same non-banking activities.[82]

Undoubtedly, the Glass-Steagall Act intended to prohibit commercial banks from pursuing the investment banking business. Admitted or not, Glass-Steagall ensured safety and soundness of the U.S.'s banking industry.[83] However, almost as soon as it was passed,[84] doubts that the hazard and financial dangers might be outweighed and that the Glass-Steagall Act is overreaction arose.[85]

Bank Holding Company Act of 1956. There were loopholes in some provisions of the Glass-Steagall Act, such that nonbanking companies could pursue banking business through a

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[75] 12 U. S. C. §377 (1994).
[76] 12 U. S. C. §78 (1994).
[77] Heidi Mandanis Schooner, *Regulating Risk Not Function*, **66 U. Cin. L. Rev. 441**, 443 (1998).
[78] Schooner & Taylor, *supra* note 55, at 319.
[79] See **Michael Gruson**, **Banking Law – Guide to the Regulation of Financial Holding Companies**, 4 (LexisNexis 2002).
[80] *Id.*
[81] Schooner & Taylor, *supra* note 55, at 319.
[82] Gruson, *supra* note 79, at 4.
[83] Cox, *supra* note 69, at 923.
[84] James A. Leach, *Introduction: Modernization of Financial Institutions*, **25 J. Corp. L. 681**, 682 (2000). ("The most vocal proponent of its repeal was, ironically, one of the bill's authors, Senator Carter Glass. Only two years after the act was adopted, Glass believed it was a mistake and an overreaction.").
[85] Cox, *supra* note 69, at 911.

banking subsidiary, and in the mean while, nonbanking activities through itself or another nonbanking subsidiary.[86] To prevent such circumvention, the Bank Holding Company Act of 1956 (BHCA) was passed, restricting banking holding companies[87] (BHC) from nonbanking activities, which means a BHC may only own or control banks, other BHCs and subsidiaries engaging in the activities closely related to banking.[88]The BHCA also prevent nonbanking entities from owning or controlling a bank or a BHC, or becoming BHCs and thus subject to BHCA.[89]

BHCs are defined as financial entities that "own or control" one or more banks. "Own or control" means that ownership or control of 25 percent of the voting shares is required, or if the Federal Reserve Board (FRB) finds a controlling influence is exercised.[90] The holding company framework is favored especially by larger banks.[91] When the BHCA of 1956 was enacted, there were only 47 registered BHCs with 7.6 percent of the nation's bank deposits, but by the late 1980's there were more than 6000 BHCs which already owned most of the commercial bank assets.[92]

The BHCA separated banking and nonbanking business, while other countries already stepped toward conglomeration of them, so that U.S. banks were put in a significant disadvantage in the international finance market.[93] Being impatient with the legislative process, the FRB permitted commercial bank holding companies to engage in investment banking

[86] Gruson, *supr*a note 79, at 1.
[87] 12 U.S.C. §1841 (a) (1) (2000) (Definition of BHC).
[88] Gruson, *supra* note 79, at 1-2.
[89] *Id,* at 5.
[90] Lovett & Jones*, supra* note 52, at 196.
[91] *Id.*
[92] *Id.*
[93] Gruson, *supra* note 79, at 7.

business without allocating investment banks to enter business of commercial banking.[94] This behavior put investment banks at a disadvantage in the competition with commercial banks. The resistance to reduce the separation among different financial entities was diminished.[95]

Banks, especially investment banks, were not satisfied with BHCA. They wanted to engage in a wide variety of financial activities, including securities, insurance underwriting.[96] They achieved through the regulatory approval process without any statutory amendments.[97] In this process, the federal banking regulators acted to further accelerate and deepen the deregulation of restrictions.[98] Regulation Y, which governs the operation of bank holding companies, is an example. The FRB authorized BHC affiliates to engage in some nonbanking activities through a laundry list in Regulation Y.[99]

There were full of controversy during the process of deregulation by the regulators.[100] Competitors challenged the legality of such approval that a bank was allowed to engage in a nontraditional banking business, directly or through a subsidiary or an affiliate in the federal court.[101] Federal courts including the Supreme Court ratified many of these approvals.[102] Under the increasing pressure to give away the remaining restrictions along the financial business lines, and facing the factual erosion of these restrictions, the Congress passed the proposal of financial modernization and deregulation legislation.[103] Besides, Regulation Y did not touch certain areas of activities restrictions, such as sales of annuities and nationwide sales of insurance from small

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[94] Macey, *supra* note 65, at 716.
[95] *Id.*
[96] Wagner, *supra* note 68, at 334.
[97] *Id.*
[98] *Id.*
[99] Wagner, *supra* note 68, at 352-54.
[100] Wagner, *supra* note 68, at 350.
[101] *Id.*
[102] *Id.*
[103] Wagner, *supra* note 68, at 381-90 (about the legislative history of Gramm-Leach-Bliley Act of 1999).

towns under 5000, mutual fund underwriting, municipal bonds, distribution through Section 4(c)(8) subsidiaries, etc.[104]

Gramm-Leach-Bliley Act of 1999. Primarily to strengthen the competitiveness of U.S. banks,[105] after struggling and arguing for almost twenty years, the Congress amended the BHCA,[106] and promulgated the Gramm-Leach-Bliley Act (GLBA).[107] Although GLBA repealed the Glass-Steagall wall,[108] and abolished legally the separation on the commercial and investment banking industries, it is rather a formal recognition to the changes that had been taking place in the past twenty years.[109] Citicorp/Travelers merger, before GLBA passed, provided the clearest indication that much of the world envisioned by GLB already existed at the time of its enactment.[110]

Citicorp, a federally chartered BHC,[111] was unable to buy Travelers under BHCA, because Travelers' business was underwriting property and casualty insurance.[112] Instead, Travelers went to the FRB[113] for a new BHC charter, planning to buy Citicorp after the new bank holding company, which was Citigroup, founded. Thus, the Citigroup got five years to divest its

