

**Dream of the Red Financial Supermarket: The Gradual Emergence of Integrated
Financial Services Provision in China in the 21st Century**

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Abstract

While the current regulatory trend in the area of banking scope regulation favors integrated financial services provision, China continues to restrict commercial banks' permissible range of business activities via its 1995 Commercial Bank Law. In this article, we propose an analytical framework which explicitly incorporates the sophistication-level constraint of a country's financial system into the regulatory trade-off calculation between banks' need for new growth opportunities and an increased risk of financial instability. Applying this framework to China, we firstly discuss the episode of financial instability that led policy-makers to resegment the financial industry in 1995 and then analyze the rationale behind China's recent, gradual movement back towards integrated financial services provision. While improved risk management capabilities mean that China may now be ready for a more liberal banking scope regulatory regime, we find that a financial crisis could still derail this important element of China's financial sector reform strategy.

Key Words: Financial Regulation, Integrated Financial Services, Banking, China.

JEL Classifications: E44, G28, K23, L51.

1. Introduction

Over the past two decades, financial sector regulators in North America, Western Europe and East Asia have taken an increasingly liberal approach to determining commercial banks' permissible business scope. In contrast to earlier times, commercial banks are now commonly authorized to conduct not only traditional intermediation activities such as deposit taking and loan extension but are free to expand into investment banking (including securities underwriting, trading and brokerage), asset management (encompassing 'alternative' asset classes such as hedge and private equity funds) and insurance.

While the current global regulatory trend in the area of banking scope regulation thus favors integrated financial services provision (IFSP), the People's Republic of China (from here on, China) continues to restrict commercial banks' permissible range of business activities via its 1995 Commercial Bank Law. With the formal segmentation of the financial industry remaining in place, recent years have also seen a gradual relaxation of Chinese regulators' approach to setting the permissible business scope of the country's commercial banks.

In this paper we examine China's slow movement towards the emerging global regulatory norm of integrated financial services provision. To develop an analytical framework that is capable of capturing the country-specific cost-benefit dynamics of regulating banks' permissible business scope, we first review the policy options of 'universal banking', 'broad banking' and 'specialized banking', assesses the contemporary global shift towards de-segmented financial sector regulation, and analyzes the benefits and costs of integrated financial services provision. We highlight that granting banks greater freedom in setting their activity scope entails certain benefits, for example, the opportunity for commercial banks to pursue new growth opportunities in the face of credit disintermediation, but also potentially generates significant risks such as the costly conflicts of interest and an increased risk of financial instability. How these benefits and costs play out in a specific country will depend on the level of sophistication the country's financial system has achieved, including the quality of its regulators and financial firms. Hence, we propose a matrix-based framework to capture the relationship between the sophistication level of a country's financial system and the cost-benefit calculation of the integrated financial service provision.

An application of this framework to the case of China shows, it was precisely the conflicts of interest and financial instability tending to be associated with hastily implemented banking scope deregulation schemes that prompted Chinese policy-makers to separate the country's commercial banks from non-bank financial institutions such as trust and investment

and securities companies via the passage of the 1995 Commercial Bank Law. On the other hand, as both Chinese regulators and banks have improved their risk management capabilities in recent years, which implies a growing sophistication of China's financial system, Chinese financial institutions may in the near future again be granted greater freedom in setting their business scope. Indeed, three 'experimental' financial holding companies (CITIC, Everbright and Ping An) have already come into existence in the recent past. These new developments suggest that a formal move towards IFSP, for example via the enactment of a Chinese financial holding company law, would benefit not only financial sector players such as Chinese commercial banks and insurance companies in their competition with foreign entrants but could also offer advantages to Chinese corporate and retail financial services customers as well as financial sector regulators. Nevertheless, before the problem of persistent soft-budget constraint in the state-dominated financial sector is reasonably resolved, a formal move to IFSP would create moral hazard and other destabilizing troubles.

The rest of the paper is organized as follows. Section 2 develops the analytical framework. Section 3 examines the evolution of China's banking regulatory regime and assesses its past departure from and recent convergence towards global practices. Finally Section 4 presents concluding remarks.

2. Banking scope regulation: policy options, recent developments and the associated cost-benefit trade-offs

2.1 Basic banking scope regulatory policy options

Three basic approaches to regulating commercial banks' permissible business scope can be distinguished, which differ in their respective answers to the following questions: First, can commercial banks engage in investment banking and insurance services or are they restricted to more traditional commercial bank functions? Second, if they are permitted to offer a broad range of services, will these be offered by an integrated financial institution or a holding company structure (Figure 1)?¹

(Insert Figure 1 here)

Representing a first policy option, *universal banking* denotes a system where financial institutions offer a range of financial services. Under such a regulatory approach, banks are allowed to take deposits and extend loans, sell (but not necessarily underwrite) insurance as well as underwrite and deal in securities. Organizationally speaking, universal banking can draw on the integrated banking model, where securities activities, for example, simply take

place within a department of a commercial bank (Benston, 1994). In addition, universal banks may also offer some or all of their non-bank activities via separate subsidiaries (Saunders & Walter, 1994).²

A second rather liberal approach to banking scope regulation is known as *broad banking* (Barth *et al.* 2000). Here, banks are also allowed to offer a wide range of financial services but typically have to do so via an indirect organizational structure. Thus, broad banking normally requires setting up a holding company structure for the purposes of business diversification. Establishing a ‘cushion’ between different financial businesses, the holding company owns and operates commercial banking, capital markets and insurance subsidiaries which are legally separate and have their own capital (Koguchi, 1993).

Universal and broad banking contrast with a system of *specialized banking*, where integrated financial services provision is not permitted and different financial business lines remain separate. Under this approach, banking services, securities business and insurance activities are all offered by separate financial institutions and cross-penetration of financial markets is not permitted.

2.2 Emergence of the mega-banks: the rise of integrated financial services provision

Despite a continuing degree of national diversity, the 1990s and the early 21st century have seen a clear trend towards more liberal banking scope regulation and actual banking practices in the world’s most important financial systems (Jackson & Symons Jr., 1998; Koguchi, 1993; Sheah & Sun, 1999).³ Put differently, in terms of Figure 1 regulators have begun moving in the direction of universal and broad banking. As Ferran & Goodhart (2001) point out:

“The growth of ‘universal’ financial services firms – financial conglomerates that operate across traditional sectoral boundaries – and the blurring of distinctions between financial products through secondary market techniques such as securitization and derivatives trading have outpaced the old functionally-driven approach to regulation [...].”

