Depositor Protection in the Chinese Bank Insolvency Regime: How is China’s Deposit Insurance Scheme Delivered in Bank Failures?

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Abstract

China’s deposit insurance scheme was established in 2015 and was first tested in 2019 when Baoshang Bank was formally declared insolvent. This article provides the first analysis to scrutinise both the legal framework and the operation of the deposit insurance scheme in China. Specifically, the article examines the implementation of China’s deposit insurance scheme in two recent events, the insolvency of Baoshang Bank and the collective bank runs taking place in Henan and Anhui provinces, which have not been extensively covered by existing literature. The findings of this article affirm that the current deposit insurance scheme does provide a fundamental level of protection to depositors. However, many uncertainties and weaknesses remain, particularly regarding the difficulty of initiating depositor compensation, the uncertain function of deposit insurance funds, the vague rights and responsibilities of the Chinese Deposit Insurance Fund Management Corporation, and the maximum level of payment. Moreover, there are two barriers pinpointed which may substantially hinder the development of the Chinese deposit insurance scheme. First, traditional beliefs in state guarantees for banks and policies aimed at maintaining social stability create an environment where banks in China may rely on implicit state support. Second, the unsound bank insolvency mechanism complicates the depositor compensation process and undermines depositor confidence in China’s deposit insurance scheme.

Keywords: Deposit insurance, depositor compensation, bank resolution, bank insolvency, bank run, depositor payment, 2022 Henan banks protests, Baoshang Bank, the Chinese Deposit Insurance Fund Management Corporation, China’s Deposit Insurance Regulation 2015.

1 Introduction

Deposits are the largest liability for Chinese banks. According to the statistics collected in 2019, the proportion of deposit liabilities in different types of banks was between 64% and 82% in China.[1] Arguably, the topic of repayment for deposit debts and depositor protection is crucial in the bank insolvency process. Against this backdrop, this article will use China's deposit insurance scheme as a starting point to explain in detail how China addresses the issues concerning depositors during bank insolvencies, who are recognised as the largest group of unsecured creditors of banks. In addition, building on the arguments presented in previous articles, this article will further explain how the Chinese regulators utilise deposit insurance funds in handling bank insolvencies.

China's deposit insurance system is still considered a novel mechanism, since the current legal framework is based on the Deposit Insurance Regulation (DIR), which was enacted by the State Council on 1 May 2015. Before the enactment of the DIR in 2015, there was no deposit insurance scheme in China. Instead of having a rule-based scheme, the state provided depositors a blanket of implicit guarantees. However, in fact, when there was a bank failure, the state did not guarantee all deposits. For example, when Hainan Development Bank was declared insolvent in 1998, the local government only paid the individual depositors, whereas the business depositors have not yet to be paid until today because the local government was fiscally unable to cover all depositors.[2] Hence, although there was an implicit guarantee, Chinese depositors were not adequately protected. Meanwhile, the blanket of implicit guarantees also increased the financial burden of local governments. Under pressures from various stakeholders, the deposit insurance scheme was finally established in 2015.

To avoid the blanket guarantee, similar to many other jurisdictions, China's current deposit insurance scheme protects depositors up to a specified limit.[3] Furthermore, banks must pay

[1] 'Explore Ways to Reduce Costs Through the Veil of Liabilities (透过负债端面纱探寻降成本路径)' (27 April 2020) Huatai Securities Research Paper, 5 <http://pdf.dfcfw.com/pdf/H3_AP202004281378820449_1.pdf> accessed 11 July 2023.

[2] Nan Wang, 'A Study on Chinese Bank Insolvency Law (我国银行破产法律制度问题研究)' (2007) 4 The Jurist (法学家) 77, 78.

[3] In the United Kingdom, the insurance covers £85,000 per eligible person, per bank, building society, or credit union. In the United States, the insurance covers $250,000 per depositor, per eligible bank, for each account ownership category.

deposit insurance premiums to the deposit insurance fund management institution each year, which makes arrangements to pay insured depositors when a bank fails.

In China, deposit insurance funds were previously managed by the Financial Stability Bureau of the People's Bank of China (PBOC). According to Mr Xiaochuan Zhou, then-governor of the PBOC, it is appropriate to allow the PBOC to manage the funds and handle the payment issues because some rules were still in the trial phase when the DIR was set to go into effect.[4] For example, Articles 18 and 19 of the DIR, the most crucial sections of China's deposit insurance scheme that define the role of the deposit institution and the functions of the funds, are still very ambiguous nowadays.[5] Therefore, the implementation of these ambiguous articles still requires tailored guidance from the PBOC and other regulators.

On 24 May 2019, the PBOC finally created the Chinese Deposit Insurance Fund Management Corporation (DIFMC). It is a one-person limited liability company wholly owned by the PBOC and is responsible for managing deposit insurance funds, which the PBOC had managed before.[6] Since the DIFMC was urgently established to pay the depositors of the insolvent Inner-Mongolian Baoshang Bank (Baoshang Bank), the PBOC did not announce the specific responsibilities and powers of the DIFMC at the time of establishment. Meanwhile, the law has not been updated with rules relevant to the newly established DIFMC so far.

Despite various ambiguities in the current legal framework, establishing the DIFMC still marks a significant milestone in enhancing China's banking safety net, which currently consists of three pillars. The National Financial Regulatory Administration (NFRA) is primarily responsible for prudential regulation decisions;[7] the PBOC sets monetary policies, controls financial risks and serves as the lender of last resort; the DIFMC plays a key role in minimising the risk of bank runs and contributing to deposit protection by collecting risk-based insurance.

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[4] Yanqing Yang, Weizhu Nie, and Shangyu Lide, 'Xiaochuan Zhou, Governor of the Central Bank: Analysis of China's Deposit Protection System (央行行长周小川: 解析中国存保制度)' *No.1 Caijing Daily News* (Beijing, 28 April 2015).

[5] This point will be precisely discussed later.

[6] Xiao Wang, 'Detailed Explanation; How does the Central Bank Invest 10 billion to Establish a Deposit Insurance Fund Company? (详解央行出资 100 亿成立存款保险基金公司如何运作)' *21st Century Economic News* (Beijing, 29 May 2019) <https://web.archive.org/web/20210507232743/https://www.jiemian.com/article/3170959.html> accessed 11 May 2023.

[7] On 18 May 2023, the China Banking and Insurance Regulatory Commission (CBIRC) changed its name to the NFRA which is a new-structured financial oversight authority to supervise all financial services except securities companies. It is worth noting that the China Securities Regulatory Commission (CSRC) still independently exists.

In 2022, 3,998 deposit-taking institutions paid deposit insurance premiums totalling RMB 48.727 billion in China.[8] In addition, the DIFMC received annual insurance premiums of RMB 46.705 billion in 2021 and RMB 42.388 billion in 2020 respectively.[9] By the end of 2022, the account balance of deposit insurance funds was RMB 54.94 billion.[10] Arguably, sufficient funds show that China has prepared well for depositor compensation during bank failures.

The goal is set at the right direction, but the issue is how they are handled in practice. Particularly, Baoshang Bank completed liquidation in 2021, making it the first case to use the deposit insurance funds. In this case, the DIFMC used RMB 630 million to pay the insured depositors on time, demonstrating the first success of the current deposit insurance scheme. However, the regulatory responses are different when Yuzhou Xinminsheng Village Bank and other banks in Henan and Anhui Provinces faced bank runs in 2022. The DIFMC did not take the immediate step of paying insured depositors to stop bank runs, leading to tens of thousands of people unable to withdraw their money over several months in Henan Province. One year later, in 2023, the authorities first allowed the mobilisation of deposit insurance funds to handle bank runs in Henan Province.[11] It seems that the regulatory response, initiating a deposit compensation scheme, was slowly arriving in cases of bank runs. Therefore, the practice indicates that there are some weaknesses under the current regime.

Following the implementation of the deposit insurance scheme in the aforementioned cases, it is time to reconsider whether China's deposit insurance scheme is effective enough to protect depositors. As for the current literature, many discussions are related to the reform of China's deposit insurance scheme, but few address the issues mentioned above. So far, some articles have discussed the current regime from a comparative perspective, introducing the deposit insurance regime in various jurisdictions and looking for areas to improve in the Chinese approach.[12] However, most articles are theoretical or doctrinal studies, while few articles focus

[8] Dan Li, 'Central Bank: The Balance of Deposit Insurance Fund is 54.94 Billion By the End of 2022 (央行:截至 2022 年末存款保险基金存款余额 549.4 亿元)' *Securities News* (Beijing, 31 March 2023) <https://www.stcn.com/article/detail/830969.html> accessed 14 May 2023.