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[104] Id. at 355.
[105] Gruson, *supra* note 74, at 7; see also Leach, *supra* note 79, at 682 ("While competition should be opened up in finance, the American model of separating commerce from banking should be maintained. Indeed, this legislation plugs the current loophole in this system--the ability of commercial firms to own federally insured unitary thrifts").
[106] Williams, *supra* note 72, at 137.
[107] The GLBA was endorsed by President Clinton on Nov. 12, 1999.
[108] GLBA did not repeal thoroughly the Glass-Steagall Act, but Section 20 and 32 (the affiliation and management interlock prohibitions), Section 16 and 21 are still effective; see Leach, *supra* note 84, at 684.
[109] Macey, *supra* note 70, at 691-92.
[110] Carl Felsenfeld & Genci Bilali, *Business Divisions From the Perspective of the U.S. Banking System*, **3 Hous. Bus. & Tax. L. J. 66**, 126 (2003).
[111] The banking system of U.S. is dual, national charted and state charted banks. The Federal tried to unify the banking system through the National Banking Act of 1864. However state charted banks won, so the dual system continues until now. Generally see Williams, *supra* note 72, at 1-27.
[112] Cox, *supra* note 69, at 922.
[113] Under BHCA, the FRB was responsible to supervise and charter BHCs.

insurance business.[114] Obviously, Citigroup was gambling that the Congress would change the separation policy in finance business in the five years it got,[115] instead of getting rid of the nonconforming business.[116]

Like Wal-Mart, Citigroup provides a broad array of financial products and services. Combining the advantages of Citicorp's client relationship and Travelers' products gave Citigroup great competitiveness.[117] Citigroup is a successful example of a good way to become a significant financial services provider. It is well equipped with the resources of its affiliates, cut overlapping costs[118] and operated in a more efficient way.

It is hard to say GLBA is a landmark in financial legislation in the U.S.. GLBA's main purpose to pull down he Glass-Steagall wall has been called a "dead letter".[119] As mentioned above, banking regulators have taken steps to permit "expansion by banks into the securities market through progressively more liberal interpretations of the 'engaged principally' clause of Section 20 of Glass-Steagall" long before GLBA passed.[120] Furthermore, GLBA did not create a new form of financial entity, but rather set a series of qualifications for BHCs to become FHC. By becoming FHC, under GLBA, the company may engage in any activities that are financial in nature, or incidental to financial activity, or complementary to a financial activity.[121]

Even though many critiques rose from all directions about the FHCA, the stock market

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[114] Generally see Cox, *supra* note 69 (Under BHCA, new bank holding company can have two years to divest activities not allowed by the act, after that, the company was able to be granted by the FRB three one-year extensions, so it is five years totally).
[115] Sarah Smith, *Gramm-Leach-Bliley: The Effect of Interim Rulings on German Banks*, **8 ILSA J. Int'l & Comp. L. 663**, 671 (2002).
[116] Cox, *supra* note 69, at 922.
[117] Felsenfeld & Genci Bilali, *supra* note 109, at 128.
[118] *Id.* at 127-128.
[119] Macey, *supra* note 70, at 707.
[120] Schooner & Taylor, *supra* note 52, at 320.
[121] Charles M. Horn & Brian W. Smith, *Financial Modernization in the New Millennium: Implementation of the Gramm-Leach-Bliley Act*, **116 Banking L.J. 689**, 692 (1999).

reacted positively to its passage, both commercial and investment banks stock rising.[122] Also, the market responded favorably to the shares of BHCs that had already engaged in some securities business.[123] Proponents believe that diversified FHCs that pursued multiple financial activities are far stronger than specialized but less-diversified rivals, and the combination of banking and securities businesses can make financial institutions and the economy safer.[124]

B. Summary of Financial Holding Company System

In a nutshell, FHC is "a combination in a holding group of banks, insurance companies, and securities companies".[125] That means that in order for either a bank or an insurance company or a securities company to offer financial services other than its original business, it must do so through a holding company.[126] It is noticeable that FHCs are still precluded from carrying on non-financial activities, and companies that are not engaging in financial activities are not allowed to acquire U.S. banks, directly or indirectly.[127]

FHCs are a subgroup of BHCs, whose depository institutions are well capitalized, well managed, and have met the rating requirement.[128] BHC and FHC are allowed to carry out different businesses. BHCs that did not meet the requirements to become a FHC were subject to the restriction of Section 4(a) of BHCA[129], prohibiting banks from engaging in securities and insurance.[130] As for the FHC, it has a much more flexible business scope than BHC. It may own

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[122] Guo, *supra* note 7, at 894.
[123] *Id.* at 903.
[124] Macey, *supra* note 70, at 720.
[125] Gruson, *supra* note 79, at 7.
[126] Jefferey Lemieus & Patrick Lincoln, *Banking Reform and Regulatory Relief*, **19 Ann. Rev. Banking L. 2**, 7 (2000).
[127] Gruson, *supra* note 79, at 7.
[128] *Id.* at 8.
[129] 12 U.S.C. §1843 (a) (2000).
[130] Gruson, *supra* note 79, at 7.

broker-dealers, other financial service providers and insurance companies, and became a broker-dealer, financial provider or an insurance company that owns a bank.[131]

Through the FHC system, financial services holding companies employ different financial services in separate subsidiaries.[132] This diverse structure allows economies of scope and the smoothing of income flow[133] to the shareholders of the holding company.[134] The advantages include (1) because of the efficiency and its income flow of the banks, financial institutions' risk of insolvency from the variance of its income stream is not affected directly;[135] (2) the bank can benefit from the source of strength of its holding company or the nonbank subsidiaries when the bank suffers losses.[136]

BHCs are not disappearing under FHCA. The BHCs that do not satisfy the requirements to become FHCs remain subject to the BHCA, and can not engage in securities and insurance activities. Although remaining BHCs can still apply to the FRB to get permitted of going into one financial activity listed in Regulation Y that are closely related to banking, the FRB does not have the right to extend or expand the laundry list of activities on the Regulation Y. Therefore, under the GLBA, there were two classes of banks. One is for the banks that are able to participate in the U.S. to traditional banking activities. And the other is for the banks that are restricted in the U.S. to traditional banking activities.[137]

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[131] *Id.*
[132] Macey, *supra* note 70, at 721.
[133] Shull & White, *supra* note 34, at 470.
[134] Macey, *supra* note 70, at 721.
[135] *Id.*
[136] *Id.*
[137] Gruson, *supra* note 79, at 194.