European countries such as Germany, France and the United Kingdom as well as Australia, New Zealand and Canada already allowed universal banking in the past or adopted it over the course of the 1980s or early 1990s (Barth *et al.*, 1997; Koguchi, 1993). In the United States, adoption of the Gramm-Leach-Bliley Act in 1999 implied a shift from specialized towards broad banking (Bhattacharya *et al.*, 1998).

In the East Asian context, Japan, too, moved towards allowing banks more freedom in choosing their product mix over the 1990s. Hence, in 1993 Japanese commercial banks were allowed to conduct securities business via separate subsidiaries (Borio & Filosa, 1994). Subsequently, the 1996 ‘big bang’ banking reform was, among other objectives, aimed at introducing greater product competition into Japan’s financial system via increasing banks’ business scope (Laurence, 1999). Following the ‘big bang’ and further legal changes, it became possible for Japanese lenders to establish financial holding companies (Chiou & White, 2005).

Similarly, South Korea and Taiwan have recently followed advanced economies and moved towards greater liberalization of banks’ business scope (Park, 1999). Beginning with banking systems that initially did not allow activity diversification and integration, Korea’s and Taiwan’s passage of their respective Financial Holding Company Laws in 2000 and 2001 concluded a movement towards integrated financial services provision that had begun in the early 1990s in both countries.

As indicated in the introduction, China meanwhile continues to formally separate its commercial banking sector from the country’s securities and insurance industries via its 1995 Commercial Bank Law.

2.3 Beneficial aspects of bank business scope deregulation

What broad factors explain this change in regulatory sentiment? As noted by a number of authors, an important part of the answer to this question relates to the fact that credit disintermediation has become more pronounced over the last two decades (see Canals 1997; Koguchi 1993; Kroszner & Rajan 1994; Rehm & Simmert 1991; Swary & Topf 1992).⁴

On the asset side of banks’ balance sheet, earnings related to traditional banking services such as simple loans have come under significant pressure as financial and technological innovations increasingly allow non-financial companies to raise money directly in capital markets. Thus, non-financial companies nowadays demand a different set of financial products from their financial intermediaries. Moreover, on the liability side of their balance sheets, banks now have to fiercely compete for funds as depositors today also invest their savings in, for example, money market and mutual funds. Ageing populations as well as steadily rising per capita incomes in advanced economies account for this change in retail customers’ preferences (Rehm & Simmert, 1991).

Advances in financial engineering techniques and telecommunications (the spread of the internet, in particular) have magnified the effects of credit disintermediation, which can in

fact also be viewed as a case of ‘information disintermediation’ (Fawcett 2001; Hawkins & Mihaljek 2001). In this regard, Greenbaum and Thakor (1995, p. 762) write:

“Ironically, banks are the victims of their own success. They worked hard to make opaque assets transparent. They have been successful, but this also means that others can readily evaluate these assets, narrowing the rents that banks can earn. Banks have worked hard to make illiquid assets liquid. Securitization has been an impressive success, but it means investors can now fund opaque assets directly in the capital market, obviating the need for deposit funding.”

Put differently, commercial banks’ post-World War 2 success in dealing with credit, liquidity and interest rate risks has often turned previously valuable information about borrowers and lenders into a cheap, readily available commodity. As a result, banks’ privileged position in the intermediation process has become critically undermined.

In practice, credit disintermediation implies a reduction in commercial banks’ profit margins. To address this demand-led challenge, the pursuit of new sources of revenue growth or cost savings has become essential for commercial banks operating on the supply side of the financial system (Koguchi 1993). In order to boost earnings, banks can either strengthen efforts to grow organically and/or engage in mergers and acquisitions (M&A) to acquire new banks or other financial institutions such as investment banks and insurance companies. Cost savings, on the other hand, can follow from internal streamlining efforts as well as from the scale and scope economies potentially associated with M&A activity. Advances in information and communications technology have meant that these scale and scope economies are enjoyed more easily today than was the case in the past (Berger *et al.* 1999), assuming that the regulatory environment actually permits their exploitation.

The indicated, worldwide legislative and regulatory initiatives that allow for integrated financial services provision can therefore in fact be understood as a reaction to the challenge of credit disintermediation, which puts increasing pressure on banks’ traditional business model. Liberalization of banks’ business scope offers lenders the chance to pursue organic growth via offering a greater variety of fee-based services. Typically, the blurring of the boundary between traditional lending and capital markets activities has already led commercial banks to venture strongly into off-balance sheet, fee-earning activities such as loan commitments, guarantees and securitization services (Greenbaum & Thakor, 1995, p. 780). Further deregulation of permissible activities expands banks’ opportunities in this area, allowing them to meet their corporate customers’ changing demands while also potentially opening up new, mostly risk intermediation-centered growth areas such as (derivatives)

trading, (prime) brokerage, hedge fund and private equity operations.⁵ Moreover, deregulation also opens the door for mergers and acquisitions activity that can further boost commercial banks' revenues as well as imply potential cost savings.

Arguably, then, the deregulation of commercial banks' permissible business scope allows the latter to successfully deal with the challenge of credit disintermediation by opening up new growth opportunities and/or reducing the cost base of running banking operations. At the same time, deregulation may in fact serve the broader public interest too, as financial institutions' corporate and retail customers can benefit from reduced search and transaction costs when dealing with 'financial supermarkets' (Saunders & Walter 1996). Regulators, in turn, may prefer supervising clearly structured, integrated financial services providers, rather than having to deal with murky conglomerates that expand their reach in a semi-legal or illegal fashion.

2.4 The dark side of deregulation: the potential costs of financial conglomerates

Importantly, while deregulation of banks' permissible business scope offers certain benefits, it can also give rise to five principal drawbacks. First and foremost among these are potential conflicts of interest. In this regard, consider an integrated financial services provider that is active in both commercial and investment banking. Such a company may, for instance, have extended a loan to a nonfinancial company that has since turned sour. In order to recoup the loan, the IFSP might underwrite an equity issue of the struggling company and convey misleading financial information to capital market investors about the company's performance. Having done so, the IFSP can use the proceeds of the equity issue to have its nonperforming loan repaid. Alternatively, if investors cannot be 'fooled' to buy the securities at the offering price set by the IFSP, the latter could place any unsold securities in its trust accounts, thereby avoiding losses in underwriting but hurting consumers' interests (Bhattacharya *et al.* 1998; Greenbaum & Thakor, 1995, p. 564).

A further danger that the operation of IFSPs could entail lies in a potentially increased risk of financial instability. The wider range of activities that IFSPs engage in might increase the risk of financial insolvency. Moreover, given the typically large size of newly created IFSPs, the threat of insolvency could undermine the health of the entire financial system and consequently lead to a large public financial exposure under the regulatory 'too big to fail' doctrine (Bhattacharya *et al.* 1998). In this respect, it is important to note that, historically, one of the main motivations for segmenting America's financial industry in 1933 was to reduce the risk of financial instability (Swary & Topf, 1992, p. 4).

