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# CHINA LAW INSIGHT

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## CBRC's New Supervisory Storm is Here – Implications for Foreign Banks in China

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### Introduction

1. The China Bank Regulatory Commission (“**CBRC**”) has issued a set of new rules (“**Rules**”) aimed at:

- controlling a broad range of risks in the financial system;
- improving the regulatory and supervisory framework; and
- ensuring that the banking sector better serves the real economy and national development policies

2. The Rules apply to both domestic banks and foreign banks in China. This publication focusses on key issues that are relevant to foreign banks operating in China

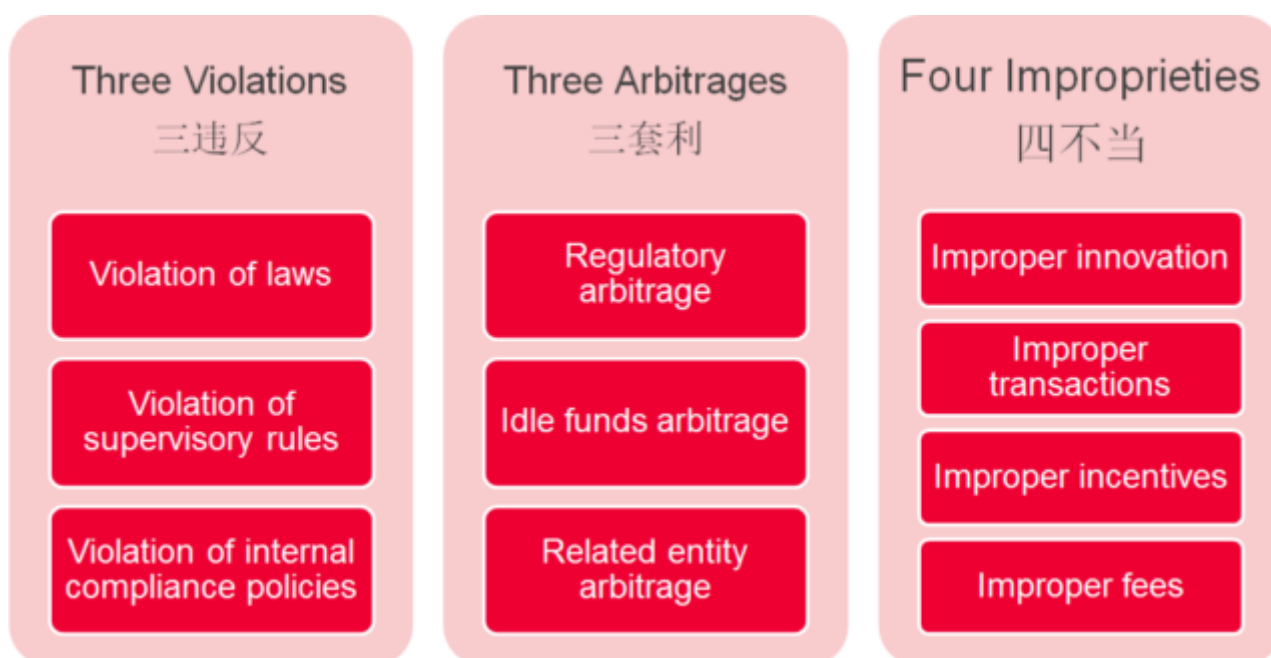
3. In addition to introducing many new requirements and guidelines, the Rules also strengthen and reinforce a number of existing CBRC policies

4. The Rules are the latest in a series of policy and enforcement measures taken by Chinese financial regulators to address financial and systemic risks

5. The Rules represent the first major rulemaking under the leadership of newly appointed CBRC chairman GUO Shuqing

## Underlying problems

The CBRC has identified the following underlying problems that has led to irregularities in the banking and financial sector:



## Irregular and improper behaviors in the industry

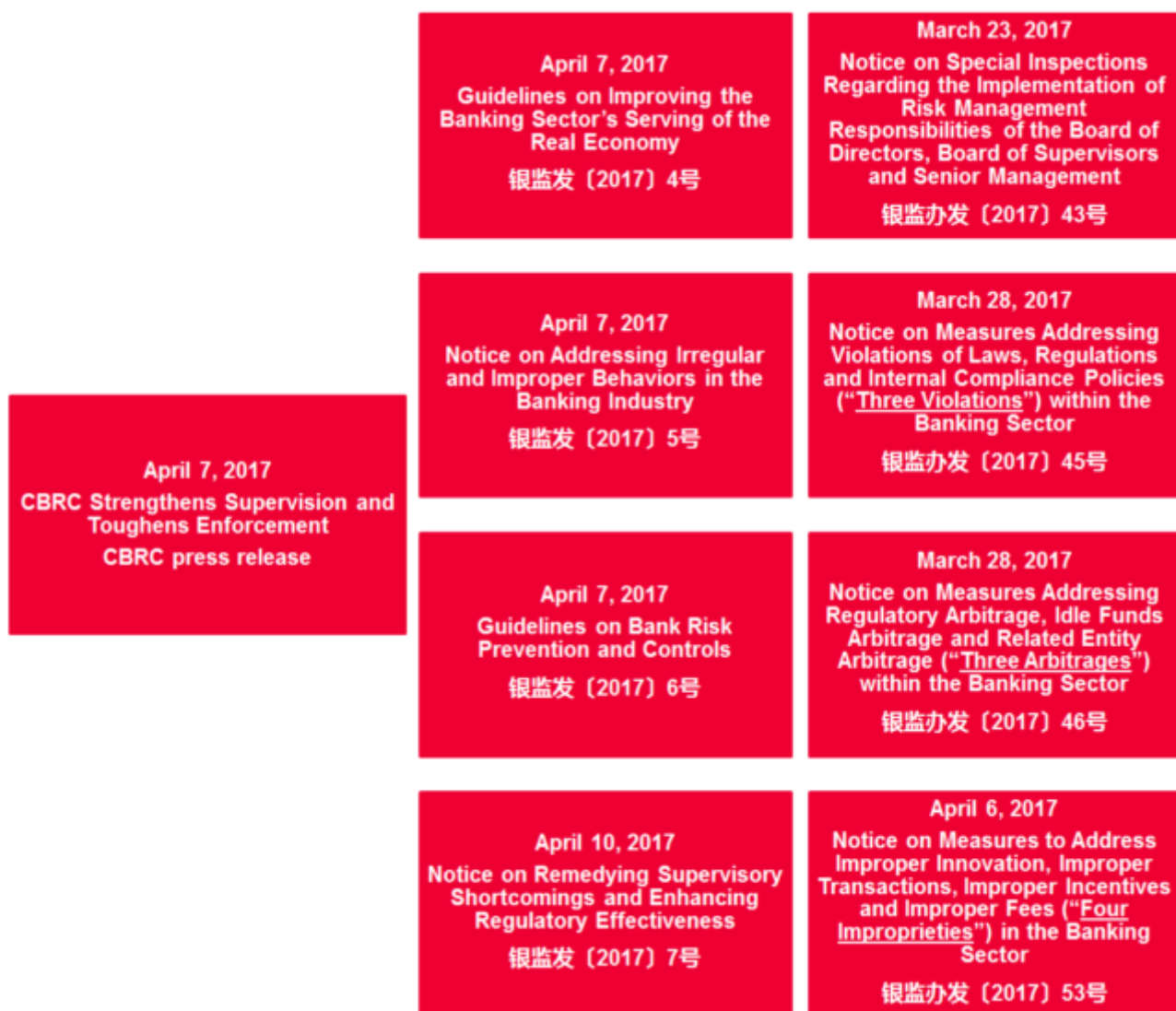
The CBRC has identified the following key irregularities and improper behaviors in China's banking and financial sector:

- Overly leveraged financial institutions
- Complex financial products involving multiple layers of transactions and financial institutions
- Idle funds circulating within the financial sector and not flowing towards the real economy

- Lengthy financing supply chain involving multiple intermediaries between the ultimate lender and borrower, leading to increased borrowing costs
- Prevalence of regulatory and other types of arbitrage activities
- Unsound corporate governance practices
- Cronyism
- Supervisory and regulatory gaps and shortcomings that create loopholes
- Charging fees that are disproportionate to the services provided
- Charging fees without doing any valuable work
- Banks continuing to lend to “zombie” companies which exacerbates over capacity problems
- Failure to serve the real economy and investing funds for speculative purposes