CHAPTER IV

THE LEGAL FRAMEWORK OF FINANCIAL INDUSTRY IN THE E.U.

A. The Development of Financial Legislation in the E.U.

The E.U. has been vigorously working to deregulate the process of entry into domestic financial markets and foster its international competitiveness of financial institutions for decades.[138] The First Banking Directive and the Second Banking Directive (SBD) are the milestones of financial legislation in the E.U..

Pre-Second Banking Directive. Prior to the SBD, there were three financial services models in Europe, the UBS model, the Belgian system model, and the hybrid model.[139] The universal banking model[140] allowed commercial banks participate in the securities and other financial services.[141] The Belgian model strictly restricted banks from involving in the securities business.[142] And hybrid model employed Chinese walls between a bank's commercial banking and securities activities.[143]

The European Economic Community (EEC)[144], the most active and influential organization in international securities regulation,[145] adopted a series of directives in the area of financial

[138] Samuel Wolff, *Securities Regulation in the European Community*, **20 Denv. J. Int'l L. & Pol'y 99**, 99-101 (1991); also see Jennifer Manvell Jeannot, *An International Perspective on Domestic Banking Reform: Could The European Union's Second Banking Directive Revolutionize the Way the United State Regulates Its Own Financial Services Industry?* **14 Am. U. Int'l L. Rev. 1715**, 1731 (1999).
[139] Zavvos, *supra* note 65, at 481.
[140] The universal banking system was adopted in Germany and the Netherlands. The E.U. universal banking system is largely based on that of Germany.
[141] Zavvos, *supra* note 62, at 481.
[142] *Id.*
[143] Guo, *supra* note 7, at 895.
[144] The European Economic Community was founded by the Treaty of Rome signed by six countries in 1957. It, together with another two, constitutes the "European Communities". See Wolff, *supra* note 137, at 102-105 (introduction to the Community).
[145] Wolff, *supra* note 137, at 99.

services since 1957.[146] First Banking Directive in 1977 and SBD in 1989, especially the latter, established the present UBS in EEC.[147]

First Banking Directive made the first major steps[148], toward unifying European banking laws.[149] It sought to eliminate banking service barriers among Member States, promote the free establishment of branches in other Member States, consolidate authorization requirements for credit institutions and supervisory standard, and mandate equal treatment of non-European Union credit institutions.[150] Yet, First Banking Directive did not, to some extent, abolish the restrictions among Member States.[151] For instance, a bank needed to obtain authorization, based on one member state, from eleven different states to branch throughout the EEC.[152] SBD completed this job later.[153]

SBD[154], the centerpiece of banking law in the EEC[155], established mutual recognition, a

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[146] Jeannot, *supra* note 137, at 1731-32.
[147] *Id*. at 1731-35.
[148] Michael Gruson & Wolfgang Feuring, *The New Banking Law of The European Economic Community*, **25 Int'l Law. 1**, 2 (1991) ("The First Banking Directive of December 12, 1977, took only a few steps in the direction of the creation of an EEC-wide banking market.").
[149] Jeannot, *supra* note 136, at 1731-33.
[150] *Id*.
[151] *Id*. at 1732-33.
[152] Wolff, *supra* note 137, at 121.
[153] It is interesting to note that The First Banking Directive has not been substituted by the Second Banking Directive, because it still remains the principal source of EEC law in the respect of the establishment of branches in Member States by non-EEC credit institutions; see Gruson & Feuring, *supra* note 147, at 3.
[154] Besides SBD, the EEC adopted two other directives in 1989 relating to capital and solvency requirements for banks. The SBD allows a bank to provide a variety of banking services, including investment banking services, if authorized by its home state, throughout the Community on the basis of a single license. … These licenses will allow banks and investment firms to tap potential market of 320 million customers. The SBD also establishes a single banking license applicable throughout the Community for the provision of banking services authorized by the home state. Banks authorized in their home state also will be able to provide in vestment banking services on a community-wide basis pursuant to the single license. This is expected eventually to lead to wider acceptance of 'universal banking' (provision of both commercial and investment banking services) throughout the Community. The SBD permits entities from non-member states to operate in the EEC through subsidiaries, but establishes a procedure under which they may be excluded if EEC banks experience difficulty in accessing the markets of such non-member countries. The SBD contains an important grandfathering provision for previously

single banking license, and an agreed-upon list of banking activities applicable in the Member States,[156] eventually led to the achievement of UBS in the E.U..[157]

First, mutual recognition mandates that if a kind of financial service is legal in one E.U. country, it can not be proscribed under similar conditions in another E.U. country.[158] Second, the single banking license provides that a bank is allowed to transact certain financial activities in any Member State, if it is authorized in its home country to engage in the same endeavors.[159] Third, an agreed-upon list of banking activities requires the E.U. countries to allow the activities listed in the Annex to the SBD to be carried on within their territories.[160]

The application of the three principles above allows credit institutions[161] authorized in the Home Member State, to establish branches and to provide financial services in any other Member State without requiring any authorization by the Host Member State.[162] In other words, any credit institution authorized in its Home Member State may pursue the same activities in the Host Member State even if such activities are not permitted under similar circumstances in the Host Member state and vice versa.[163] As a consequence, member countries of the E.U. have strong incentives to harmonize their banking laws with SBD by liberalizing their own regulation.[164]

Most notably, the UBS was not imposed on all the member states under the framework of

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established institutions. For information about SBD; generally see Wolff, *supra* note 137, at 99-101.