Nowadays, this consideration acquires particular strength from the fact that in recent years a number of commercial banks' trading activities within their investment banking subsidiaries or divisions have increased significantly. As a result of such strategies, commercial banks' 'value-at-risk' or exposure to a downturn in the markets has increased substantially. Now, under a strict separation of the commercial banking and securities industries, the former would obviously not be in a position to rely so heavily on risky trading activities. Thus, there is a risk under universal and broad banking that financially unstable – yet not necessarily more profitable - commercial banks may arise and threaten the stability of the financial system (Rumble & Stiroh 2006; Stiroh 2004, 2006).

Thirdly, Boot & Thakor (1997) show that stand-alone investment banks tend to innovate more than IFSPs that own commercial banking and investment banking subsidiaries. The intuition of their theoretical argument is that while IFSPs are engaged in a zero-sum game when it comes to investing in the development of innovative capital market instruments (any new mandate won by the investment banking division/subsidiary may take away business from the commercial banking division/subsidiary), stand-alone investment banks unambiguously gain from new, innovative products they bring to the market. Capital market development may thus be retarded under universal and broad banking.

A further point raised against IFSPs is that they will crowd out other financial institutions due to their superior scale and scope, leading to a dangerous concentration of power and influence in their hands (Benston 1994; Koguchi 1993). Crowding-out may be fueled further by the access that banks often have to deposit insurance schemes: The cheaper funding they can obtain as a result of deposit insurance might be used as an unfair cross-subsidy against competitors in other fields such as insurance (Barth *et al.*, 2000). The result of such cross-subsidization, it is sometimes alleged, will be crowding-out other financial institutions and resulting in a concentration of financial and economic power in a relatively small number of huge, unaccountable and opaque IFSPs. Commonly, this potential development is seen as detrimental to the interests of small and medium sized companies (SMEs) who possibly find it harder to obtain credit from 'mega-banks' (Carrow *et al.* 2006).

A fifth and final potential drawback of deregulating commercial banks' permissible business scope relates to financial conglomerates seemingly insatiable appetite for mergers and acquisitions. In the past few years, substantial M&A activity has occurred in the global financial scene. Indeed, some financial institutions have become veritable 'mergers and acquisition machines' since the early 1990s: The current J. P. Morgan Chase, for example, has resulted from mergers and acquisitions among some 550 banks and other financial firms.⁶

A number of economists have viewed these developments with suspicion. Milbourn *et al.* (1999), for example, have argued that expanding the scale and scope of banking operations by way of M&A activity may have little to do with maximizing shareholder wealth and could rather be the result of self-dealing executives who aim to enhance their own reputations and salaries via managing larger institutions. Other bank managers will have to follow this example because otherwise their own shareholders will believe them to have inferior skills and thus pay them lower salaries. Herding behavior thus results and shareholder wealth will be dissipated via size- and scope-enhancing mergers and acquisitions that contribute little to a financial company's fundamental competitive advantage (Rehm & Simmert 1991). From this perspective, the only results of M&A activity apart from higher managerial salaries may actually consist in a dispersion of management control and loss of transparency that are both detrimental to the public good (Koguchi 1993).

2.5 The relationship between the sophistication of a country's financial system and the IFSP cost/benefit trade-off

On the whole, policy-makers considering the deregulation of commercial banks' permissible business scope will have to weigh the potential benefits of such a move (new growth opportunities for commercial banks, the associated exploitation of scale and scope economies, reduced search and transactions costs for customers, increased regulatory transparency) against the indicated costs (conflicts of interest, increased risk of financial instability, reduced financial innovation, crowding-out and herding behavior).

Crucially, this cost-benefit calculus associated with the choice for or against integrated financial services provision will be shaped by the level of sophistication a country's financial system (and its corporate sector) has achieved (Figure 2).

(Insert Figure 2 here)

In Figure 2, quadrant 'A' represents a country with a comparatively unsophisticated financial system, where banks merely engage in basic intermediation and regulators rely on simple supervisory tools. In such an environment, both the costs and the benefits of IFSP are rather low: While regulators may find it difficult to supervise banks, the latter may not be able to engage in excessive risk taking due to for instance the underdeveloped capital markets, implying limited potential costs of IFSP. At the same time, with little credit disintermediation and low customer demand for 'one-stop shopping', the benefits commonly associated with IFSP presumably also do not count for much.

As a country's financial system develops, the IFSP cost-benefit profile changes significantly. Typically, financial institutions such as banks will now begin exploring new business opportunities in related financial markets. In such an 'emerging market context', some welfare benefits for society may follow from allowing banks' greater leeway in setting their activity scope; nevertheless, regulators' lack of experience with supervising financial conglomerates entails significant potential deregulation costs (quadrant 'B'). Indeed, only in quadrant 'C' does the IFSP cost-benefit profile cross the 45° line, meaning that the benefits of deregulating financial institutions' activity scope now exceed the associated costs. As financial institutions as well as their corporate and retail customers increasingly profit from IFSP, the value of the corresponding benefits rises whereas regulators' growing supervisory capabilities reduce the associated potential costs. This development gains added momentum in quadrant 'D'.

3. The regulation of commercial banks' permissible business scope in China: the long march towards global practices

How, then, has China's banking scope regulatory regime evolved over the past three decades? In terms of Figure 2, have Chinese policy-makers appropriately taken account of the sophistication of the country's financial sector (including both financial firms and regulators) when deciding on banking scope policy initiatives in the past and present?

3.1 1978-1995: universal banking

Following China's turn towards 'reform and opening-up' in 1978, the country's financial system in general and banking sector in particular underwent dramatic change (compare Bowles & White, 1993; Leung & Mok, 2000; Wolken, 1990). Through various reform cycles in the 1978-1995 period, the old 'socialist monobanking' structure was dismantled, with the People's Bank of China emerging as China's central bank and the 'big-four' state-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank and Agricultural Bank of China) in control of the commercial banking sector. In order to boost competition and efficiency in the financial sector, other reforms during this time led to the phase-in of new financial institutions, including national and regional commercial banks (including foreign institutions), three 'policy banks' and a range of non-bank financial institutions (NBFIs) such as trust and investment companies (TICs), securities companies and finance and leasing companies.

The trust and investment sector proved particularly vigorous (Hong & Yan, 2000): Engaging in a range of activities that principally encompassed lending, securities business and real estate transactions, China's TICs mushroomed in the largely unregulated transition environment they found themselves in during the 1980s and early 1990s. Between 1990 and 1994 alone, their assets more than tripled to reach Renminbi 390 billion (US\$ 41.1 billion) (Figure 3).