## **Package of tough new measures**

The Rules represent the CBRC’s response to these underlying problems and irregular and improper behaviors. The Rules include the following key components:



## Key objectives and outcomes

The Rules are intended to achieve the following key supervisory objectives for CBRC:



These supervisory objectives are intended to achieve the following key outcomes for the banking sector:

**Ensure strict compliance with laws, regulations and internal policies**

**Return to the fundamental essence of banking services**

**Ensure the banking sector serves the real economy**

**Prevent and guard against risks**

## **How can banks better manage risks?**

To achieve the key outcome of better risk controls and compliance, the Rules require banks to do the following:



## How can banks better serve the real economy?

To achieve the key outcome of better serving the real economy, the Rules require banks to do the following:



## Specific actions that banks must take



- **Information-based risk controls:** Requiring banks to use information systems to objectively control and manage all types of risks
- **Clear responsibility:** Requiring the financial institution (e.g. bank) that originated the funds to assume responsibility for financial products that cut across multiple sectors within the financial industry (e.g. banking, securities and insurance sectors)
- **Strengthen control over activities between banks:** Require oversight of board of directors with respect to the development and risk management of wealth management activities between banks (i.e. within the banking sector)



- **Firewalls:** Establish firewalls between the banking system and the capital markets, bond markets, insurance markets and FX markets
- **Ex ante review:** Internal management framework and procedures must be established for any financial innovation, and the prior approval of the risk management department, the legal compliance department and the board of directors (or relevant committee) must be obtained before engaging in actual activities
- **Stress testing:** Targeted stress testing of rapidly growing new products, new business lines and business areas with significant potential risks

## Behaviors that banks must avoid

- Engaging in business activities without first obtaining the required approval or making the required filing
- Engaging in new and innovative business without establishing the required internal framework and procedures
- Bank employees improperly accessing, searching, disclosing or selling customer information
- Improper product bundling – forcing customers to purchase certain products and services in order to obtain other products or services from the bank
- Passing mortgage registration fees onto the customer
- Charging too much fees, not providing enough services and charging fees in excess of prescribed levels
- Failure to provide customer with 3-month's advance notice of fees and charges
- Failure to publicize fee schedule or fee adjustments in a timely manner
- Making non-complying real estate related loans
- Making non-complying loans the proceeds of which are used to invest in the stock market and futures market
- Forming improper business cooperation with micro-lending companies and other non-financial institutions
- Non-compliant sale, disposal and write-off of NPLs



- Non-compliant transfers of performing loans
- Non-genuine transfers of credit assets
- Non-compliant conversion of NPLs into off-balance sheet items
- Using refinancing and other methods to conceal NPLs

## Behaviors that banks must avoid (*cont.*)

- Issuing bank acceptance bills that are not based on genuine underlying trades
- Converting assets under the discounting business into investments by contributing bills of exchange assets into asset management plans
- Failing to use the look-through approach and substance over form principle in accounting, risk and capital measurement practices
- Providing financial services to illegal, non-regulated trading platforms
- Using the bank's own funds to purchase its own or another bank's wealth management products
- Layering one wealth management product onto another wealth management product
- Increasing leverage by entrusting funds to external fund managers for investment purposes
- Providing or accepting guarantees or similar arrangements in connection with investments between banks or otherwise for wealth management products
- Banks investing in each other's wealth management products and asset management plans to increase leverage and earn more spread
- Banks transacting with each other to inflate their balance sheets
- Using deceptive, bribery and other improper methods to attract deposits
- Non-compliant transfers of credit assets by investing in related funds or partnerships
- Using related entities to engage in equity and real estate investments that are prohibited for banks
- Using the Qualified Domestic Institutional Investor ("**QDII**") regime to invest in offshore bonds issued by domestic real estate companies (as opposed to lending directly to these companies)