[9] Jie Cheng, 'China's Deposit Insurance Protects more than 99% of Depositors (中国存款保险全额保障 99%以上存款人)' *Beijing Youth Daily* (Beijing, 16 March 2020) <https://www.jnnews.tv/p/961195.html> accessed 11 May 2023.

[10] Li (n 9).

[11] Cheng Leng and Robin Harding, 'China to Deploy Deposit Insurance to Repay Victims of Rural Banking Fraud' *Financial Times* (Hong Kong, 15 Jun 2023) <https://www.ft.com/content/b3d883df-090f-4a51-99d9-3c07dcdc9826> accessed 26 June 2023.

[12] Jingyun Chi, 'International Experience of the Early Corrective Measures in the Deposit Insurance System (存款保险早期纠正制度的国际经验与借鉴)' (2023) 2 West Finance (西部金融) 87; Ningyao Ye, 'The Reform of Deposit Insurance in China: How China Evolves from Implicit Deposit Insurance to Explicit Deposit Insurance'

on the practice of the deposit insurance scheme in China, let alone to reveal the gaps between the existing legal framework and practice.[13] Concerning this, this article aims to provide an in-depth analysis of the key components of the current deposit insurance mechanism and examines whether the current practice is effective in meeting its objectives, particularly in the field of depositor protection.

The article proceeds in five sections. Following this brief introduction, Section 2 provides an overview of China's legal framework for the deposit insurance scheme. Section 3 takes recent cases as examples to analyse the operation of China's deposit insurance scheme. Section 4 sheds light on the findings of the gaps between law and practice in response to what has been revealed in Section 3. It also exposes some flaws in the current regime and offers some solutions. Section 5 discusses the prospects of the future deposit insurance scheme and summarises the barriers to future development in the context of the Chinese social-legal environment. Finally, Section 6 offers a conclusion.

2 The Legal Framework of China's Deposit Insurance Scheme

The legal framework of China's deposit insurance scheme is stipulated in the DIR, which is a short and concise law with only 23 articles. The law's objectives are clear.[14] Objective 1 is to limit bank risks early, report risks to banking authorities and take early corrective measures, which requires the deposit insurance institution to determine the insurance rate and collect insurance premiums.[15] Here, it shows that the DIFMC undertakes a regulatory function. However, some immediately point out a problem of this regulation. The undertaking of a regulatory function by the DIFMC is vague and unable to be implemented, because there is no workable rule to explain the details of regulatory function.[16] Objective 2 is compensating eligible depositors when a bank fails, which is the key contribution of the DIR.[17] This means

(2022) 30 Asia Pacific Law Review 265; Shen Wei, 'Is China's New Deposit Insurance Scheme a Panacea? And Why Now? A Functional Analysis' (2016) 31 Journal of International Banking Law and Regulation 80.

[13] Rongfeng Zhang, 'Suggestions on Improving China's Deposit Insurance System (完善我国存款保险制度的建议)' (2023) 3 Hebei Finance (河北金融) 54; Ruiting Xiao and Qing Wang, 'Employ Legal Strategies and Methodologies to Bolster the Deposit Insurance System (运用法治思维和法治方式推动完善存款保险制度)' (2022) 6 West Finance (西部金融) 60; Hui Peng, 'The Risk Resolution Mechanism of Commercial Banks under the Current Deposit Insurance System: A Case Study of China's Practice (存款保险制度下商业银行风险处置机制探究:以我国处置实践为例)' (2021) 10 International Business Accounting (国际商务财会) 58.

[14] China's Deposit Insurance Regulation 2015, Article 1.

[15] Ibid, Article 7.

[16] Jieche Su, 'Considerations of Public Choice and Institutional Framework of Bank Resolution (银行风险处置的公共选择考量与制度建构)' (2023) 2 Global Law Review (环球法律评论)128, 139.

[17] Yang, Nie and Lide (n 5).

that deposit protection in China has formally changed from an implicit to an explicit insurance regime, though some still criticise that there is an implicit blanket government guarantee for most deposits nowadays.[18] The criticism is verified in recent cases, which will be particularly discussed in Section 3 of this article.

Specifically, the DIR tackles the first objective by putting forwards some measures. First, the DIFMC and banking regulatory authorities, including the Ministry of Finance, the PBOC and the NFRA, should establish an information-sharing mechanism.[19] For example, the DIFMC is supposed to report the risk of banks to the banking regulatory authorities and facilitate them to take some actions, such as increasing the profit retention ratio, reducing non-performing assets, supplementing capital, regulating high-risk businesses of banks, limiting high-interest deposits, reducing leverage and supervising corporate governance.[20] Second, the DIFMC can deliver a risk-based premium system to take early corrective measures.[21] It has begun to execute a differentiated and flexible deposit insurance rate based on the results of the official rating agency and adjust the insurance premium quarterly since 2016.[22] However, critics point out that implementing corrective measures is questionable due to banks' opaque corporate governance, leading to numerous difficulties.[23]

If the first objective of the DIR is to limit risk and take early corrective measures before a bank fails, the second objective could be summarised as limiting the destruction caused by bank insolvencies, which includes depositor compensation and bank resolution rules. According to the DIR, all eligible depositors may receive up to RMB 500,000 within seven working days when a bank fails.[24] Any deposit over RMB 500,000 is not covered by the insurance scheme.[25]

[18] Ye (n 13) 285.
[19] Law of the People's Bank of China 2003, Article 35; Law of the People's Republic of China on Banking Supervision and Administration 2006, Article 29; China's Deposit Insurance Regulation 2015, Article 14.
[20] Guohui Li and Ling Ma, 'Improving the Deposit Insurance System and Strengthening a Financial Safety Net (完善存款保险制度织牢金融安全网)' *China's Finance Times* (11 Marth 2021).
[21] China's Deposit Insurance Regulation 2015, Article 7.
[22] Ming Lei, Xiaoyu Qin and Shenggang Yang, 'Differential Rate Mechanism of Deposit Insurance and Bank Risk-taking: Evidence from China's Rural Banks (差别化存款保险费率与银行风险承担)' (2022) 3 Finance Study (金融研究) 41, 44.
[23] Fanxia Meng and Yitong Song, 'The Continuance of the Anti-corruption Campaign: Senior Executives are Widely Ousted and Local Banks Are Endemic to Corruption (金融反腐延续: 高管频落马地方银行成腐败高发地)' *People's Daily* (Beijing, 11 June 2020) <http://finance.people.com.cn/n1/2020/0611/c1004-31742475.html> accessed 9 May 2023; 'The Summary of Corruption Cases in the Financial Sector in 2020 by the CPC Central Commission for Discipline Inspection (中纪委盘点 2020 年金融领域反腐案例)' *National Business Daily* (Beijing, 2 January 2021) <https://baijiahao.baidu.com/s?id=1687764664954803353&wfr=spider&for=pc> accessed 9 May 2023.
[24] China's Deposit Insurance Regulation 2015, Articles 4, 5 and 19.
[25] Ibid, Article 5.

After compensating depositors, the deposit insurance institution obtains the right of subrogation in the subsequent liquidation procedure.[26]

According to Article 5 of the DIR, the calculation for the RMB 500,000 limit is the total amount of the principal and interest of all insured deposits of a bank account in the same insured institution.[27] This may raise an issue in the case of joint accounts, whether each depositor could be considered separately and compensated equally, which is not mentioned in the current legal framework.[28] In addition, there is no special rule for company accounts and accounts with 'temporary high balances' in China; especially, the once-sizzling property market can easily lead to temporary high balance in some bank accounts.