(Insert Figure 3 here)

Much of the growth in TICs' activities at the time could be explained by the intimate ties that existed between them and China's commercial banks: Attracted by the much looser restrictions that governed TICs' activity scope, Chinese commercial bankers were keen on setting-up their own trust (as well as securities) businesses. While the state had begun encouraging the legal separation of commercial banks and TICs as early as 1986, this directive only had the effect that banks stopped running trust and investment operations out of internal departments. Instead, TICs became wholly or partly owned subsidiaries of China's commercial banks (Albrecht *et al.*, 1997). By one estimate, out of 391 TICs that existed in 1995, 186 were operated directly by banks, with the remainder mostly associated with various government agencies (Hong & Yan, 2000). Apart from direct ownership ties, Chinese commercial banks also lent heavily to affiliated and unaffiliated TICs and securities companies. As one indicator of such fund flows between banks and NBFIs, TICs' net borrowing from the Chinese interbank market amounted to about Renminbi 39.5 billion (US\$ 4.7 billion) in 1994 alone (Albrecht *et al.* 1997).

In a sense, Chinese policy-makers' universal banking approach to regulating banks' permissible business scope in the early- to mid-1990s appeared to simply mirror international practices. As seen in Section 2, a number of countries allowed banks greater freedom in determining their desired business portfolio during the 1990s. Indeed, the World Bank (1988, p. 328) had recommended just such a course of action for China in the late 1980s:

“Newly created [Chinese] full-service banks might themselves prefer to keep investment and trust banking and commercial banking in separate subsidiaries, [...], but they need not be required to do so. Indeed, while there are good reasons to regulate banking, it may not be necessary to regulate the non-bank business of banks, except for capital adequacy rules, and, perhaps the separation of non-bank business from the financial accounts of the bank.”

3.2 *The great banking wall: the separation of China's financial industry via the 1995*

Commercial Bank Law

Nevertheless, China's 1990s experience with universal banking proved short-lived. Far from leading to the exploitation of scale and scope economies, reductions in transaction costs and improvements in regulatory transparency, it soon became apparent that the direct (ownership) and indirect (funding) links between China's commercial banks on the one hand and TICs and securities companies on the other hand bred conflicts of interest, speculation, instability and corruption on an unprecedented scale (Albrecht *et al.*, 1997; Brahm, 2002; Ding, 2000; Gamble, 1997). Going back to Figure 2, China in the mid-1990s found itself in quadrant 'B': An emerging market economy where the potential benefits of integrated financial services provision were comparatively low but significant damage could be done by reckless bank expansion into non-banking business, especially since regulators had not yet acquired the necessary capabilities to keep banks in check.

Accordingly, rather than sensibly expanding their institutions' business portfolios, Chinese commercial bankers in the early 1990s utilized their NBFIs subsidiaries for reckless speculative ventures that threatened capital and deposit levels in the banking sector. Ultimately, such speculation stemmed from a fundamental conflict of interest facing Chinese commercial bankers in the country's state-dominated financial system, where bad investment decisions would not necessarily imply the punishment of the managers responsible. A popular Chinese saying summarized this situation thus (see Ding 2000):

“Guojia fukui, yinhang fuzhai, jingli fuying [The state takes care of losses, the bank takes care of debts and the manager takes care of profits].”

Put differently, a situation where losses and non-performing loans could be socialized while any profits were at least partly available for private appropriation led to significant involvement of the state-owned banks in the securities and real estate sectors in the early- to mid-1990s.

Facing mounting non-performing loan levels, associated financial instability in the form of serious (asset) price inflation as well as pervasive embezzlement and fund 'diversion' in the financial sector, Chinese policy-makers decided that the costs of integrated financial services provision exceeded the associated benefits and that the country was thus not yet ready for this regulatory regime. The country's new Commercial Bank Law, adopted in 1995, thus mandated the strict separation of banks and NBFIs (Article 43) and banned the former from lending to the latter (Article 46) (compare Green, 2004, p. 95).⁷

Given its tough provisions, the 1995 Commercial Bank Law had a marked impact on the structure of China's financial industry: Shortly after the law's adoption in May 1995, China's major state-owned commercial banks submitted comprehensive restructuring plans to divest themselves of their non-bank businesses. China Construction Bank and the Industrial and Commercial Bank of China submitted their plans by late 1995, and began the divestiture process by early 1996. Bank of China and the Agricultural Bank of China, meanwhile, submitted their separation plans and began implementation during 1996 (Albrecht *et al.*, 1997). In the words of Pei (1998):

“By the end of 1996, banks had sold, closed, or made independent nearly all their securities, trust, and investment businesses.”

Given China's successful 'soft landing' in 1995-1996, the central leadership appeared to have achieved its primary objective of reigning in runaway inflation when separating commercial banking from other forms of financial intermediation in 1995.⁸ In other words, the country's financial sector policy-makers had rectified their earlier mistake of allowing for integrated financial services provision at a comparatively unsophisticated stage of China's financial system development.

3.3 Dawn of a new era: China's gradual move towards integrated financial services provision in the 21st century

Building on the earlier achievements, the Chinese leadership after 1995 pushed forward a range of other initiatives to further promote the commercialization and professionalization of the Chinese financial industry, in particular after neighboring economies tumbled in the 1997 Asian financial crisis (Fewsmith, 1999; Li, 2000). Thus, central bank independence was to be strengthened by the introduction of a regional branch structure, starting in 1998 (Cho, 1999). A separate banking regulator – the China Banking Regulatory Commission - was set-up in 2003. To deal with the pressing issue of non-performing loans in Chinese commercial banks, four 'asset management companies' were set-up in 1999 (each associated with one of the 'big-four' state-owned banks) and massive capital injections into the banking sector occurred in 1998 and 2003.⁹

Subsequent to China's entry into the World Trade Organization in late 2001, competition by foreign financial institutions also picked up and the Chinese leadership attempted to accelerate the pace of banking reform by selling strategic equity stakes in a number of financial institutions to foreign investors as well as beginning the process of listing

the ‘big-four’ on local and foreign stock exchanges (Bonin & Huang, 2002).¹⁰ With these measures, Chinese policy-makers hoped to improve the operational efficiency and corporate governance of the country’s financial institutions (Sun & Tobin, 2005).

Towards the late 1990s, China’s capital markets were also given their first comprehensive regulatory framework by the adoption of the 1998 Securities Law, which incidentally reinforced the compartmentalization of China’s financial industry.¹¹ Importantly, following on from deliberations that matched the rationale behind the provisions of the 1995 Commercial Bank Law, the new Securities Law reinforced the compartmentalization of China’s financial industry. Thus, Article 6 of the 1998 Securities Law specified that securities, banking and trust businesses had to be carried out separately, thereby mirroring the provisions contained in Article 43 of the 1995 Commercial Bank Law. In fact, China’s new Insurance Law (adopted in 1995) in Article 104 also cemented the separation of China’s different financial sector business lines.