- Failure to comply with annual report and other disclosure requirements

## **Behaviors that banks must avoid (*cont.*)**

- Bank employees selling financial products that are not offered or authorized by the bank
- Bank employees misleading customers to purchase wealth management financial products
- Selling products without conducting investor suitability tests
- Not clearly disclosing to customers when selling other organizations' products, thereby causing customers to falsely believe that they are the bank's own products
- Forced bundling of wealth management products
- Pooling of funds relating to different wealth management products
- Transactions between wealth management products
- Engaging non-financial institutions to provide investment management services for wealth management products
- Wealth management products that invest in products issued by non-financial institutions
- Wealth management products that directly invest in credit assets or receivables
- Wealth management products that invest in NPLs, NPL asset-backed securities or other rights related to NPLs
- Principal-guaranteed wealth management products that are not managed as deposits and no deposit reserves have been placed with the People's Bank of China

## **Behaviors that banks must avoid (*cont.*)**

- Engaging in cross-border business without receiving approval
- Failing to timely monitor and detect abnormal accounts
- Providing financial services to illegal immigration activities
- When providing services to a customer, requiring the customer to use services provided by accountants, lawyers or rating agencies specified by the bank

- After an incident occurs or after a risk eventuates, directly dismissing the persons responsible without effectively seeking responsibility
- Employing the children and other family members of government and Party cadres on preferential terms
- Arranging with other organizations in the banking sector to employ the children and other family members of each other's employees
- Employing the children and relatives of customers on preferential terms
- Providing unfairly advantageous pay and benefits to relationship hires

## Key corporate governance shortcomings targeted by the CBRC

### Structural shortcomings of the board of directors

- Failure to establish strategy, audit, risk management, related entity transactions, nomination and remuneration committees of the board of directors in accordance with relevant requirements

### Directors and senior management failing to completely fulfil their duties and responsibilities

- The amount of time spent actually working at the bank is less than the minimum requirement
- A director failing to attend more than two-thirds of board meetings
- A director failing to express views or demanding remediation with respect to major business strategy deviations, failure to meet prudent supervisory standards, material risk management policy failures and similar incidents
- Directors and senior management should be held personally responsible for failing to comply with supervisory requirements to take remediation action with respect to declines in asset quality, false risk classification of loans, material cases, internal control incidents and material reputational risk incidents

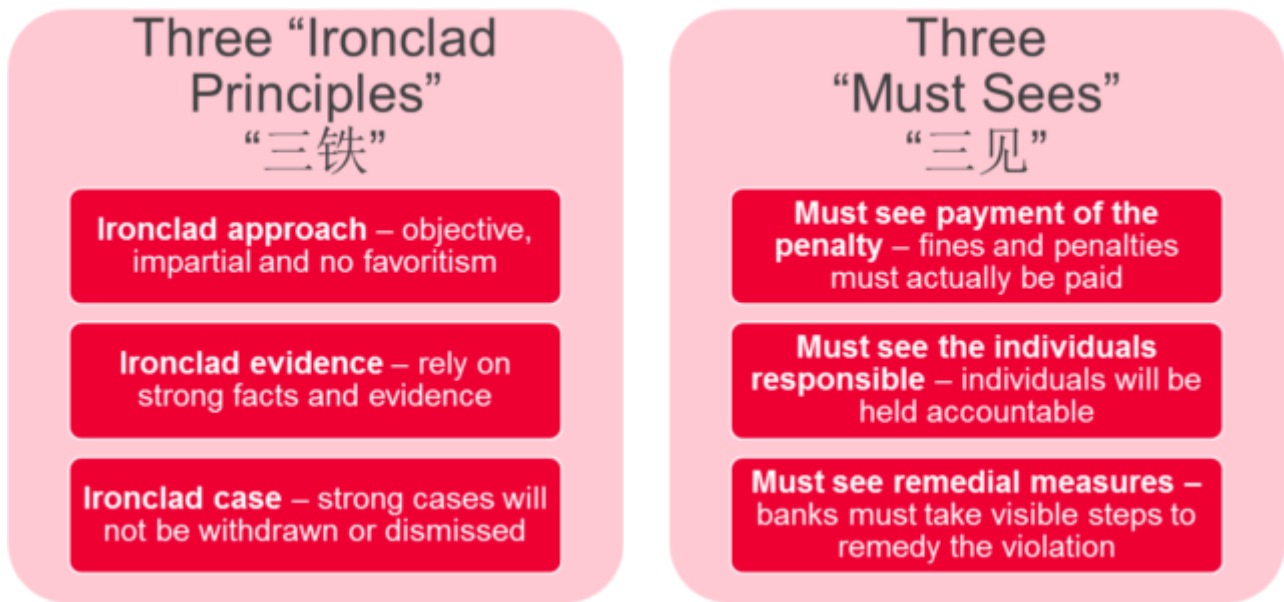
### Shortcomings in remuneration management and payment systems