In addition, some wealth management and investment products issued by banks are not covered as well, although these products are particularly designed to attract deposits, and identifying these products is always a controversial point among depositors/investors in China.[29] More importantly, these deposit-attracting products are regularly sold by banks, but some small or unsophisticated depositors may not realise that these products are not covered by insurance, as they may be misled by bank staff presenting them as deposits.[30] Hence, some doubt whether the current target compensation range is broad enough to protect general depositors; also, some point out that the authorities should redefine the classification of insured deposits and the insurance cap.[31] Although unclear rules may lead to disputes in practice, officials believe the overall situation is manageable and predictable, because the targeted funding level can cover 99.3% of deposits in China by the end of 2022, compared to 99.6% in 2015.[32]

Moreover, to achieve the second objective of the DIR, Article 19 addresses the depositor payment conditions when (1) the deposit insurance institution is one of the members of the takeover team, (2) the deposit insurance institution acts as the liquidator, or (3) the court accepts

[26] Ibid.
[27] Ibid.
[28] This is the practice in the UK <https://www.fscs.org.uk/what-we-cover/> accessed 9 July 2023.
[29] Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks 2018, Articles 5 and Article 26.
[30] Nan Hu, 'Deposit Insurance Does Not Cover Wealth Management Products and Citizens Need to Be Alert to Risks (存款保险不保理财产品市民需警惕风险)' *Changjiang Daily* (9 April 2015) <http://finance.people.com.cn/money/n/2015/0409/c42877-26818233.html> accessed 11 May 2023.
[31] Huimei Wang, 'Survey on the Draft of the Deposit Insurance Regulation (存款保险条例征求意见稿调查)' *China Banking Industry* (February 2015) <https://finance.sina.cn/bank/yhgd/2015-02-15/detail-ichmifpx8114520.d.html> accessed 11 September 2023.
[32] PBOC, 'China Monetary Policy Implementation Report Q4 2022' (Monetary Policy Analysis Group 2022), 24; Yang, Nie and Lide (n 5).

the insolvency petition of the failed bank.[33] Then, the DIFMC should begin to pay the depositors within seven working days.[34] It is worth noting that an inconsistency exists between Article 19(1) of the DIR and Article 38 of the Banking Supervision and Administration Law, because the latter states that only the banking regulatory authority, generally, the NFRA, can take over a failed bank.[35] However, Article 19(1) of the DIR grants the DIFMC an implicit right to take over an insolvent bank. Notably, in terms of legal hierarchy, the DIR, as an administrative regulation, ranks below the Banking Supervision and Administration Law, which is an Act of Parliament. This inconsistency has persisted for nine years and remains unresolved.

Another inconsistency is whether the deposit insurance institution could perform the role of a liquidator in a bank insolvency. The prerequisite of the application of Article 19(2) is when the DIFMC become a liquidator. However, no law authorises that the DIFMC can be a liquidator under the current legal framework, which appears confusing. In addition, whether the DIFMC could file for insolvency and/or lead liquidation issues is unknown. This is also relevant to the debate over when depositor compensation begins, because the entity who becomes a liquidator or receiver may trigger depositor compensation simultaneously. However, Article 19 is too ambiguous to demonstrate this point. Due to the ambiguities of Articles 19(1) and (2), Article 19(3) becomes the only clear legal basis for the start of depositor compensation in practice, which suggests that depositors could receive payments after the bank enters into an insolvency procedure.

Article 18 is another important article in the DIR, which specifies the functions of deposit insurance funds. According to this article, the deposit insurance institution may pay depositors directly or contract with other qualified institutional policyholders to pay insured deposits up to RMB 500,000.[36] However, the identification of 'other qualified institutional policyholders' remains unknown under the existing legal framework. Moreover, Article 18 empowers the deposit insurance institution to provide credit support, share losses or give financial support for insolvent institutions, and facilitate their acquisition or assumption of all or part of the businesses, assets and liabilities of insured institutions to be taken over, closed or file for insolvency; meanwhile, the resolution must follow the least cost principle for the use of funds.[37]

[33] China's Deposit Insurance Regulation 2015, Article 19.
[34] Ibid.
[35] Law of the People's Republic of China on Banking Supervision and Administration 2006, Article 38.
[36] China's Deposit Insurance Regulation 2015, Article 18.
[37] Ibid.

Therefore, according to Article 18, deposit insurance funds not only can be used to pay depositors, but also have a wide function to facilitate a bank resolution. Nevertheless, due to the lack of further explanation, this article seems to provide authorities too much leeway in utilising deposit insurance funds, which may at the risk of abuse in practice.

In general, although there are some loopholes in the existing rules, China has established a legal framework of a deposit insurance scheme, providing a protective cushion for depositors. Notably, more crucial is how these rules can be materialised, which will be discussed in the next section.

3 How has China's Deposit Insurance Scheme been Delivered in Bank Failures?

The insolvency of Baoshang Bank in 2019 was the first case in which deposit insurance funds were used to compensate depositors when a bank was declared insolvent in China.[38] After that, other two banks (Liaoyang Nong Shang Rural Bank and Liaoning Taizihe Rural Bank) declared insolvent and all deposit accounts of these two banks were completely transferred to Shenyang Rural Commercial Bank, an acquiring bank.[39] Deposit insurance funds also played an important role during the bank account transfer process, but these cases remain confidential, and the application of deposit insurance funds in these two banks has not yet been reported to the public, so these two cases will not be mentioned in this section. Furthermore, in 2022, many small rural banks in Henan and Anhui Provinces were suspected of fraud.[40] Consequently, depositors could not withdraw funds from the banks, resulting in a collective bank run crisis involving six rural banks. Arguably, the crisis served as a litmus test for the effectiveness of the China's deposit insurance system in preventing the spread of bank crisis.

Against this backdrop, this section focuses on two iconic events, the insolvency of Baoshang Bank and the collective bank runs in Henan and Anhui, to show how the current deposit insurance scheme dealt with bank failures and how deposit insurance funds were used in China.

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[38] The First Intermediate People's Court of Beijing Municipality, 'Verdict of the Completion of the Insolvency of the Baoshang Bank Co. Ltd' (19 August 2021) <https://pccz.court.gov.cn/pcajxxw/pcws/wsxq?id=DDA6E7AD234E350F6DEE12250593280B> accessed 11 May 2024.

[39] 'The Businesses of Two Bankrupt Banks in Liaoning Will Be Taken Over by Shenyang Rural Commercial Bank and the Depositors Will Not Be Affected (辽宁两破产银行业务由沈阳农商行承接,储户存取款不受影响)' *Ifeng Finance* (Beijing, 26 August 2022) <https://i.ifeng.com/c/8InUSmvFhPC> accessed 11 September 2023.

[40] Zongyuan Zoe Liu, 'China's Village Bank Collapses Could Cause Dangerous Contagion' *Foreign Policy* (27 July 2022) <https://foreignpolicy.com/2022/07/27/china-village-banks-economic-growth-dangerous-contagion/> accessed 29 October 2023.

3.1 The Insolvency of Baoshang Bank

On 24 May 2019, Baoshang Bank was taken over by the PBOC and the China Banking and Insurance Regulatory Commission (CBIRC) due to the serious risks.[41] The takeover team took over the management of this bank and directed a large state-owned bank, the China Construction Bank, to assist in managing the businesses of the failed bank during receivership. The regulators initially hoped to find investors to restructure the bank, but it was unsuccessful. After that, they mobilised deposit insurance funds to help with the resolution and insolvency process.[42] Thus, the use of deposit insurance funds in the event of Baoshang Bank insolvency consist of two parts: compensating depositors and providing financial resources for bank resolution.

From the perspective of depositor compensation, the authorities used deposit insurance funds to guarantee 100% of individual depositors without limits, which were 5.2 million individual depositors in total, and paid 25,000 business depositors up to RMB 50,000,000 respectively.[43] It is worth mentioning that the actual compensation level in the Baoshang case was 100 times greater than the RMB 500,000 statutory cap enshrined in the DIR.

Furthermore, not only depositors, but also non-depositor creditors received special treatments. For example, non-depositor creditors with liabilities of up to RMB 50,000,000 had their payments fully covered by deposit insurance funds.[44] Other creditors with liabilities of more than RMB 50,000,000 were partially paid by the funds.[45] In fact, most of these debts were interbank liabilities, and the regulators made this decision so as to ensure financial stability within the banking system.[46]

From the perspective of bank resolution, deposit insurance funds made a significant contribution to the acquisition and purchase process in dealing with Baoshang Bank. First, the regulators instructed two state-owned banks, Huishang Bank and Mengshang Bank, as

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[41] The CBIRC has now changed its name to the NFRA.
[42] PBOC, 'China Monetary Policy Implementation Report Q2 2020' (Monetary Policy Analysis Group, 6 June 2020), 22.
[43] Yu Wu, 'The Press Conference of the Takeover team of Baoshang Bank (包商银行接管组负责人就有关问题答记者问)' *Xinhua News* (17 Jun 2019) <https://www.gov.cn/xinwen/2019-06/17/content_5400862.htm> accessed 21 July 2023.
[44] 'New Baoshang Shareholders Revealed: The Deposit Insurance Fund Management Corporation Was Listed as a Shareholder of a Commercial Bank for the First Time (新包商股东揭盅存保基金首现商业银行)' *Sina Finance News* (Beijing, 10 February 2020) <https://tech.sina.com.cn/roll/2020-02-10/doc-iimxyqvz1694694.shtml> accessed 11 May 2023.
[45] Ibid.
[46] Wu (n 44).

purchasers of Baoshang Bank. However, the acquiring banks could not afford the purchase by themselves. Then, the DIFMC injected RMB 8.89 billion to capitalise Huishang Bank and RMB 6.6 billion to Mengshang Bank.[47] Finally, the purchase and acquisition process was completed with financial support by deposit insurance funds.