As the years passed, however, this restrictive policy came under increasing strain. In a sense, the Commercial Bank Law’s provisions governing the separation of commercial banks and NBFIs were akin to the lid of a pressure cooker that had been forced upon a boiling financial sector: With more hot steam gathering post-1995, it proved difficult to keep the lid in place. A range of factors combined during this time period to again blur the boundaries between different sub-sectors of China’s financial industry.

To begin with, *non-compliance* with the key provisions of the Commercial Banking Law plagued the government’s new financial sector strategy from its inception. As local government representatives, regulators, commercial bankers and staff at NBFIs were critical of the separation of commercial and investment banking from the start due to the policy’s growth dampening effect, they colluded in circumventing and at times directly violating the central government’s instructions. Thus, for example, commercial bank loans continued to flow into the securities industry even after the Commercial Bank Law’s adoption, often at the prodding of local government officials (Green, 2004, pp. 95-96; Pei, 1998).¹²

Short of non-compliance, commercial banks also exploited *loopholes* to continue to offer business services that went beyond the legal intent of the Commercial Bank Law. Thus, the Bank of China continued to supply investment banking services via its Hong Kong subsidiaries Bank of China International and Bank of China Group Investment as well as insurance products via Bank of China Group Insurance.¹³ The strategy of venturing into offshore integrated financial services proved lucrative for the Bank of China. As the *Far Eastern Economic Review* reported in an article on the Bank of China’s business strategy:

“[Bank of China chairman] Liu [Mingkang] cites the takeover of Cable & Wireless HKT by Pacific Century CyberWorks, the expansion of shipping concern Cosco in Panama and the expansion by electronics firm Konka in Southeast Asia as recent instances where BOCI [Bank of China International] has provided ‘bundled’ services, from commercial loans to financial advice.”¹⁴

The Industrial and Commercial Bank of China for its part offered clients mergers and acquisitions as well as restructuring advice from its Chinese branches, while shying away from directly engaging in more contentious investment banking business such as trading, brokerage and underwriting.¹⁵

Furthermore, a number of important *exceptions* to the top leadership’s new policy line existed from the start in 1995. China Construction Bank, for example, continued to operate its high-profile joint venture investment bank China International Capital Corporation after the Commercial Bank Law’s passage. The joint venture, for which foreign partner Morgan Stanley had enlisted political heavyweights such as future US vice-president Dick Cheney as lobbyists, opened for business in the summer of 1995 and counted Zhu Rongji’s son as one of its employees (Becker, 2000, p. 359; McGregor, 2005, pp. 58-93).¹⁶ Too much political capital had been invested into this venture by the Chinese political leadership to pull the plug on it after the Commercial Bank Law’s adoption.

Similarly, CITIC in the 1990s combined a number of financial businesses under its roof, drawing on its connections to the central leadership and its role as a ‘pioneer’ in Chinese economic reforms (Becker, 2000, pp. 137 & 357; Dumont & Gilmore, 2003, pp. 111-124; Xiao, 2004).¹⁷ China’s asset management companies could also be seen as exceptions to the Commercial Bank Law’s provisions: With one asset management company assigned to each of the ‘big-four’ commercial banks since 1999, the asset managers’ involvement in loan recovery, loan repackaging and ultimate loan sale into the capital markets amounted to a significant move by the state-owned commercial banks into the terrain of NBFIs.

Most importantly, however, as China’s financial industry became more sophisticated in the decade following the Commercial Bank Law and foreign integrated financial services providers entered the market in ever larger numbers, the Chinese leadership at the turn of the century began to entertain the notion that successful economic performance could best be ensured by the integration of different financial business lines and the gradual phase-out of the former, strict regulations.¹⁸ At the same time, China’s largest commercial banks and insurance companies (as well as foreign financial firms), backed by massive capital raisings and lured by growth prospects, were keen to expand their reach into other financial business

lines, whereas the fragmented and under-capitalized domestic securities industry resented liberalization efforts.¹⁹ In terms of Figure 2, a new view thus began to emerge that argued that China's financial system had gained sophistication since 1995 and now represented quadrant 'C' in the figure, meaning that a more liberal banking scope regulatory regime could be welfare enhancing.

According to this new thinking, four key constituencies would benefit from a gradual move towards the emerging global practice of integrated financial services provision: Firstly, commercial banks would be able to compete more effectively with foreign players and supplement their narrowing interest margins with non-interest income.²⁰ As pointed out by Jiang *et al.* (2003), following China's entry into the World Trade Organization in 2001, Chinese banks lost key corporate customer accounts to foreign competitors which entered the Chinese market in record numbers by setting-up branches and subsidiaries as well as buying into established Chinese players. In March 2002, for example, the Swedish multinational Ericsson AB transferred its entire banking business in China from three Chinese banks to America's Citigroup, principally because the Chinese institutions could not offer advanced risk management services (Jiang *et al.* 2003). By relaxing restrictions on Chinese banks' permissible business scope, the government thus hoped to equip the country's financial institutions with the necessary tools to compete effectively against new foreign entrants.

Intriguingly, recent developments indicate that the domestic competitiveness of Chinese financial institutions in the area of integrated financial services provision may in fact be critically bolstered by the acquisition of foreign expertise: In 2007 alone, Chinese financial institutions acquired equity stakes in the UK's Barclays (China Development Bank), South Africa's Standard Bank (Industrial and Commercial Bank of China), America's Bear Stearns (CITIC Securities), Belgian-Dutch financial group Fortis (Ping An) and US private equity group Blackstone (China Investment Corp).²¹ Reputedly, a crucial factor behind all these transactions was the opportunity for Chinese financial players to learn about the latest trends and techniques in financial services provision from advanced foreign competitors.

Moving on to a second group that could possibly benefit from a looser framework governing Chinese commercial banks' permissible business scope, it appeared to policy-makers in the early 21st century that China's largest state-owned enterprises, township and village enterprises and private enterprises would benefit from dealing with more sophisticated local financial institutions. In recent years, Chinese corporations' stronger reliance on self-raised funds such as stocks, bonds and retained earnings as well as their growing involvement abroad via mergers and acquisitions and overseas listings all imply that these firms

increasingly depend on financial advisers familiar with the latest corporate finance and risk management techniques (compare Hong & Sun 2006). Currently, this advisory role is still largely reserved for foreign financial institutions: For example, when ranked by deal revenue, eight of the ten largest investment banks in China in 2005 were foreign (in descending order these were Morgan Stanley, Citigroup, CSFB, Goldman Sachs, Merrill Lynch, Deutsche Bank, HSBC and J. P. Morgan). Only two Chinese institutions - China International Capital Corporation and Bank of China - made the list.²² While foreign expertise is thus readily available to fill the current skills gap, Chinese corporations would clearly benefit in terms of reduced transactions costs if major Chinese commercial banks could in the future directly offer them one-stop shopping opportunities for loans and capital markets-related advice.