[155] Gruson & Feuring, *supra* note 147, at 1.

[156] Jeannot, *supra* note 137, at 1734.

[157] *Id.*; also see Guo, *supra* note 7, at 895.

[158] *Id.*

[159] *Id.*

[160] *Id.*

[161] A credit institution is "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account"; see Gruson, Feuring, *supra* note 147, at 13.

[162] Gruson, Feuring, *supra* note 147, at 3.

[163] *Id.* at 4-5.

[164] Jeannot, *supra* note 137, at 1735.

the SBD. The single banking license actually leaves room for hybrid financial systems. However, the option to adopt UBS will confer a competitive advantage on banks.[165] Undoubtedly, SBD actively promoted the development of UBS in the E.U..

B. Summary of Universal Banking System

In a universal bank, both commercial banking and investment banking activities can be conducted in a thoroughly integrated bank.[166] Based on the Annex's list of conforming activities, commercial banks are allowed to engage in transactions for their own account, and for the account of their customers, and are able to participate in share issuances and related services.[167]

Compared to the system of FHC in the U.S., European financial institutions enjoy more expansive powers, according to the SBD. The Directive's annex set forth the activities that European financial entities can engage in including: integrated banking, securities and insurance.[168] The most significant difference between FHC and universal banks is that the SBD explicitly permits commercial banks to enter into the securities business. Those activities can be done by the same corporate entity.[169]

Comparing the U.S. and E.U.'s paths, it is clear that the legislative concerns are fundamentally different. The U.S. intended to maintain the safety and soundness of financial system, therefore viewing the expansion of commercial banks into securities activities as an increase of risks of the economic health,[170] so that they took a more cautious way to complete the consolidation. On the contrary, the E.U. thought that first the diversification would actually

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[165] Zavvos, *supra* note 62, at 483-84.
[166] Shull, White, *supra* note 34, at 469.
[167] Jeannot, *supra* note 137, at 1736.
[168] *Id.* at 1735.
[169] *Id.* at 1737.
[170] *Id.*

decrease the risks and increase the health of finance industry.[171] Second, permitting bank participation in te securities industry secures bank earnings when traditional banking business is less profitable because of adds depth and liquidity to them.[172] Third, the E.U. also believed that the conglomeration would also make both commercial banks and investment banks more profitable.[173]

There are also critics of UBS. The most significant criticism is that the stand-alone universal bank might become vulnerable because of its size.[174] Therefore it is interesting that, in Germany, on which the UBS of the E.U. is mainly based, a combination of universal bank and FHC like financial enterprises, a financial services holding structure, is emerging and is generating attention.[175]

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[171] Jeannot, *supra* note 137, at 1738.
[172] Zavvos, *supra* note 62, at 481.
[173] Jeannot, *supra* note 137, at 1738.
[174] Nance, Singhof, *supra* note 1, at 1358.
[175] *Id*.

CHAPTER V

WHETHER FHC OR UBS SERVE CHINA'S FINANCIAL INDUSTRY BETTER?

Before step into the analysis of the optimal corporate structure for China, this article will set three standards. In other words, what goals we want achieve from this reform of financial legislation. There is no doubt that whichsoever approach cannot be a beauideal, not only because FHC, universal bank, or any other approach would have some inherent problems of themselves, but also the practical situation of China needs to be carefully reckoned. Thus after set up the framework of analysis, in part B and C, this article will lay out the advantages and disadvantages of FHC and UBS, and explore the observations of different approach supporters and objectors under the circumstances of China. And then, part D will introduce a new phenomenon in Germany combining both approaches. Finally this Chapter will lead to the second sub-conclusion that although FHC system is more promising for China than the UBS, simply transplanting any of them might not work. And a new financial corporation structure emerging in Germany may give us some inspiration.

A. Standards

The three standards are safety and soundness, impartial allocation of credit, and limitations on the concentration in the banking industry.[176]

Safety and Soundness. Safety and soundness is the most basic and important rationale to decide whether the corporate structure is optimal or not. As a matter of fact, it is also why financial industry, especially banking industry is the highest regulated industry. It is important for lawmakers of China to think carefully that the purpose of safety and soundness is not to prevent

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[176] Wagner, *supra* note 68, at 343

individual financial firms from failing, but to avoid the destabilizing effect on the economy that would triggered by financial corporations' failure.[177] Because the biggest four banks in China are all state owned, which are generally called the States Owned Commercial Banks (herein SOCB) still have some marks of planned economy. The SOCBs often lend for reasons other than pure credit evaluation.[178] The complication of the duel status of SOCBs as both financial corporations and executor of administration leads them not to give much consideration to risk, when they make managing decisions.[179] Thus if the banks do not change their thinking, same problems even severer would happen in the capital markets when banks are allowed to enter securities market.[180]

Impartial allocation of credit. Due to the significant status as the source of capital for other industry, banks should allocate capital based on neutral economic criteria, which generally means preventing conflict of interest transaction involving extensions of credit to insiders and affiliates.[181]

Limitations on concentration in banking industry. As discussed above, it could be dangerous if very few institutions have controlled over vast aggregations of capital.[182]

B. Pros and Cons of FHC System

The U.S. approach seems very promising for China. Actually, it is becoming more and more popular in the past few years in China. Some comprehensive financial holding group companies

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[177] *Id.*
[178] Guo, *supra* note 7, at 905-06.
[179] *Id.*
[180] *Id.*
[181] Wagner, *supra* note 68, at 343.
[182] *Id.* at 344.

already exist.[183] These companies are forming a very influential interest group which is putting pressure on the legislative.[184] According to the empirical experience in the U.S., the advantages of FHC system include:

"(i)desirable for the maintenance of financial stability, avoidance of financial crises, and beneficial risk taking; (ii) greater government ability to direct resources; (iii)greater efficiencies through economies of scale; (iv)promotion of entrepreneurship through the development of an active market for securities; (v)less concentration of power; (vi) enhanced competition, greater consumer choice; (vii) avoidance of abusive practices, such as tie-in sales and favoritism; and (viii) fewer conflict –of-interest situation."[185]

The disadvantages of FHC system include:

"(i)an adverse effect on public confidence if the bank or affiliate performs poorly because of the association in the mind of the public[186]; (ii) the risk of unsound loans to the ailing affiliate in an effort to raise public confidence; (iii) the risk that the bank may provide credit more freely to companies in which the affiliate has a vested interest; (iv) the risk that the bank may act more as a sales man than as an unbiased source of credit; (v) the risk that customer goodwill diminish if losses are incurred because of the affiliate; (vi) the loss of reputation for prudence and restraint because of investment banking needs; (vii) the temptation to make loans merely to facilitate the purchase of more securities; (viii) conflicts of interest between the need to offer impartial advice as a commercial bank and the salesman's interest as an investment bank."[187]

Last but not the least, the bankruptcy of a non-bank affiliation would have negative effects on the bank, if (a) the creditors of the non-bank affiliate take the bank's assets to satisfy their claims, or (b) the bank loses customers because its reputation is ruined by the bankruptcy of the affiliate, or (c) the bank has a significant ownership in the affiliate, or (d) the holding company tries to save the affiliate by transferring assets from the bank to the affiliate.[188]

The opponents of establishing FHC system in China mainly ground, besides the claiming

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[183] Guo, *supra* note 7, at 898.
[184] *Id.*
[185] **George J. Benston**, **The Separation of Commercial and Investment Banking,** 6-10 (1990).
[186] Even the U.S. Congress thought about cutting back the GLB due to the concerns about conflicts of interest between the banking and securities businesses. Such as the concern that banks tried loans to underwriting. This concern might be not necessary if the bank had more leverage in the lending market. See Guo, *supra* note 7, at 898-99.
[187] *Id*; also see Investment Company Institute v. Camp, 401 U.S. 617 (1971).
[188] Shull & White, *supra* note 34, at 471 ("Points (c) and (d) highlight the importance of 'firewall' restrictions on a bank's transactions with an affiliate").

advantages of this system, such as convenient exchange of client information, cross-marketing one another's products, sharing facilities and economic and productive benefit,[189] on the current situation that some comprehensive FHCs already existed.

The proponents doubted that the holding company structure was created to bypass the Glass-Steagall Act, and to serve the U.S. dual banking system.[190] Also, there is few sophisticated investment players in China, and the four SOCBs play key role in China economy.[191] Thus, the proponents concern that FHC system would lead China back to rampant 'hot money', and would let the SOCBs dominate most of the financial sector, so that there will be undesirable effect of decreasing competition.[192]

C. Pros and Cons of UBS

In a universal bank, both traditional and non-traditional activities can be conducted in an integrated bank.[193] No firewalls separate any type of banking activities from another.[194] Both advantages and disadvantages of this approach deprive the closeness of segments in universal banks.

Highly efficient might be the most mentioned advantage of UBS by its opponents. The UBS allows the bank to maximize the cooperation between different financial businesses, traditional or non-traditional.[195] Some observers believe that the traditional Continental –style universal bank has proven to be a highly efficient type of bank with considerable merits and success

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[189] Chang, *supra* note 32, at 1.
[190] Guo, *supra* note 7, at 902.
[191] *Id.*
[192] *Id.*
[193] Shull & White, *supra* note 34, at 467.
[194] *Id.* at 467-70.
[195] *Id.* at 470.

enabling it to survive without any great changes.[196] Dismantling walls between banking and commerce enhanced at the most the efficiency and increased competitiveness abroad stemming from the ability of banks to better monitor borrowers and reduce associated costs.[197] And the universal bank has less incentive to support one segment of the organization at the expense of another, because they are so closely related that they are not willing to sacrifice any of its segments.[198]

The drawbacks of UBS's include (a) dangers of transferring its depositors' funds from investment and commercial banking under one roof; (b) possible abuse of information; (c) dangers to competition deriving from the ability of banks to become permanent shareholders.[199] Last but not least, some analysts think the ability of the universal bank to extend its business to a new market might pose the greatest risk from this new activity causing big problem to the banking segment, which might also pose great threat of regulatory expansion.[200]

Some commentators believe that the universal bank model is more appropriate for China, on the basis of analysis of Germany situation. They observed that the Chinese banking system resembles the German banking system in four aspects. First, both tie to industry.[201] Due to underdeveloped securities market and concentrated banking industry, Germany and China's banks are able to develop extensive relationship with their corporate clients.[202]

Second, in the aspect of allocative decision making, German universal banks make credit decisions based on rational economic risk analysis.[203] They could also rely upon accumulated

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[196] Nance & Singhof, *supra* note 1, at 1403.
[197] *Id*. at 1402-03.
[198] *Id.*
[199] *Id.* at 1403-04.
[200] Shull & White, *supra* note 34, at 470.
[201] Wu, *supra* note 11, at 633-38.
[202] *Id.*
[203] *Id.* at 635.

experience and knowledge of the inherent risks in investment banking when making investment decisions.[204] Specifically to China, it is experiencing a highly decentralization through economic reforms. Explicitly providing that commercial banks shall operate independently and releasing the burden of making policy loans by commercial banks, Chinese authorities show their determination to relinquish administration control over banking.[205] Banks in China will enjoy more and more autonomy in decision-making.