Under such circumstances, a further consideration is whether it was reasonable to use deposit insurance funds to capitalise the purchasing banks in the Baoshang Bank resolution process. In theory, since Baoshang Bank was not a systemically important bank, if there was no suitable purchaser and the bank had already met the 'insolvency standard' in the legal sense, the regulators should have allowed the bank to wind up after transferring accounts or compensating depositors.[48] However, the regulatory responses indicate that the authorities were unwilling to strictly adhere to insolvency rules, as they had other concerns in handling Baoshang Bank.

The first concern is that Huishang Bank was one of Baoshang Bank's largest creditors. Although the authorities had already guaranteed to pay RMB 50,000,000 liabilities, Huishang Bank still lost nearly RMB 6 billion during Baoshang Bank's insolvency, including RMB 3 billion interbank debts and RMB 3 billion interbank investment liabilities. As a result, to limit losses, Huishang Bank converted debts to shares and thus became a shareholder of 'newly restructured Baoshang Bank'.[49] Notably, Huishang Bank acquired only part of Baoshang Bank's assets, specifically four branches located outside Inner-Mongolia Autonomous Region. In order to facilitate the smooth transition of these assets, the banking regulators used deposit insurance funds to inject capital into Huishang Bank. Therefore, after the completion of the merger of part of Baoshang Bank's assets in 2020, the DIFMC held 11.22% of Huishang Bank's shares, becoming the largest shareholder.[50]

The second concern is more relevant to political demands. Regarding the branches within Inner Mongolia Autonomous Region, even if there was no suitable purchaser, the authorities did not permit these branches to be liquidated. The primary reason was that the local government hoped the part located inside the Inner Mongolia Autonomous Region would continue to exist, as

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[47] Cheng (n 10).
[48] Law of the People's Republic of China on Commercial Banks 2015, Article 71.
[49] Xiaona Zhou, 'Behind RMB17.7 Billion of Acquisition expense, Huishang Bank Has Lost RMB 6 Billion (斥资 177 亿元收购包商银行背后,徽商银行渡 60 亿同业损失之殇)' *Sina News* (30 November 2020) <https://finance.sina.com.cn/stock/s/2020-11-30/doc-iiznctke4086207.shtml> accessed 21 June 2024.
[50] Yujia Zhang and Anqi Dai, 'Deposit Insurance Fund Injects Capital into Huishang Bank (存款保险基金“补血”徽商银行)' *Securities News* (26 August 2020) <https://stock.stcn.com/gsdt/202008/t20200826_2274562.html> accessed 31 January 2024.

liquidation would lead to employee replacement issues and affect public confidence. For the other political reason, Baoshang Bank, as a regional bank, primarily served the Inner Mongolia area, meaning that it significantly contributed to local revenue and provided large financial support to local government projects.[51] Therefore, the local government had sufficient motivation to rescue it. As a result, a new bank, Mengshang Bank, was established as a purchaser to fulfill the 'survival' objective of the parts of Baoshang Bank within Inner Mongolia Autonomous Region. Notably, the main shareholders of the new bank are the Inner Mongolia local government, the DIFMC and other local state-owned companies.

As a result, deposit insurance funds were not only used to compensate depositors in the Baoshang Bank insolvency proceeding, but also used to share the costs of resolving a bank failure and bank restructuring in accordance with the arrangements of the government.

3.2 Bank Runs in Henan and Anhui Provinces

Unlike the Baoshang Bank insolvency discussed above, the regulatory response was entirely different in the bank run chaos witnessed in Henan and Anhui provinces. In other words, the DIFMC did not make any contribution to stopping bank runs in Henan and Anhui Provinces; even the local banking regulatory authority did not make any reasonable and prompt response to solve the issues.

On 18 April 2022, four regional banks in Henan Province, including Yuzhou Xinminsheng Rural Bank, Shangcai Huimin Rural Bank, Zhecheng Huanghuai Rural Bank and Kaifeng New Oriental Rural Bank, suddenly closed their online services almost on the same day. Two small banks in Anhui Province, Guzhen Xinhuaihe Rural Bank and Yixian Xinhuaihe Rural Bank, encountered the same issue the following day. Then cash withdrawals over the counter also became difficult. These incidents caused panics among hundreds of thousands of depositors.[52] However, the DIFMC did not respond to the chaos, meaning that the depositors cannot receive compensation promptly through the deposit insurance scheme. Thus, the matter became serious, and some depositors began demonstrating before the building of local government, resulting in

[51] 'Bayannur Local Government Forum of High Quality Development: Financial and Economic Development (高质量发展大家谈之蒙商银行:金融赋能,助力经济高质量发展)' (31 January 2023, Government Conference Record) <https://www.bynr.gov.cn/hdjl/zxft/wqhg/202302/t20230227_501938.html> accessed 16 May 2023.
[52] Yangrui Hu, 'Chinese Rural Banks' Risks May Impact Deposits in Small Banks' (14 July 2022) S&P Global Rating Working Report, 2.

physical violence.[53] Even so, the regulators did not allow the DIFMC to compensate the depositors immediately or permit these banks to liquidate.

The main reason for the delayed compensation of depositors is that the authorities initially categorised these events as 'financial fraud'.[54] They attempted to recover funds from the suspects, as some shareholders and senior managers issued high-interest investment products to attract depositors. This led to suspicions of fund embezzlement, which contributed to withdrawal difficulties.[55] In addition, the authorities took a considerable amount of time to determine the compensation range and source of funds. Specifically, some deposits were classified as 'investments' due to fraud, while investment products are excluded from the compensation range under the current legal framework.[56] As a result, the authorities are unable to cover losses related to these investment products.

Despite the intense protests, the authorities did not explicitly deny compensation for these investment products, but they also did not take any proactive measures to address the issue. Moreover, some deposits have never been registered or recorded by banks due to fraud, making compensation more complex.[57] More importantly, the law does not provide a clear guidance to handle such a conundrum.

After several months of struggle, the local provincial government finally promised to compensate customers to maintain social stability. They were concerned that ongoing and intense demonstrations by victims would escalate further and increase distrust between the government and the Chinese people, especially during the COVID-19 lockdown period.[58] Consequently, under pressure, the local government began addressing depositors' withdrawal concerns. Notably, the compensation to customers were actually paid by the local government, not by deposit insurance funds. On 11 July 2022, small deposits below RMB 50,000 began to

[53] 'Henan: Violent clashes after hundreds show up for China bank protest' *BBC News* (11 July 2022) <https://www.bbc.co.uk/news/business-6211830> accessed 19 May 2023.
[54] Chen Chen, 'One Lady's Savings of RMB 800,000 in Many Village Banks in Henan But She Cannot Withdraw 29 Days (女子 80 多万积蓄存入河南多家村镇银行连续 29 天无法取出)' *Qilu Wanbao* (17 May 2022) <https://www.thepaper.cn/newsDetail_forward_18127556 > accessed 19 May 2023.
[55] Ibid.
[56] Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks 2018, Article 26.
[57] Chen (n 55).
[58] This information is from Weibo (one of the largest Chinese social media platforms). Many people complained about this on Weibo in May 2022, but it was quickly deleted by Weibo officials.

be reimbursed.[59] Then, deposits below RMB 100,000 began to be paid and the payments below RMB 50,000 continued.[60] In August 2022, the compensation level increased to RMB 500,000.[61] In January 2023, depositors with more than RMB 500,000 were informed to register their amounts, but it is still unknown whether all of them received full deposits.[62] By the end of January 2024, there was no news mentioning whether all depositors and investment product holders have received their full funds.

As a result, some depositors had been unable to withdraw their funds or receive compensation for over a year.[63] However, even with such serious liquidity problems in the banks, these banks were still not allowed to enter the liquidation procedure by the Chinese banking authorities. Therefore, the depositors who had not been paid could not claim compensation through the DIFMC or courts, leading to persistent demonstrations.[64]

On the other hand, the source of compensation funds became a significant challenge for the local government. In fact, local finances were unable to cover such large payments because the incident involved six banks and 400,000 depositors, and the cost of the depositor compensation may reach RMB 20 billion.[65] To address this, the PBOC announced in June 2023, one year after the collective bank runs, that it planned to use more than RMB 10 billion from the deposit insurance fund (approximately one-fifth of the currently available funds) to assist the local government in repaying depositors.[66] Despite the delayed announcement, this action represents a monumental step forward, indicating that the DIFMC may intervene in future bank run issues. However, it is still unclear whether the PBOC is willing to spend more deposit insurance funds if RMB 10 billion is insufficient.