Thirdly, moving towards integrated financial services provision could offer Chinese retail bank customers improved access to high quality financial services. As the Chinese state continues to retreat from its past practice of providing free housing, health care, education and pensions for a majority of the population, Chinese savers more than ever depend on a decent return on their savings to finance the purchase of homes, hospital treatments, schooling and university attendance as well as provisions for old age. Allowing commercial banks to diversify their business scope could help the banks provide the needed higher returns on savers' deposits. Opening new investment opportunities and asset classes to banks, in turn, could boost the prospects and stability of China's capital markets. Moreover, the growing Chinese middle class in particular could benefit from 'financial supermarkets' that offered not only savings accounts but also fund management tools and insurance services.

Finally, financial sector regulators could benefit from introducing an explicit framework governing commercial banks' involvement in the NBFIs sector: According to the Chinese leadership's reasoning in this respect, rather than dealing with the numerous instances of non-compliance, loopholes and exceptions to the existing banking scope regulatory regime discussed previously, it could be preferable from the perspective of financial sector safety and soundness to adopt and implement a new, more liberal yet also more consistent law governing commercial banks' permissible business scope, possibly in conjunction with reforming China's fragmented supervisory apparatus.²³

Following on from such deliberations, policy-makers began to act around the turn of the century, following China's trademark 'experimental approach' to policy reform. In 2001, the People's Bank of China produced a first draft regulation on financial holding companies which was aborted later, however.²⁴

Subsequently, the 6th session of the 10th National People's Congress in 2003 passed a number of amendments to the 1995 Commercial Bank Law. Central to the discussion provided here, a key amendment to the Commercial Bank Law's Article 43 formally introduced the possibility of banks venturing outside their traditional business territory. According to the official *China Daily* newspaper:

*“The [2003] amendment to the Law on Commercial Banks has left room for the possibility of banks dabbling in non-banking financial businesses. Commercial banks are forbidden to engage in trust and securities businesses, or invest in non-banking financial institutions or enterprises in violation of government regulations, the amendment said. Before being changed, the law had absolutely banned commercial banks from engaging in non-banking businesses such as securities, insurance and trust services.”*²⁵

The 18th session of the 10th National People's Congress in 2005 similarly opened up some room for the expansion of securities companies' business scope by adopting amendments to the 1998 Securities Law. As the *Xinhua* news agency reported:

*“One of the most important amendments [to the 1998 Securities Law] is that it allows the State Council to stipulate new regulations regarding the management and operation of different financial sectors including banks, securities companies, trust companies and insurance firms [...]. It leaves room for future reforms in this field, with the possibility of allowing different financial firms to enter into others areas.”*²⁶

Common to both the Commercial Bank Law's and the Securities Law's relaxation of financial institutions' permissible business scope in 2003 and 2005 respectively was the legal formulation that banks and securities firms were not allowed to enter each-other's business territory “unless otherwise provided for by the state”.²⁷ Thus, Chinese policy-makers were gradually and cautiously phasing-in the possibility of financial sector integration, matching the experimental spirit of China's approach to economic reform more generally.

Also, in 2005 a number of 'trial financial holding companies' such as CITIC, Everbright and Ping An that had formed over the years were given the formal blessing to operate commercial banks, investment banks and insurance companies under one roof by the 5th Plenum of the 16th Chinese Communist Party Central Committee (Table 1).²⁸ Finally, in 2006 commercial banks and insurance companies were authorized to move into their respective business territories.²⁹

(Insert Table 1 here)

China's 'trial financial holding companies' explicitly aim to leverage their brand name across the financial services value chain and attempt to offer their customers opportunities for 'one-stop shopping'. At the same time, interviews with financial sector professionals in Shanghai also revealed that Chinese financial holding company executives are aware of the potential problems associated with offering a too complex and far-reaching product range. Hence, even China's 'trial financial holding companies' will in the future produce and market only a certain range of financial services, while other products will not be produced and distributed at all or, alternatively, sourced for distribution from other players, possibly enhanced by an equity investment and/or a strategic alliance in/with the latter.³⁰

The government, for its part, approves of the brave new world of integrated financial services provision it is helping to engineer. Liu Mingkang, at the time head of the China Banking Regulatory Commission, pointed out in 2006 that:

*"Banks in Western, developed countries are increasing their capabilities and functions by the day. Jointly operating banking, securities and insurance businesses is a huge development trend."*³¹

An editorial in the official *China Daily* backed up this view in October 2006:

*"The time is ripe now to make it clear that the barriers [between different financial businesses] will be torn down gradually to give our financial institutions an opportunity to become more competitive and thus make the whole financial industry more efficient."*³²

The separation of China's financial industry, achieved with such effort in the mid-1990s, may soon be coming to an end after just one short decade.³³

4. Conclusion

As the international world of finance moves towards the integrated financial services provision paradigm, China belatedly appears to get on the bandwagon. Having allowed its commercial banks to operate non-bank financial subsidiaries until the mid-1990s under a universal banking regime, the Chinese leadership sharply changed course on the subject when it opted for a specialized banking system and the segmentation of the financial industry via its new 1995 Commercial Bank Law. However, recent years have seen indications of yet another potential shift in banking scope regulatory strategy, this time towards broad banking and the introduction of financial holding companies. As this paper has argued, such a shift would essentially represent a convergence towards global and regional regulatory trends, as

regulators in North America, Western Europe and East Asia now all subscribe to the notion of integrated financial services provision in one form or another.

Arguably, the gradual emergence of a more liberal banking scope regulatory framework in China reflects the growing sophistication of the country's financial industry as well as the genuine benefits Chinese regulators, financial institutions and corporate and retail customers will be able to reap from deregulation.³⁴ Still, the previous experience with integrated financial services provision remains a cautionary tale for today's decision-makers: As seen in Section 3, in the run-up to China's 1995 Commercial Bank Law, banks' involvement in the non-bank financial sector bred conflicts of interest, instability and corruption, without the benefits of scale and scope economies, reduced customer transaction costs and improved transparency actually materializing.