Third, central banks of both countries provide strong regulatory support.[206] German central bank takes steps to stabilize the weakening banks in the earlier stage.[207] PBOC had, CRBC has also been taking its responsibilities of cleaning up the banking disorder seriously.[208]

Fourth, de facto division isolates banking industry into specialty areas.[209] In German, such division has been going with banking industry since the incipient years.[210] In China, banking structure could also be distinguished along product lines, which is similar to that found in Germany.[211] The specialized and commercial banks dominate the deposit – taking business, the trust investment companies would be the veteran experts in investment banking activities, the Rural Credit Cooperatives and the Urban Credit Cooperatives serve the regional needs of individuals and smaller enterprises.[212]

The objectors contend that although China's banking system resembles the German banking

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[204] *Id*.
[205] *Id*. at 639-40.
[206] *Id*. at 633-38 (The Current Supervision Framework of China, since 2003, CBRC is authorized, instead of PBOC – central bank of China, to supervise and regulate banks, assets management companies, trust and investment companies and other deposit-taking institutions).
[207] Wu, *supra* note 11, at 635.
[208] *Id*.
[209] *Id*. at 633-38.
[210] *Id*. at 636.
[211] *Id.* at 641.
[212] *Id.*

system more closely than that of the U.S., there are still two characteristics cannot be ignore.[213] First, German banks have more autonomy and are freer from control by the government or their clients than China banks.[214] Second, Germany has a more active and competent banking regulator than China.[215] China started the decentralization reform in economy not more than 30 years. Due to the high closeness among financial sectors in finance of UBS, it requires more skillful, experienced and sophisticated bankers and regulators, which so far China does not possess. Therefore adopting universal bank system might cause China financial enterprises distress.[216]

D. An Interesting Change of Combining Both of the Approaches

As discussed above, whether from the feasibility or the aspect of current situation of China, FHC approach would be more promising for China. There are still some doubts concerning this approach, though. Simply transplanting one system might not work for China.

Interestingly, there is a new financial corporate structure emerging in Germany today. Separate banks with strengths in certain business are grouped and managed under the direction of a parent bank company.[217] This new financial service holding structure is popular in Germany without being singled out for special regulatory treatment.[218] By doing this, German is trying to avoid the disadvantages of the UBS and assimilate the advantages of FHC system.

One must take into consideration China's current situation when decide which system to adopt. The undeveloped financial enterprises and supervision in China will be an obstacle to the

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[213] Guo, *supra* note 7, at 898.
[214] *Id.*
[215] *Id.*
[216] *Id.*
[217] Nance & Singhof, *supra* note 1, at 1358.
[218] *Id.*

adoption of the UBS. Therefore, the FHC system seems more promising. Yet because of the disadvantages of FHC, it is not sure if it will lead China fulfilling the goals of financial legislation reform. Germany set a good example by creating a hybrid derived from FHC and the UBS.

CHAPTER VI

THE POTENTIAL PROBLEMS

The financial business is the foundation of a developed and stable economy. We need to be prudent to decide the direction that financial law of China is heading. In this Chapter, article will analyze respectively three main problems deserve more consideration when lawmakers of China are pursuing the conglomeration reform in finance. The three issues are privacy protection, safety and soundness, and supervision and regulation.

A. Privacy Protection

Privacy protection is among the most important and most controversial aspects of the new financial services legislation.[219] Although to customers sharing information among affiliations in a financial group is not much different than among departments in a corporation, and they might hope to get a "one-stop-shop" kind of financial services from the information sharing, they are afraid that companies will exploit their privilege[220] to access and misuse the information in the course of offering services. Furthermore, because of the development of internet[221] and the close relationship among affiliates in a financial group, the protection of consumer's privacy will become critical. Just like some legal scholars remarked, "privacy law is part of a national legal system and must be fitted into this system with proper respect to its legal environment and national institutions."[222]

Since the 1960s the U.S. has passed legislation to protect consumers' privacy mandated on

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[219] Macey, *supra* note 70, at 713.
[220] *Id.*
[221] Schooner & Taylor, *supra* note 55, at 327.
[222] Virginia Boyd, *Financial Privacy in the United States and The European Union: A Path to Transatlantic Regulatory Harmonization*, **24 Berkeley J. Int'l L. 939**, 967 (2006).

banking regulators.[223] GLB continued this job by providing in Title V that "[i]t is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information."[224] According to Title V, affiliates may share consumers' information inside the FHC, but not with third parties.[225] A more detailed look at Title V of GLB is as follows:

What kind of entities subject to Title V? Financial institutions. GLB did not restrict the financial institutions in a FHC, but created a broad definition of such financial institutions. As long as an institution is carrying on a business permissible for FHCs, it is subject to Title V, regardless whether it is actually part of a FHC[226]

What kind of information is protected? Non-public personal information. Non-public personal information means information that is provided by a customer to a financial institution, or results from a transaction, and obtained by the financial institution.[227]

What is the requirement for financial institutions? No disclosure. The financial institutions are prohibited from disclosing to a nonaffiliated third party any information that meets the requirements of non-public personal information as mentioned above.[228]

Under what circumstances can financial institutions disclose? There are six exceptions to the no-disclosure requirements for financial institutions. First, the disclosure is to perform

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[223] Schooner & Taylor, *supra* note 55, at 327.
[224] Id.
[225] Macey, *supra* note 70, at 714; also see 145 Cong. Rec. H5310 (daily ed. July 1, 1999) (statement of Rep. Oxley).
[226] Robert M. Jaworski, *Title V of Gramm-Leach: One Small Step for Consumers, One Giant Leap for Financial Institutions*, **116 Banking L.J. 770**, 771 (1999).
[227] Id.
[228] Id.

services for or functions on behalf of the financial institutions.[229] Second, the disclosed information is necessary to effect a consumer-requested transaction.[230] Third, the disclosed information is needed to protect the confidentiality of the institution's records.[231] Fourth, the disclosed information is given to a person holding a legal or beneficial interest relating to the consumer.[232] Fifth, the disclosure is permitted by the Right to Financial Privacy Act of 1978.[233] Sixth, the disclosure is connected with a proposed merger or acquisition of business and concerns consumers of such business.[234]

Nevertheless, the consumers are always allowed to opt out. In other words, the consumers only have the right to restrict their non-public personal information from nonaffiliates.[235] They cannot choose to restrict the disclosure of information to affiliate companies within the bank holding company structure.[236]

Privacy Protection for online banking. Electronic and online banking pose new problems concerning the security of consumer information provided via the Internet. However, to date, most of the U.S. online privacy statutes are about children or some specific abuses. Website operators are not imposed any responsibilities for customers' privacy protection.