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[59] Henan Banking and Insurance Regulatory Bureau and Financial Supervision Bureau, 'Henan Banking and Insurance Regulatory Bureau and Henan Provincial Financial Supervision Bureau Announcement No.1' (11 July 2022) <https://jr.henan.gov.cn/2022/07-11/2485267.html> accessed 17 May 2023.

[60] Bengbu Banking and Insurance Regulatory Commission and Financial Supervision Bureau, 'No.1 Announcement' (21 July 2022) <https://jrj.bengbu.gov.cn/xwdt/tzgg/9168057.html> accessed 17 July 2023.

[61] 'New Progress of the Four Rural Banks in Henan: Beginning the Compensation Appointment Process for Depositors with more than RMB 500,000 Saving (河南四家村镇银行新进展:启动 50 万元以上客户预约办理)' *Sina News* (Zhengzhou, 10 January 2023) <https://finance.sina.com.cn/wm/2023-01-10/doc-imxzscsq8605121.shtml> accessed 19 May 2023.

[62] Ibid.

[63] This information is from the anonymous netizen who complained on Weibo, but it cannot be verified <https://weibo.com/1087736174/N9DFHlDnB> accessed 26 June 2023.

[64] Ken Moritsugu, 'Chinese Bank Depositors Face Police in Angry Protest' *AP News* (Beijing, 10 July 2022) < https://apnews.com/article/covid-health-china-beijing-bad852e21bc4c5fbbbcc3996ab4bce91> accessed 15 January 2024.

[65] Hu (n 53).

[66] Leng and Harding (n 12).

As a result, the events in Henan and Anhui Provinces suggest that the current framework for depositor compensation may not adequately protect depositors, let alone to enhance market confidence. In particular, concerns have been raised about whether timely protection would be available for depositors and whether there is a lack of regulation to illustrate the compensation scope. Moreover, there have been concerns raised regarding Chinese small banks' management and supervision. For example, the problematic banks in Henan and Anhui did not register accurate information about depositors' accounts, whereas the DIFMC failed to detect this in a timely manner. The most noteworthy point would be the different regulatory responses in two events: the insolvency of Baoshang Bank and collective bank runs in Henan and Anhui, which will be discussed in depth in the next section.

4 Findings: Gaps Between Law and Reality

The two events mentioned above were cases that happened in recent years where deposit insurance funds were used to compensate depositors in China. However, the regulatory responses to these two events were far from identical. In the case of Baoshang Bank's insolvency, the banking regulators and the DIFMC took significantly prompt measures, even before the commencement threshold of depositor compensation set by law.[67] On the contrary, in the collective bank runs in Henan and Anhui, the regulatory response was much slower than in the Baoshang case. Even though the DIFMC mobilised deposit insurance funds eventually, the late intervention meant that deposit insurance funds were merely used as a financial supplement for the local government, whereas the DIFMC did not assume its legal responsibilities to protect the depositors in time.[68]

Therefore, some gaps can be identified from the past several years' experience of operating deposit insurance funds in China. This section will highlight four main gaps between the legal framework and practice, providing a reference for future amendments to China's deposit insurance scheme. These gaps are: (1) conditions for depositor compensation; (2) the limit of depositor compensation; (3) the unclear role of the DIFMC; and (4) the management of deposit insurance funds.

[67] China's Deposit Insurance Regulation 2015, Article 19.
[68] Ibid, Articles 17 and 18.

4.1 Conditions of Depositor Compensation

As mentioned in the first part, the existing legal framework for the conditions of depositor compensation is unclear in the DIR. The only applicable rule is Article 19(3), in which depositor compensation will be initiated when the judicial insolvency procedure begins.[69] In comparison to other countries, it seems that the current applicable compensation time is too late, especially when there is usually a lengthy administrative resolution period before the start of the judicial bank insolvency procedure in China. However, the current legal framework does not stipulate that depositor compensation needs to be initiated during pre-insolvency interventions, such as the administrative receivership process.

Nevertheless, Article 64 of the Commercial Banks Law provides a general guideline for banking regulators to protect depositors' interests when taking over a troubled bank.[70] However, it does not specify how compensation should be handled; instead, regulators use their administrative authority to manage compensation and related issues. As seen in the Baoshang case, the banking regulatory authorities begin compensating depositors as soon as they take over a bank.[71] Thus, this broad principle in Article 64 becomes a legal endorsement for the banking regulatory authorities to use deposit insurance funds at an early stage, before the judicial bank insolvency, such as the arrangement in the Baoshang case. Admittedly, this arrangement is more beneficial to depositors. Notably, since Baoshang Bank is the only bank to have entered the administrative receivership process to date in China, it remains uncertain whether the compensation policy used for Baoshang Bank depositors will apply to future cases of administrative receivership.

However, in China, when regulators have significant discretion in how they use their power, it can lead to delays in compensating depositors. For example, if the authorities are hesitant to place a struggling bank into a receivership or a takeover process, depositors will not be paid due to the absence of relevant laws.[72] In other words, if the authorities take a long time to make

[69] Ibid, Article 19.
[70] Law of the People's Republic of China on Commercial Banks 2015, Article 64.
[71] Yumin Li, 'Takeover or restructuring, Why Different Ways to Solve Problems between Baoshang Bank and Jinzhou Bank (被接管还是重组,包商和锦州银行为何结局迥异)' *21th Century News* (8 August 2019) <https://www.jiemian.com/article/3387067.html> accessed 14 March 2023.
[72] Selina Wang, 'US Bank Run Victims Were Bailed out in 3 Days; In China, Many have Been Waiting a Year' *CNN Business* (Beijing, 22 April 2023) <https://edition.cnn.com/2023/04/21/investing/china-us-banking-crisis-hnk-intl/index.html#:~:text=In%20China%2C%20many%20have%20been%20waiting%20a%20year,-By%20Selina%20Wang&text=Wearing%20surgical%20masks%20to%20cover,to%20demand%20their%20savings%20back.> accessed 13 May 2023.

a decision, depositors will bear the losses themselves during the decision-making period; the DIFMC is unable to take immediate measures when depositors are unable to withdraw money within a certain period from a bank. It precisely explains the challenges faced by the depositors in Henan and Anhui.

As a result, there is a loophole in the existing legal framework about the conditions of depositor compensation. The legislators appear to have forgotten a basic purpose of the deposit insurance scheme, which is to allow depositors to get money from deposit insurance quickly when there is a problem with the bank; whatever causes bank liquidity problems and withdrawal difficulties, the DIFMC is supposed to be responsible for a prompt payment. To address the loophole, two areas need to be considered. First, the initiation of payments should not be contingent upon the initiation of a formal court-involved insolvency proceeding but rather on the fact of withdrawal difficulties. Second, the DIFMC should be accountable to depositors and act promptly or automatically in response to depositors' requirements, aligning with the legislative purpose of the seven-day limit stated in Article 19 of the DIR.[73]

4.2 The Limit of Depositor Compensation

The DIR clarifies that the maximum compensation for each depositor is RMB 500,000 under the current insurance scheme.[74] Meanwhile, the prescribed compensation rule can be adjusted by banking regulators and legislation authorities according to China's economic and financial development.[75] However, it is worth mentioning that there has not been a single case in which the Chinese banking regulators have strictly applied the legal limit to compensate depositors so far. Therefore, the prescribed amount appears to become an optional reference in reality, whereas clearly articulated rules are often disregarded.

Take the Baoshang Bank insolvency case as an example. After increasing the compensation level to RMB 50,000,000, nearly 90% of creditors, notably including non-depositor creditors, were fully paid, whereas the planned payment rate would be 60% if the regulators strictly followed the existing cap at RMB 500,000.[76] This action was probably because the regulators

[73] China's Deposit Insurance Regulation 2015, Article 19.
[74] Ibid, Article 5.
[75] Ibid.
[76] PBOC (n 43), 21.

did not worry about the affordability of deposit insurance funds since they believe that bank insolvency is rare in China and the funds are sufficient.[77]

However, the regulators seem to be somewhat ambivalent about this behaviour because they also want to reduce the cost of improper intervention.[78] Furthermore, ad hoc government interventions are likely to increase more susceptibility to public panics as they may lead to greater confusion in the future.[79] Arguably, it is difficult to speculate whether the previous arrangement will continue in future bank failures. For example, it remains unclear whether the depositors having their credit balances over RMB 500,000 in the Henan and Anhui rural banks will be paid in full or in part. Nevertheless, given that the banks in Henan and Anhui are not allowed to enter formal court-involved insolvency proceedings, it is uncertain that the maximum compensation limit is applicable in this context. This might give the authorities more leeway to handle the issues.