The story could be different this time around: For a start, foreign competition and participation in China's financial industry have induced improvements in local institutions' risk management techniques. Having consulted with regional (Taiwanese) counterparts on their recent financial holding company experiences, Chinese regulators may also be better equipped to deal with financial conglomerates than they were during the 1980s and 1990s.³⁵ Nevertheless, it is unclear how China's leadership would react to, say, a major trading loss at a securities subsidiary of one of the 'trial financial holding companies': Would the subsidiary be allowed to fail? Would the holding company be pushed towards bailing out the subsidiary? Or would the state itself attempt to preserve market confidence via a public bail-out, thereby creating future moral hazard issues?

More generally speaking, the danger exists that, in terms of Figure 2, China's financial system may now indeed be sophisticated enough to find itself in quadrant 'C', yet the cost-benefit trade-off associated with integrated financial services provision could still be negative. Put differently, even today, China's financial system may not yet have crossed the graph's 45° degree line. In the future, when faced with widespread instances of conflicts of interest and the risk of financial instability, the Chinese state could conceivably even abandon its entire current project of gradually phasing-in integrated financial services provision. It would not be the first time.

Notes

¹ Given the complexity of banking scope regulation, it is obvious that the two dimensions of ‘degree of organizational integration’ and ‘activity scope’ are highly stylized within Figure 1 and cannot do complete justice to reality (cf. Jackson, 1998, pp. 19-24). Hence, countries’ banking systems do not actually fit neatly into the depicted boxes but rather tend to fall in between different categories.

² Note that in the following discussion the focus will be on the extent to which banks are allowed to offer non-bank financial services. Bank involvement in commerce (as well as commercial firms’ involvement in banking) will not be considered here. For a discussion of salient issues in this regard, see for example the discussion provided by Borio & Filosa (1994, pp. 13-15, 19-24).

³ More liberal banking scope regulatory regimes do not necessarily imply that successful financial institutions nowadays need to be active across the *entire* financial services value chain. Rather, such regimes entail that financial institutions are free to ‘manufacture’ and/or distribute their favored portfolio of financial services. A particularly popular strategy here appears to be the bundling of commercial banking and investment banking functions. Compare *The Economist*, May 20th, 2006 and May 19th, 2007: “A survey of international banking”.

⁴ *The Economist*, April 15th, 1999, page 3: “On a wing and a prayer”.

⁵ See *The Economist*, May 19th, 2007: “A survey of international banking”.

⁶ *The Economist*, May 20th, 2006, page 6: “A survey of international banking”.

⁷ 1995 also saw the adoption of China’s Central Bank Law and Insurance Law.

⁸ Compare the optimistic commentary in *China Daily*, December 30th, 1995, page 4: “A 1995 retrospection”.

⁹ On the non-performing loan and recapitalization issue, see Bonin & Huang (2001), Bottelier (2002), and Lo (2004) among others.

¹⁰ Also see *Business Week*, October 31st, 2005, page 18: “Betting on China’s banks”; *The Economist*, October 29th, 2005, page 93: “A great big bank gamble”.

¹¹ See Zhu (2000) on the provisions of the Securities Law and Green (2004) on its adoption process.

¹² An interview partner in Shanghai pointed out that state-owned commercial banks’ partial non-compliance with the Commercial Bank Law may technically have been legal: Article 2 of the Commercial Bank Law states that the law applies to those Chinese commercial banks that are enterprise legal persons “in accordance with this law [the Commercial Bank Law] and the Company Law of the PRC.” According to the interview source - a Chinese corporate lawyer - it was debatable whether or not Chinese state-owned commercial banks in 1995 actually fell under the Company Law. If not, the new bank law would not have applied to them. Interview with corporate lawyer in Shanghai, November 24th, 2006.

¹³ Interview with Bank of China investor relations executive in Shanghai, November 16th, 2006.

¹⁴ *Far Eastern Economic Review*, December 7th, 2000, page 78: “Bank of China thinks global”.

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- ¹⁵ See the bank's website at <http://www.icbc.com.cn>. Accessed January 25th, 2007.
- ¹⁶ *China Daily*, March 12th, 1995, "Business Weekly", page 1: "Cheney visits as Morgan Stanley envoy" and August 12th, 1995, page 3: "China's first world investment bank opens".
- ¹⁷ Also *China Daily*, May 28th, "Business Weekly", page 3: "CITIC makes plans to extend reach".
- ¹⁸ Following the adoption of the Commercial Bank Law, the People's Bank of China had repeatedly stressed the importance of continuing to *separate* different financial businesses. See Cai (1998) and Huang & Xu (2000).
- ¹⁹ Interviews with financial sector professionals in Shanghai, November 2006.
- ²⁰ *CFO Asia*, November 2006, page 42: "In the country of next moves".
- ²¹ *South China Morning Post*, November 30th, 2007: "Ping An acquires key stake in Fortis". Available at <http://www.scmp.com>. Accessed December 16th, 2007.
- ²² *Wall Street Journal Europe*, February 27th, 2006, page 21: "Vying for China's bank IPOs".
- ²³ *China Daily*, October 30th, 2006, page 4: "Roadmap for finance".
- ²⁴ See *China Daily*, August 9th, 2004: "Segregation of 3 financial branches should remain". Available at <http://www.chinadaily.com.cn>. Accessed May 15th, 2007.
- ²⁵ *China Daily*, December 29th, 2003: "Bank watchdog gets new teeth". Available at <http://www.chinadaily.com.cn>. Accessed October 10th, 2007.
- ²⁶ *Xinhua* news agency, October 28th, 2005: "Top legislature adopts amended securities law". Available at <http://www.china.org.cn>. Accessed October 12th, 2007.
- ²⁷ Compare Law of the People's Republic of China on Commercial Banks (Article 43) and Securities Law of the People's Republic of China (Article 6). Available at <http://www.china.org.cn>. Accessed October 5th, 2007.
- ²⁸ Speech by People's Bank of China governor Zhou Xiaochuan at the Bank of Communications/HSBC forum on June 15th, 2006: "Switch to a new way of thinking and steadily experiment with cross-sector operation in the financial industry". On these financial holding companies, see Lin 2003. Also interviews with with financial sector professionals in Shanghai, November 2006. According to CITIC's former president and vice chairman Qin Xiao, CITIC's application for financial holding company status was approved by the State Council in November 2001. See Xiao (2004, p. 163).
- ²⁹ *Wall Street Journal Europe*, June 12th, 2006, page 19: "China will let banks establish insurance arms" and September 5th, 2006, page 5: "China's insurers push into the banking sector."
- ³⁰ Interviews with financial sector professionals in Shanghai, November 2006.
- ³¹ *Wall Street Journal Europe*, June 12th, 2006, page 19: "China will let banks establish insurance arms."
- ³² See *China Daily*, October 30th, 2006, page 4: "Roadmap for finance".
- ³³ This is certainly also the view of a number of influential foreign analysts. Compare Boston Consulting Group 2002 and 2006.