B. Safety and Soundness

Conglomeration in the financial area is a global trend. However, separation made more sense for financial safety.

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229 Jaworski, *supra* note 225, at 771-72.
230 *Id.*
231 *Id.*
232 *Id.*
233 *Id.*
234 *Id.*
235 Macey, *supra* note 70, at 714.
236 *Id.*

Strict threshold to be a FHC. GLB enumerated a series of standard to decide what FHCs could or could not do, one of which is "does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[237] In order for a BHC to become a FHC, it needs to meet certain eligibility requirements: (i) filing a declaration with the FRB, (ii) all its depository institution subsidiaries are both well capitalized and well managed.[238]

The consequences will be harsh if the FHCs fail to meet these requirements and maintain their status as a FHC.[239] For example, the FRB could force a sale of any subsidiary bank or mandate the FHC to cease any new activities that not previously permitted for a BHC.[240]

Limitation on the size of subsidiaries. The aggregate consolidated assets of all financial subsidiaries must not exceed 45% of the bank's total assets or $50 billion.

Rating requirement of subordinating debt. A bank among first 50 largest insured banks, is required to get rated by a nationally recognized rating agency in one of the top three investment grade categories, when it subordinates debt.[241] If a bank is one the second 50 largest insured banks, the FRB and Department of Treasury set another comparable and consistent rating requirement.[242] If a bank fails the rating requirement, it is prohibited from making any further equity or debt investment in any financial subsidiaries.[243]

Risk management and corporate identity. The bank is required to have in place procedures to identify and manage financial and operational risks which adequate to protect itself.[244]

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[237] Schooner & Taylor, *supra* note 55, at 325; slso see 12 U.S.C. §1843 (k) (4) (2000).
[238] 12 C.F.R. §208.43.
[239] Schooner & Taylor, supra note 55, at 325 (The FHC has 45 days to execute a corrective agreement and 180 days to correct); also see Lorenzo, *supra* note 3, at 39.
[240] Schooner & Taylor, *supra* note 55, at 325.
[241] Lorenzo, *supra* note 3, at 39.
[242] *Id.*
[243] *Id.*
[244] *Id.* at 39-40.

C. Supervision

The current supervision framework of China. Until 1992, the People's Bank of China (herein PBC), as the central bank, was the only supervisor of financial business in China.[245] Another two regulatory institutions were founded in 1992 and 1998, successively. First is the China Securities Regulatory Commission (CSRC), in charge of supervising the securities area, and second is the China Insurance Regularity Commission (CIRC), whose responsibility is regulating insurance industry.[246] Most notably, the China Banking Regulatory Commission, created in 2003, which manifested that regulation system in China is making a structural adjustment.[247] The PBC finished its regulatory power lasted for more than twenty years, and left this to the CBRC. This can be also seen as an indication that China is thinking about taking functional regulation.

Institutional Regulation and Functional Regulation. Technically, there are two types of regulation models in finance. One is institutional regulation and the other is functional regulation.[248] The difference is institutional regulation means the division among regulators is based on the institutional identity of the companies conducting activities, while under functional regulation, regulatory authority is allocated on the basis of the nature of the activities.[249]

The supervision provision of GLB. Prior to the passage of GLB, U.S. adopted institutional regulation. Financial institutions were regulated along industry lines.[250] For the banking industry, there are three federal agencies: the FRB, the Office of Comptroller of the Currency (OCC) and

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[245] Guo, *supra* note 7, at 903.
[246] *Id*.
[247] *Id.*
[248] Macey, *supra* note 70, at 710.
[249] *Id*.
[250] *Id.*

the Federal Deposit Insurance Corporation (FDIC).[251] The FRB regulated state banks that were members of the Federal Reserve System and regulated bank holding companies. The OCC regulated national chartered banks. The FDIC, together with state regulators regulated the state banks that were not Federal Reserve members.[252] The OCC is the only inclusive banking agency that has the power not only to charter a bank but also to supervise and regulate.[253]

For other financial industries, the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers regulated broker-dealer firms, while state insurance commissioners regulated insurance companies.[254]

Such institutional regulation generated a significant conflict and competition among regulators.[255] For example, state agencies regulated the insurance activities of insurance companies, while at the same time the OCC regulated the insurance activities of national banks.[256] Thus, regulations by stricter state insurance regulators could be avoided by carrying on those activities within national banks.[257]

This problem has been improved by GLB. As a matter of fact, GLB endorsed neither functional regulation nor institutional regulation, but, more accurately, a combination of both.[258] It seems that the intention of legislative was to establish functional regulation by saying that "similar activities should be regulated by the same regulator", which means banking activities are regulated by bank regulators, securities activities are regulated by securities regulators and

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[251] Cox, *supra* note 69, at 916.
[252] Id. at 918; also see Macey, *supra* note 70, at 710.
[253] Cox, *supra* note 69, at 916-918 (Unlike the Federal Reserve Board, the OCC is an Executive branch, a part of the Treasury Department. The Federal Reserve Board is independent from government, which is assumed as a reason that leads to the regulation conflict between them. Someone believes the regulation framework of FHCA is a result of the turf war between these two agencies).
[254] Macey, *supra* note 70, at 710.
[255] *Id.*
[256] *Id.*
[257] *Id.*
[258] Schooner & Taylor, *supra* note 55, at 328.

insurance activities are regulated by insurance regulators.[259] However, what GLB really provided is rather a compromise of the status quo for existing regulators.[260].