Therefore, there is a significant disparity between the legal and practical payments for depositors. Based on the resolution of Baoshang Bank, the amount depositors received from the deposit insurance when the bank failed was determined by the ad hoc decisions of the banking regulatory authorities, rather than by existing rules. The only predictable aspect from the Baoshang Bank's experience is that the actual amount of depositor compensation will not be less than the amount fixed in the DIR. To address this disparity, it is recommended to clarify rules regarding the compensation limit. The law might be amended to empower the regulators to determine the compensation level at their discretion. Alternatively, it is expected to follow the current compensation rule and increase consumer awareness and depositor confidence under the compensation arrangement of the DIR. After all, an effective rule on depositor compensation level should provide certainty for depositors as well as eliminate the blanket guarantee by the state.[80]

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[77] Yu Wu, 'Taking over the Management of Baoshang Bank is Just an Individual Case and the Current Financial System is Safe and Well-Controlled—Response Inquiries by PBOC' (包商银行被接管是个难案, 当前金融风险总体可控——中国人民银行有关负责人答记者问)' *Xinhua News*, (2 Jun 2019) <https://www.gov.cn/xinwen/2019-06/03/content_5396962.htm> accessed 11 March 2023.

[78] CCP of CBIRC, 'Insisting in Preventing Major Financial Risks (持之以恒防范化解重大金融风险)' (2020) 10 Qiushi (求是) <http://www.qstheory.cn/dukan/qs/2014/2022-05/16/c_1128649199.htm> accessed 11 May 2023.

[79] David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (Wiley 2011) 26.

[80] Andrew Campbell, John Raymond LaBrosse, David G. Mayes and Dalvinder Singh, 'A New Standard for Deposit Insurance and Government Guarantees After the Crisis' (2009) 17 Journal of Financial Regulation and Compliance 210, 224.

4.3 The Unclear Role of the DIFMC

The DIFMC is a recently established institution that holds a significant role in the deposit insurance scheme. Legislators probably aim to confer certain regulatory powers upon the DIFMC and empower it with the ability to participate in bank liquidation.[81] However, specific details have not been provided yet. Unlike the Federal Deposit Insurance Corporation (FDIC) in the United States, the DIFMC lacks the mandate to initiate the depositor compensation process or to start a bank insolvency procedure, as these decision-making powers still rest with the Chinese banking regulatory authorities.

There are many ambiguities in the existing rules. First, there is inconsistency in the existing rules. The law introduces the measures after the DIFMC becomes the receiver but does not empower the DIFMC to become a liquidator or a receiver in bank resolution.[82] Second, there is ambiguity in the current legal framework. The law generally allows the DIFMC to take risk-reduction measures and to take early corrective actions but does not define the explicit regulatory function of the DIFMC.[83] Third, there are many legislative gaps in China's deposit insurance scheme. For example, it is unclear whether the DIFMC will be able to develop its own contingency planning and crisis management plans, let alone whether there will be a regular contingency planning exercise of bank resolution involving all banking safety-net authorities, as recommended by the International Association of Deposit Insurers (IADI).[84] As a result, arguably, the only clear role of the DIFMC is charging and safeguarding insurance premiums for the banking regulators at present.

In comparison with the international standards provided by the IADI, there are four categories of the role of the deposit institution and the funds as follows:

(a) Pay-box: A mandate in which the deposit insurer is only responsible for the reimbursement of insured deposits.
(b) Pay-box plus: A mandate in which the deposit insurer is given additional duties, such as certain resolution functions (e.g. financial support).
(c) Loss minimiser: A mandate in which the deposit insurer actively engages in a selection from a range of least-cost resolution strategies.

[81] China's Deposit Insurance Regulation 2015, Articles 13 and 19.
[82] Ibid, Article 19.
[83] Ibid, Article 7.
[84] IADI, 'IADI Core Principles for Effective Deposit Insurance Systems' (November 2014) IADI Handbook, 10 <https://www.iadi.org/en/core-principles-and-guidance/core-principles/> accessed 19 December 2023.

(d) Risk minimiser: A mandate in which the deposit insurer has comprehensive risk minimisation functions, such as risk assessment/management, a full suite of early intervention and resolution powers, and, in some cases, prudential oversight responsibilities.[85]

Under this classification, the DIFMC currently belongs to the second category, 'pay-box plus', because it has 'additional responsibilities' to provide financial support with the banking regulators, along with the responsibility of depositor payment. Meanwhile, this categorisation is also evident in the officials' description of the DIFMC, referring to it as the 'pay-box' and the 'fire extinguisher' to mitigate financial risk.[86] As some working in the Chinese banking industry predicted that China's deposit insurance funds will be widely used to rescue banks in the near future, because many small and medium banks are in danger at present under the backdrop of economic recession, especially after the COVID-19 pandemic.[87] Therefore, the beneficiaries of deposit insurance funds are not only depositors but also struggling or failed banks, which can use the funds as one of the resorts to rescue or restructure themselves.

Nevertheless, the facts reveal that the DIFMC has encountered obstacles in fulfilling its mandates. For example, the incidents in Henan and Anhui illustrate some challenges in the collaboration among the banking regulatory authorities and the DIFMC. Thus, some argue that certain rights should be granted to the DIFMC, which aims to reduce government intervention in its affairs and enable it to take prompt measures in the interests of depositors.[88] This opinion has been presented since the enactment of the DIR, but the law has not been amended accordingly. Against this backdrop, some even criticised the relationship between China's deposit insurance institution and the central government as follows:

> [T]he institution that has paid the money to general public depositors does not have the decision-making powers to make payments, whereas the authorities that have the decision-making powers do not care how much they spend and cannot be questioned.[89]

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[85] Ibid.

[86] 'Improve the Deposit Insurance System and Build a Financial Safety Net (完善存款保险制度构建金融安全体系)' *Rural Financial Times* (Beijing, 30 November 2020) A02.

[87] Peng Du, 'Practice and Enlightenment of Deposit Insurance Fund Management (存款保险基金管理的实践与启示)' (2021) 11 Financial Sight (金融视线) 101, 102.

[88] Meiruo Ma, 'To Win the Liaoshen Battle in the New Era in the Financial Field (打响新时代的金融"辽沈战役")' *China's Finance Times* (13 Marth 2023) A004.

[89] Chuan Du, 'Provide Full Protection for over 99% of Depositors: The Deposit Insurance Scheme Should be Alert to the Risk of Pay-box (为超 99%存款人提供全额保障,存保制度应警惕"付款箱"风险)' *No.1 Finance* (Beijing, 7 March 2023) <https://finance.sina.com.cn/money/bank/bank_hydt/2023-03-07/doc-imyiyvxf8422920.shtml> accessed 15 May 2023.

However, to prevent future occurrences of issues like those seen in Henan and Anhui, the DIFMC does not necessarily need to function as a regulatory authority. Specifically, in China, expecting the DIFMC to function as a regulator akin to the FDIC in the United States is unrealistic, because the DIFMC is a subsidiary of the PBOC, which is in a lower administrative/political status than the PBOC and the NFRA in the Chinese power hierarchy, meaning that it cannot require the PBOC and the NFRA to take actions unless there is an institutional restructuring.

For the future responsibilities of the DIFMC, one foreseeable aspect would be its participation in receivership and liquidation proceedings. Only by making such an amendment can the conflicting point in Article 19 of the DIR be resolved. However, the uncertainty lies in whether the DIFMC can assume the role of a receiver or liquidator similar to the role of the FDIC in the United States. Notably, according to the new Bill of the Financial Stability Law, the DIFMC will have more regulatory powers. For example, the Bill stipulates that the DIFMC can be a member of the takeover group and act as a receiver under the permission of the banking regulatory authorities.[90] In addition, the Bill states that the DIFMC is responsible for monitoring risks in the banking industry and the PBOC must share banking information with the DIFMC.[91]

4.4 The Means of Deposit Insurance Funds

The practice shows that deposit insurance funds have been extensively utilised in bank resolution in China. Apart from depositor payments, the funds have been used to rescue high-risk deposit-taking institutions, lend money to local governments for bank bailouts, purchase non-performing loans, and capitalise struggling banks.[92] For example, in 2021, the DIFMC capitalised Liaoshen Bank with RMB 1 billion from deposit insurance funds, when the bank was experiencing severe liquidity issue and was on the verge of insolvency. Liaoshen Bank was finally rescued and returned to normal after the recapitalisation. In addition, in 2020, the DIFMC and Liaoning Financial Holding Company established Jinzhou Jinyin Enterprise Management Partnership (Limited Partnership) to carry some of Jinzhou Bank's debts and issued some corporate bonds for bank restructuring.[93]

[90] The bill of Law of the People's Republic of China on Financial Stability, Article 35.
[91] Ibid, Articles 7 and 17.
[92] Cheng (n 10).
[93] Ibid.