- Not complying with regulatory requirements relating to performance-based pay of senior management personnel, including risk indicator adjustments and claw-back requirements

## Enforcement principles

- Violations of the Rules will result in severe supervisory and enforcement actions taken by CBRC.

- CBRC will adhere to the following enforcement principles:



## CBRC's roadmap for enforcement

The Three "Ironclad Principles" and Three "Must Sees" form the basis of the following roadmap for enforcement by the CBRC:

#### Carry out targeted actions

- Implement the “three responsibilities” (primary responsibility falls on the entity that caused the incident, secondary responsibility falls on management and tertiary responsibility falls on the supervisory department)
- Secure the “three lines of defence” (the business line, the risk management and compliance function, and the audit function)
- Create a culture of compliance where financial institutions are afraid to break the rules, unable to break the rules and unwilling to break the rules

#### Address regulatory shortfalls

- Where appropriate, enact new laws and regulations, amend existing laws and regulations, and repeal redundant laws and regulations
- Close regulatory gaps and loopholes

#### Increase supervisory penalties

- The penalty imposed should be proportionate to the violation
- Regulatory arbitrage must be prevented
- Financial institutions must not profit from their violations

#### Ensure accountability

- When an incident occurs, the manager, the stakeholder and the person responsible must be held accountable
- When a risk eventuates, the business originator, the person who approved the transaction and the person in charge of the organization must be punished
- Establish an industry blacklist and implement industry-wide bans to prevent disqualified individuals from working in the industry or being promoted

#### Address regulatory shortfalls

- Encourage compliance by requiring remediation in each case and holding individuals accountable
- Holding senior executives responsible for violations

## Severe penalties for violations

The CBRC can impose the following penalties on banks and individuals for violations:

- Combine a financial institution’s self-examination with supervision inspection, severely punish problems and violations that were not fully addressed through self-examination
- Depending on the facts and circumstances of each case, a financial institution may be ordered to suspend its business, cease starting any new business, cease opening new branches, change its directors and senior executives or comply with other prudential supervisory measures

- Severe punishments will be imposed in cases involving repeat offenders, inadequate remedial measures, and failure to cooperate with regulators and inspectors
- Severe punishments will be imposed in cases involving improper transactions with related entities and arbitrage activities
- Fines will be imposed along with the confiscation of illegal gains
- Penalties received by the financial institution will be reflected in its market access, performance evaluation and regulatory ratings etc.
- “Double punishment” will be imposed on both the financial institution and the individual(s) responsible for the violation

## **Penalties already imposed by CBRC**

Following is a snapshot of the CBRC’s enforcement efforts in the first quarter of 2017. We expect the CBRC to further strengthen enforcement over time.



## Next steps for banks

### Actively carry out self-examination and proactively remediate violations

For example, a bank should:

- Comprehensively review the effectiveness and compliance of risk management framework and internal policies
- Verify the compliance status of lending activities and fund flows
- Remediate non-compliant structures and arrangements with respect to wealth management products



- Address non-compliant fee arrangements and related contractual provisions (especially with respect to financial adviser fees, consulting fees and requiring the customer to bear mortgage registration fees)
- Consider how the Rules will impact the relationship between a foreign bank's Chinese operations and its operations outside of China

**Cooperate with regulators in relation to supervisory inspections and examinations; diligently complete all remediation steps**

For example, a bank should:

- Strengthen communications with regulators
- Be prepared to provide adequate explanations to regulators from a legal and compliance perspective

***Note: This has been updated on 18 April.***

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