GLB broke some of the originally institute regulation by repealing the general exception of banks from the definitions of "broker" and "dealer" under the federal securities laws and abolishing the institutional restrictions for new activities housed outside the bank.[261]

Yet, GLB did not walk onto the way of pure functional regulation as the Conference report said through setting the FRB as an umbrella regulatory authority over FHCs.[262] GLB made that adjustment to respond to the concern that financial institutions being regulated by several regulators might be treated at an inappropriately different level.[263] By arranging a single regulator, the FRB, shoulder the responsibility for the overall safety and soundness can of course solve, to some extent, this concern,[264] but another problem rose that the system of umbrella agency would jeopardize the healthy competition among different regulators.[265] It is generally thought that the FRB leaned toward suppressing innovation and was very conservative.[266]

Some comparison of other different countries. U.K.. U.S. and U.K. have very different approaches to financial regulation.[267] GLB still assigns direct regulatory power to the central bank. On the contrary, the U.K. removed that responsibility from the central bank to a single unitary regulator.[268]

Australia. Australia created two agencies. One provides federal regulation of corporations,

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259 *Id*. at 327-28.
260 *Id*.
261 *Id.* at 328-29.
262 *Id.* at 329.
263 Macey, *supra* note 70, at 712.
264 *Id.*
265 *Id.*
266 *Id.*
267 Schooner & Taylor, *supra* note 55, at 340.
268 *Id*.

financial market integrity, and consumer protection, while the other is responsible for the prudential regulation of all institutions licensed to conduct the deposit taking or capital-back life products etc.[269]

Germany. Similar to the U.K. and Australia, Germany reformed its regulatory system by creating a single regulatory authority in replace of three existing agencies.[270] The difference between Germany, Australia and U.K. is that Germany did not significantly diminish its central bank's weak regulatory power.[271]

Japan and Korea. Japan established a Financial Services Agency comprising the regulation of banking, securities and insurance.[272] The Ministry of Finance is responsible for financial policy planning and legislation.[273] As for Korea, it similarly created a Financial Supervisory Commission that included all the financial supervisory agencies.[274]

Compared the regulation system of different countries, many countries have created a unified supervisory agency in regulating financial conglomerates instead of adoption of either functional regulation or institutional regulation.[275] Unified regulatory system can deal efficiently with new financial services when they come up.[276] Curiously, most of them maintained the traditional division their organizational structures.[277] This is more efficient than allocating among different organizations in that it enhances cooperation and communication.[278]

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[269] *Id.* at 341 (Australia made this decision on the basis of a report by a Financial System Inquiry, which examined in detail regulation models to date and found that a regulatory system segmented along the traditional industry lines was not optimal any more).
[270] *Id.* at 342
[271] *Id.*
[272] *Id*. at 343
[273] *Id.*
[274] *Id.*
[275] *Id.*
[276] *Id.*
[277] *Id.* at 343-44.
[278] *Id.*

The concerns about unified financial regulation is that it might be less effective if they are overloaded by too broad supervisory responsibility,[279] and may lead to reputation contagion problem.[280]

Until now, the preparatory framework of functional regulation has been established in China, CIRC, CSRC, and CBRC were recently founded. It is hard to imagine that China would abolish them and create a system of unified supervision instead, not long after the establishment of functional regulation. Therefore, China should think about how to resolve conflict among three regulators, how to deal with new financial products that are hard to tell which area they belongs to, and how to assure smooth cooperation and information sharing with different supervisors.

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[279] *Id.* at 344.
[280] *Id.*

CHAPTER VII

CONCLUSION

Finance, especially banking, is one the most heavily regulated industries in many countries. The primary reason is it is the heart of economy, transporting blood, capital to other industries. It is related so closely to every one, every business. Reform of financial systems and relevant legislation in China is inevitable.

While this article has highlighted the history of FHC system in U.S. and UBS in the E.U. over last few decades, and the potential issues with establishing financial conglomeration system for lawmakers, the goals of the reform remains constant. The goals are to keep the financial industry safe and soundness, strengthen the competitiveness of financial institutions in internantional financial markets, and provide consumers all-around, efficient, and convenient financial services. These goals can be achieved through systematic consideration of China's current situation and the global trends, and of how financial systems can fit needs best.

APPENDIX 1:

ABBREVIATIONS (ALPHABETICALLY)

BHC: Banking Holding Company

BHCA: Banking Holding Company Act of 1956

CBRC: China Banking Regulation Commission

CIRC: China Insurance Regulation Commission

CSRC: China Securities Regulation Commission

FDIC: Federal Depository Insurance Company

FHC: Financial Holding Company

FHCA: Financial Holding Company Act of 1999

FRB: the Federal Reserve Board

GATS: the General Agreement on Trade in Service

GLB: Gramm-Leach- Bliley Act

OCC: the Office of the Comptroller of the Currency

PBOC: the People's Bank of China

SEC: the Securities and Exchange Commission

SBD: the Second Banking Directive

WTO: World Trade Organization

APPENDIX 2:

MAIN LEGISLATION RELEVANT IN THIS THESIS

CHINA

People's Republic of China Central Banking Law

People's Republic of China Commercial Banking Law

People's Republic of China Securities Law

People's Republic of China Insurance Law

THE UNITED STATES

The Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (1933)

The Glass-Steagall Act, 12 U. S. C. §24, 78, 377,378 (1994)

The Bank Holding Company Act of 1956, 12 U. S. C. §§1841-1850 (2000).

The Financial Holding Company Act of 1999, Gramm-Leach-Bliley Act, 113 Stat. 1338-1481 (1999).

THE EUROPEAN UNION

The First Banking Directive

The Second Banking Directive

APPENDIX 3:

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