This raises the question of whether the government could use deposit insurance funds to share the cost of bank rescue and resolve bank failures. Notably, in the Baoshang insolvency case, the DIFMC spent RMB 67.6 billion to share the bank resolution cost whereas the cost of depositor compensation only amounted to RMB 0.63 billion.[94] In addition, as mentioned in the previous section, China's deposit insurance funds effectively undertake some of the fiscal responsibilities, which are supposed to be taken by the PBOC, to maintain financial stability. This is also due to the close connection between the DIFMC and the PBOC. Apart from being a wholly owned subsidiary of the PBOC, the DIFMC's first CEO is Xiaolong Huang, who was the deputy director of the PBOC's Financial Stability Bureau, indicating that some actions of the DIFMC are still subordinate to the PBOC's guidance, despite the feature of being a legally independent corporation.

Against this background, some confusing and untenable activities in using deposit insurance funds in the Baoshang case could be explained logically. The reason is that the regulators used the fund for the purpose of maintaining financial stability. For example, the regulators used the fund to pay interbank liabilities, although Article 4 of the DIR clearly states that the funds should not cover interbank lending.[95]

On the contrary, paying interbank liabilities in the Baoshang case seems to be reasonable, because huge debts may trigger a chain reaction throughout the entire banking industry.[96] According to a lawyer who participated in the Baoshang insolvency case, the interbank liabilities of Baoshang reached 52% of the total liabilities in September 2017, although the PBOC clearly stipulates that the interbank lending ratio should not exceed one-third of the total liabilities in banks.[97] In 2019, the year when Baoshang Bank was taken over, the interbank liabilities of the bank were much greater than the overall deposits (the ratio has not been disclosed yet).[98] Thus, these data reveal a regulatory vacuum that has existed for at least two years, resulting in an unreasonable increase in interbank borrowings. Consequently, if deposit insurance funds are not utilised to settle Baoshang Bank's interbank debts, the insolvency of Baoshang could potentially drag other banks into insolvencies. Finally, most interbank

[94] Ibid; the First Intermediate People's Court of Beijing Municipality (n 39).
[95] China's Deposit Insurance Regulation 2015, Article 4.
[96] 'The Baoshang Insolvency Case (包商银行破产案)' (This article is published by an anonymous lawyer who participated the Baoshang insolvency case at a WeChat Account on 10 June 2023) <https://mp.weixin.qq.com/s/GN4yuakw5USpwh4yY3tHIA> accessed 11 June 2024.
[97] This information is collected by the author from an anonymous interview (Interview D).
[98] Ibid.

liabilities were paid from deposit insurance funds.[99] Therefore, Chinese deposit insurance funds bear the cost of regulatory oversight for the banking regulatory authorities.

From the perspective of the banking regulatory authorities, they successfully controlled the potential contagious risk in the Chinese banking system without using taxpayer money or borrowing from the central bank.[100] However, from the perspective of non-paid creditors, their rights were probably infringed. Paying off partial creditors in advance may violate the fundamental principle of *pari passu* in insolvency law, resulting in other creditors not being equally protected during liquidation.[101] As a result of such an administrative intervention, the court-based bank insolvency procedure, particularly the liquidation procedure, becomes merely a formality to declare the insolvency fact, because the debt distribution had already been completed by regulators prior to the insolvency stage.

Another example of using deposit insurance funds to share bank resolution cost is that the funds were mobilised to provide capital to the purchasers of the insolvent Baoshang Bank. This resulted in the DIFMC becoming a shareholder of the purchasing banks. This implementation seems unsustainable, and the only solution is that the DIFMC promises to sell these shares in the near future. However, the DIFMC has not yet made such a commitment, and China does not have the bridge bank regime to assist the purchase process.

It can be concluded that China's deposit insurance funds are, in essence, taking on the role of a financial stability safeguard, not only as the protector of depositors. Currently, the Chinese central government is expediting the establishment of the financial stability guarantee fund.[102] However, it is still uncertain whether the financial stability guarantee fund will be a specialised fund for resolving failing financial institutions or whether it will be under the management of the DIFMC.

In a nutshell, it is challenging to define the conditions for utilising deposit insurance funds based on the recent cases, as it heavily relies on the discretion of the banking regulatory authorities. Moreover, the practice shows that resolution does not require that the troubled bank

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[99] Sina Finance News (n 45).
[100] PBOC, 'The Spokesperson of PBOC and CBIRC Answered Correspondent on Baoshang Bank's Takeover' (26 May 2019) <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3834130/index.html> accessed 16 May 2023.
[101] The *pari passu* principle holds that, in a winding up, unsecured creditors shall share rateably in those assets of the insolvency company that are available for residual distribution.
[102] The bill of Law of the People's Republic of China on Financial Stability, Article 29.

be designated as systemically important. If regulators want to intervene in a struggling bank, they can do so as long as they declare that the bank is in danger or at default and that doing so would alleviate the concern of financial stability. Notably, this problem is not unique to China, as it has also occurred in other jurisdictions where the bank insolvency process is led by administrative powers.[103] In addition, it is also difficult to assert that the Chinese authorities have strictly applied to the least-cost principle regulated in Article 18 of the DIR so far.[104] As a result, the deposit insurance fund effectively serves as a large 'pay-box' for regulators to provide financial assistance to failed banks to reduce financial risks.

5 Difficulties in Future Development of China's Deposit Insurance Scheme

According to the arguments above, there are two main characteristics in the implementation of China's deposit insurance scheme. First, regardless of what the law stipulates, it appears that the regulators, in consideration of social and political impacts, often ignore the existing rules. Second, the existing legal framework has many loopholes and needs to be improved. Therefore, this section untangles these two features of China's deposit insurance scheme, which could also be regarded as the challenges for the future legislation development.

5.1 The State's Concerns: A Social-legal Issue

In China, the problems of bank failures and depositor protection has always been regarded as not only a legal issue but also a political one, given the characteristics of the historical development of the Chinese banking industry. For example, there was a long period when almost all banks in China were state-owned, and banking businesses were conducted in accordance with the central or local government plans.[105] Even though China's banking sector was commercialised in the 1990s, banks still maintain close link with the state nowadays. For instance, the central government has the right to appoint senior managers of major state-owned banks, and local governments could influence the appointment of directors of non-state-owned banks in their regions.

As a result, there is arguably a close connection between the existence of banks and the reputation of the state. Moreover, a bank failure may undermine public confidence, raising concerns about the banking supervision system and even challenging the political party's

[103] Skeel (n 80), 9.
[104] China's Deposit Insurance Regulation 2015, Article 18.
[105] Guogang Wang, '70 Years of Banking Sector in China: Development, Characters, and Experience (中国银行业 70 年:简要历程、主要特点和历史经验)' (2019) 7 Management World (管理世界) 15, 17.

creditworthiness. Against this backdrop, how to compensate depositors in bank failures becomes a significantly cautious matter in China. For the central government, compensating depositors beyond the prescribed limits could not only maintain social stability, but also demonstrate the attitude of the Chinese Communist Party (CCP) to place people first regardless of spending money, which is also an opportunity to dispel public scepticism of the governing ability of the CCP. After all, the Party retains the final decision on how bank resolution and depositor compensation will be handled.[106]

The solution to the collective bank runs in Henan and Anhui is a typical example illustrating the State's concern for social stability. It is worth mentioning that the bank runs in Henan and Anhui are not one-off incidents. In 2022, bank runs were also reported in Nanjing and Shenzhen by social media, but the media later retracted their reports, identifying the bank runs as rumours.[107] Hence, some media suggest that these bank runs are precursors to a nationwide reshuffling of Chinese small and medium-sized banks, which is also in alignment with the central government's recent policy aimed at reducing risks in small and medium-sized banks.[108] As a result, the public could easily conclude that China is currently combating banking insecurity. This perception may trigger panic regarding the solvency of other high-risk banks and increase the nationwide risk of bank runs on smaller institutions.

The event that escalated into a social stability trouble was the demonstrations by the angry depositors in Henan. To prevent large-scale demonstrations, the local government even utilised the COVID-19 control policy as an excuse to order demonstrators into quarantine centres in order to halt the protests.[109] This action was later rectified by the central government, resulting in an investigation into certain officials.[110] The news sparked widespread discussions on Chinese social media platforms, especially on Weibo. As the discussion intensified, netizens

[106] Weiyi Cai, Aaron Byrd, 'Chris Buckley and Pablo Robles, How Xi Returned China to One-Man Role' *The New York Times* (2 September 2023) <https://www.nytimes.com/interactive/2023/09/02/world/asia/china-xi-rule.html> accessed 9 September 2023.