³⁴ Foreign financial groups may also benefit from being able to establish financial holding companies in China. For example, the China head of America's AIG group was quoted in 2004 as "waiting for a change of [Chinese] law to allow for the application of building a financial holding company in China" to integrate the company's numerous financial assets in the country. See *China Daily*, August 9th, 2004: "Segregation of 3 financial branches should remain". Available at <http://www.chinadaily.com.cn>. Accessed May 15th, 2007.

³⁵ Interview with a director in Taiwan's Financial Supervisory Commission in Taipei, June 2005.

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Table 1: China's 'trial financial holding companies'

<i>Key mainland subsidiaries*:</i>	CITIC	Everbright	Ping An
<i>Banking</i>	CITIC Industrial Bank	China Everbright Bank	Ping An Bank
<i>Investment banking</i>	CITIC Securities	China Everbright Securities	Ping An Securities
<i>Insurance</i>	CITIC Prudential Life Insurance	China Everbright Insurance Agency	Ping An Life Insurance, Ping An Property & Casualty Insurance

Note: * Not all subsidiaries are wholly-owned

Sources: Company annual reports, available from company websites. All accessed June 2007. Lin (2003).

Figure 1: Stylized policy options for regulating banks' activity scope and organizational form

		Activity Scope	
		<i>Unrestricted</i>	<i>Restricted</i>
Organizational integration	<i>High</i>	Universal banking* (for example Germany)	NA
	<i>Low</i>	Broad banking** (for example US after 1999)	Specialized banking (for example US prior to 1999)

Note: * Different financial services are typically offered directly by the same institution or by subsidiaries

** Different financial services are offered indirectly via a holding company structure. Note that rules governing information sharing between various holding company subsidiaries differ between countries

*** The shaded area corresponds to banking scope regulatory regimes that allow for 'integrated financial services provision'

Figure 2: Relationship between the sophistication of a country's financial system and the integrated financial services provision cost-benefit trade-off

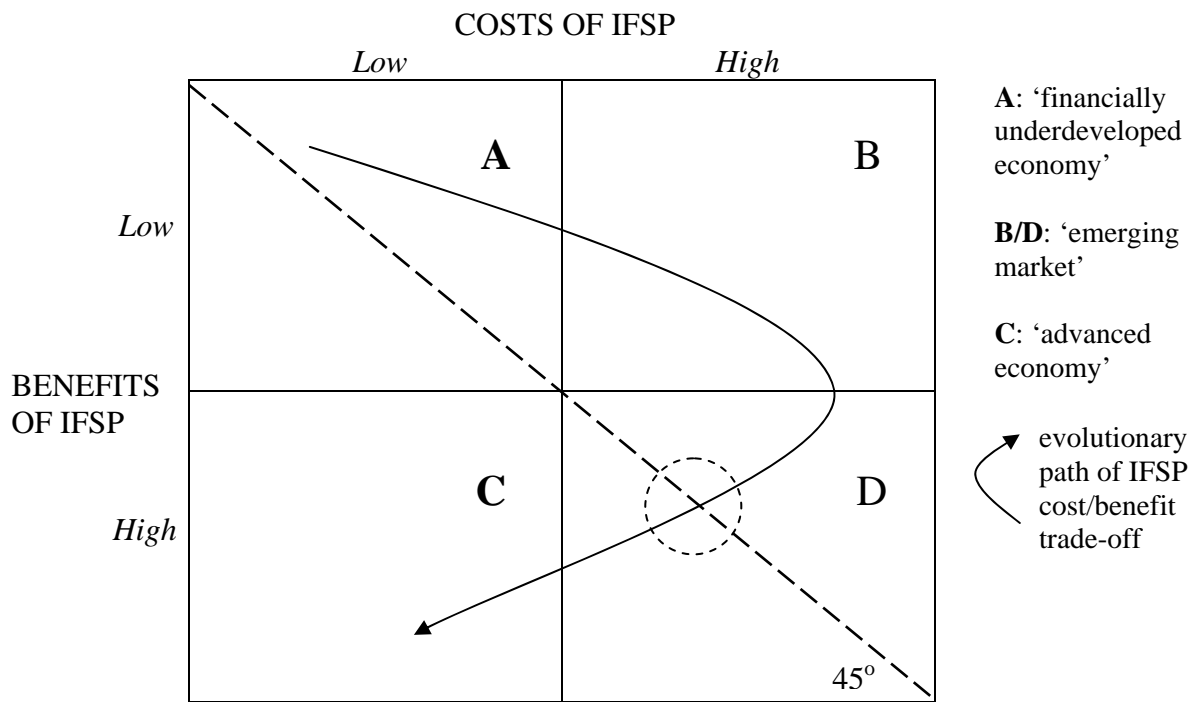
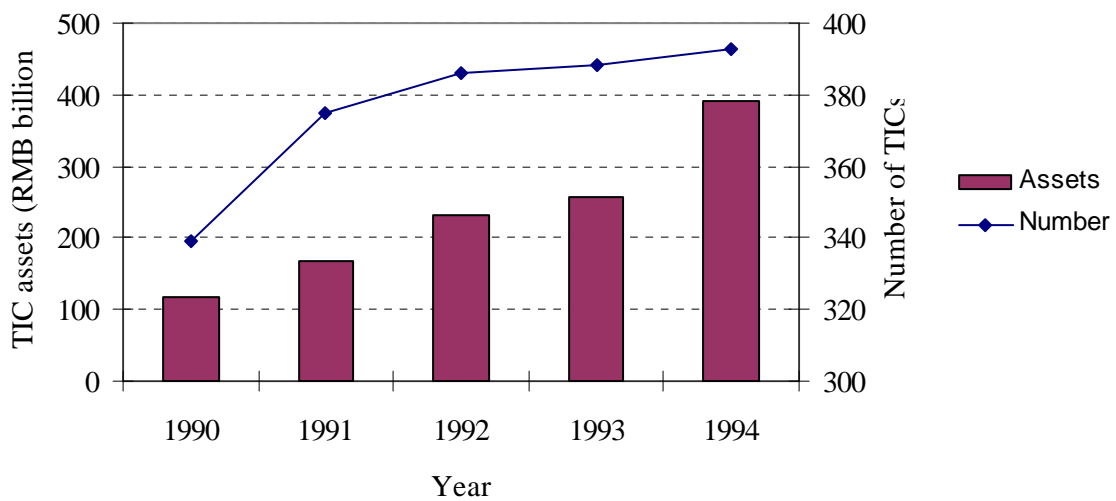


Figure 3: Development of Chinese TICs in the early 1990s



Source: Albrecht *et al.* (1997, p. 10).