[107] Xiao Su, 'Why Are Financial Rumours Still Being Banned Amid Ongoing Turmoil?' *Sohu News* (5 July 2022) <https://www.sohu.com/a/564124805_579490> accessed 17 March 2024; 'Why Shenzhen Needs to Strengthen Cash Withdrawal Management' *Netease Finance* (4 October 2022) <http://money.163.com/special/00252EBE/shenzhen_xianzhi.html> accessed 17 March 2024.

[108] Liu (n 41); State Council, 'Implementation Opinions of the State Council on Promoting the High-Quality Development of Inclusive Finance' (No.15 State Council Documents, 2023) <https://www.gov.cn/zhengce/zhengceku/202310/content_6908496.htm?trs=1> accessed 13 February 2024.

[109] 'Henan Government Penalises Numerous Officials for Red Code Incident, Yet Public Complaints Persis' *BBC* News (23 June 2022) < https://www.bbc.com/zhongwen/simp/chinese-news-61907664> accessed 17 March 2024.

[110] Ibid.

shifted from complaining the Henan provincial government to criticising the CCP's policies.[111] Therefore, the compensation of these depositors became a hot and sensitive issue that could impact social and political stability, thus attracting the attention of the central government.

When addressing the issues related to social stability, the banking regulatory authorities usually adhere to the instructions of the Central Financial and Economic Affairs Commission, which is a commission of the Central Committee of the CCP in charge of leading and supervising economic work of the State Council.[112] In 2023, the Central Committee of the CCP and the State Council established the Central Financial (Work) Committee with the aim of guiding the work in China's financial sector.[113] Notably, the Party's stance is generally to prioritise the needs of the public and minimise factors that may disrupt social stability.[114] Hence, the perspective is reflected in the utilisation of substantial deposit insurance funds for bank resolution and exceeding compensation for depositors.

In summary, considering that China takes into account more political and social factors when dealing with bank failures and depositor payments, the implementation of China's deposit insurance scheme may consistently be guided by the government and the Party. Therefore, there might always be a gap between the law and practice.

5.2 An Unsound Bank Insolvency Regime: The Background of China's Deposit Insurance Scheme

The gaps between the legal framework and its actual implementation does not merely stem from political pressures but also from the weaknesses of law itself. As a result, the regulators have to make on the spot decisions and take administrative measures to address issues like depositor compensation during bank failures and bank resolution. To ensure the effective implementation of the deposit insurance scheme, it is crucial to establish a robust bank resolution and insolvency mechanism as the background. However, China's bank insolvency system is still in the early stage of development, lacking a comprehensive legal mechanism to serve as a reference for regulators. For example, the DIR, as an administrative regulation, lacks

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[111] Ibid.

[112] Chinese Central Government, 'The State Council Information Office Held a Press Conference on Strengthening Confidence, Keeping Innovating, and Improving the High-quality Development of the Real Economy' (3 March 2023) <http://www.gov.cn/xinwen/2023-03/03/content_5744366.htm> accessed 15 January 2024.

[113] Cheng Leng and Edward White, 'Xi Jingping Tightens Financial Sector Control as New Super-regulator Takes Shape' *Financial Times* (Hong Kong and Seoul, 26 October 2023) <https://www.ft.com/content/14d601cb-2121-48a2-a47a-6244257f538c> accessed 19 November 2023.

[114] This information is collected by the author from an anonymous interview (Interview G).

guidance from higher-level laws, leading to unclear conditions for depositor compensation and vague responsibilities of the DIFMC.

Generally, an effective bank resolution and insolvency mechanism involves timely intervention in troubled banks and effective bank insolvency procedures. For instance, the Dodd-Frank Act outlines capital regulation, enhanced supervision, stress tests, and cooperation among resolution authorities alongside deposit insurance.[115] Regardless of any country, protecting the interests of depositors is paramount throughout the bank resolution process. Key issues regarding depositor protection include transferring accounts to other banks, depositor compensation under the deposit insurance scheme, and the preferential status of depositors during the liquidation procedure. However, recent bank insolvency cases in China highlight the significant administrative intervention and guidance required from the banking regulatory authorities due to the absence of adequate laws. Hence, it is unsurprising that the Chinese government assumes full responsibility for depositor compensation issues and the utilisation of deposit insurance funds.

For instance, there is no purchase and assumption transaction regime or bridge bank mechanism in China, creating a highly ambiguous role for the DIFMC in participating in bank resolution. This lack of clarity may result in regulators potentially abusing deposit insurance funds. In comparison to the United States, the FDIC has several options for resolving bank failures, including immediately closing the bank, selling the failed bank or establishing a bridge bank to find a successor. But there is no parallel rule in China. In the American approach, the bridge bank is a temporary bank funded by the FDIC that will assume all deposits and liabilities of the failed bank in order to keep the bank's businesses running.[116] In addition, bridge banks typically exist for no more than two years before being merged with other banks or dissolved.[117] There is also a comparable system in the United Kingdom. When the failed bank meets the specific conditions, the Bank of England could transfer all or part of a bank's business to a bridge bank, which is a company wholly owned by the Bank of England.[118] In addition, the

[115] John H. Cochrane, 'Challenges for Cost-Benefit Analysis of Financial Regulation' (2014) 43 Journal of Legal Studies S63, S76.
[116] FDIC, *Managing the Crisis* (April 1998, FDIC) 175.
[117] Look Chan Ho, 'UK Bank Insolvency Reform' (2008) 3 Capital Market Law Review 320, 323.
[118] Banking Act 2009, Section 12.

Treasury may take the failed bank into temporary public ownership when the general conditions are satisfied and then find suitable purchasers.[119]

As a result, for future amendments to the laws, it is not sufficient merely to amend the provisions in the DIR. It is also essential to systematically update the entire legal framework governing bank resolution and insolvency regimes to provide the necessary legal infrastructure for implementing the deposit insurance scheme, particularly concerning the involvement of the DIFMC in bank insolvency procedures. In fact, depositors can only maintain their confidence during bank failures through the establishment of a smooth bank resolution and insolvency system, supported by a deposit insurance scheme.

Furthermore, the Chinese government is supposed to establish a reasonable system to regulate the application of deposit insurance funds based on a cost-benefit analysis. While quantifying political or social goals in financial regulation may be challenging, this does not impede the establishment of a flexible mechanism to regulate excessive discretionary power of regulators. In addition, Chinese officials also need to depart from their conservative tradition of making every effort to bail out banks.[120] Afterall, relying on deposit insurance funds as a bailout mechanism for troubled banks is not sustainable. Especially, the current implementation may worsen moral hazard among the banking sector, potentially leading to a larger crisis.

6 Conclusion

China has already established a deposit insurance scheme via the DIR to protect depositors' interests and facilitate bank resolution when a bank fails. However, the current legal framework's ability to maintain depositor confidence needs practical validation. The insolvency of Baoshang Bank serves as a positive example, as depositors were promptly and fully protected, likely bolstering depositor confidence in China's banking sector. However, the resolution of Baoshang Bank also reveals a critical issue in the current deposit insurance scheme: regulatory hurdles arising from ambiguous rules. In fact, the safeguarding of depositors in Baoshang Bank is largely attributed to proactive regulatory intervention rather than the efficacy of China's deposit insurance mechanism. However, regulators may not guarantee that every regulatory response will be as robust as that of Baoshang Bank. Hence, when depositors in Henan and Anhui faced similar issues, their deposits were not adequately

[119] Ibid, Section 13.
[120] Mark Hsiao, *Regulatory Principles of Banking Law in China* (Sweet & Maxwell Asia, Hong Kong 2015) 193.

safeguarded. Therefore, the recent cases illustrate that the current legal framework for depositor protection may not sufficiently protect depositor confidence.

To enhance depositor confidence, there are some areas for improvement under the current deposit insurance scheme. First, the ambiguities of depositor payment conditions result in amending compensation terms to ensure prompt depositor compensation proceedings. Second, given that payments often exceed the prescribed compensation level for depositors, the regulators should strike a new balance between the legislative purpose of the DIR and political demands. Moreover, there are some ambiguities regarding the role of the DIFMC and the function of depositor insurance funds. In particular, it is still debatable whether deposit insurance funds could be extensively used to share the cost of resolving bank failures and whether they were potentially abused by the government. Therefore, future laws need to clarify these uncertainties.

Furthermore, two macro points of view need to be considered in the future development of China's deposit insurance scheme. First, the tradition thought of state guarantee for banks and the current policy of maintaining social stability will impact the implementation of depositor compensation and the utilisation of deposit insurance funds. Second, the inadequacy of rules and the unsound bank insolvency mechanism may also affect the implementation of China's deposit insurance scheme.