

# Peking University Transnational Law Review

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國際法學院  
SCHOOL OF TRANSNATIONAL LAW



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TRANSNATIONAL  
LAW REVIEW**

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SCHOOL OF TRANSNATIONAL LAW**

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# Peking University School of Transnational Law

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## MESSAGE FROM THE EDITOR-IN-CHIEF

Welcome to our inaugural issue of the Peking University Transnational Law Review. The Peking University Transnational Law Review focuses on publishing articles and speeches covering a broad area of Chinese law, U.S. law, and transnational law, as well as comparative law issues. The first issue includes two articles and two speeches. The articles and speeches are in the area of Chinese law, U.S. law and international law.

All year round, we welcome submissions made by professors, practitioners, and students worldwide. We publish two issues annually in winter and summer respectively. We accept manuscripts year-round and undergo a review process once we receive submissions.

The journey to publishing the first issue of the Peking University Transnational Law Review has been a long one. It started as an adventure and while it came across several stumbling blocks, it managed to overcome all of them. Today, we see the inaugural issue being published and we will continue to see it being published.

Over the past years, the generous help from our advisory board and our faculty advisors has helped the Law Review grow from its cradle and prosper. I thank them for their help in establishing the Peking University Transnational Law Review and their kind words and support. I also thank all 18 members of our Law Review for their dedication towards publishing the first issue. As the Law Review will continue to publish subsequent issues I hope the Peking University Transnational Law Review will continue to expand its reach to readers and become a strong legal research tool for global researchers, academics, and practitioners.

More importantly, we would also like to welcome any thoughts or comments from our readers. Any comments will be thoroughly read upon being received at [lawreview@stl.pku.edu.cn](mailto:lawreview@stl.pku.edu.cn).

Best Regards,

ZHU Zhaoke (Derek)  
*Editor-in-Chief*

## FOREWORD

*Jeffrey S. Lehman\**

The publication of this, the first edition of the Peking University Transnational Law Review, is a moment of signal importance to the world of legal scholarship.

The Peking University School of Transnational Law (“STL”) opened its doors in 2008 and graduated its first class of students in 2012. In five short years, STL has established itself as an exemplar of a new model of legal education for the twenty-first century.

STL provides a four-year, post-baccalaureate education in transnational law. The curriculum builds upon the Juris Doctor curriculum offered at American law schools and the Juris Master curriculum offered at Chinese law schools, adapting each in significant ways to the modern transnational legal environment. Students prepare themselves to be attorneys within either the American or the Chinese professional context. They develop the intellectual skills that characterize the best lawyers worldwide—critical and precise analysis, sympathetic engagement with counterargument, creative synthesis, effective written and oral expression, and a capacity to work with people from different cultures.

STL students also develop a uniquely transnational perspective on legal problems. For four years, they are encouraged to consider substantive legal rules in a comparative perspective. For four years, they are encouraged to think about claims that some legal rules developed by national sovereigns have an appropriate extraterritorial reach. For four years, they are exposed to substantive legal rules whose force arguably

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\* Jeffrey Lehman is Chancellor and Founding Dean of the Peking University School of Transnational Law, and Vice Chancellor of NYU-Shanghai. He studied at Cornell University and the University of Michigan Institute of Public Policy Studies, and he holds a Juris Doctor degree from the University of Michigan Law School. He has served as President of Cornell University, Dean of the University of Michigan Law School, Law Clerk to Chief Judge Frank Coffin of the U.S. Court of Appeals for the First Circuit, Law Clerk to U.S. Supreme Court Justice John Paul Stevens, and President of the American Law Deans Association. He has also taught at the Yale Law School, l’Université de Paris II, and Tsinghua University. He is a scholar of tax law and public benefits law, and he is the author of *An Optimistic Heart*, and *Corporate Income Taxation*.

transcends the boundaries of national sovereignty. For four years, they examine the ways that different parties structure transactions that cross national borders, as well as the ways that those parties resolve disputes as they arise. Guided by faculty members who are among the world's foremost authorities on these topics, they develop the kind of sophistication that a globalized legal profession requires.

Finally, STL students come to understand how they must develop different lawyer voices, appropriate to different contexts. They learn to speak and write as counselors, as negotiators, and as advocates. And they also learn to write as scholars. In order to graduate from STL, every student must complete a thesis – a serious work of original writing that illuminates a topic that touches and concerns transnational law. And in a fundamental rite of intellectual passage, all STL students must defend their theses orally before an academic jury.

The rigorous thesis requirement helps to ensure that all STL students appreciate the culture of legal academic writing from the very outset of their legal education. It is therefore not surprising that STL students, like their counterparts at other top law schools, would want to assume responsibility for editing a journal of legal scholarship focused on transnational law. A highly competitive process led to the appointment of the first board of editors of the *Transnational Law Review*, and the fruits of their labors are now ready for publication.

The *Transnational Law Review* addresses an important need in legal scholarship. Over the past few decades, as the domain of transnational law has rapidly grown in importance, a number of specialized journals have emerged with a particular focus on that domain. The *Transnational Law Review*, however, is the first to emerge as the flagship journal of a law school, a true unifying focus for all students and faculty.

It is important to recognize the critical role that journals such as this one continue to play in the world of legal scholarship. Modern technologies of publication make it easy for scholars to distribute their ideas online. Although that is in general a highly salutary development, it leaves readers in danger of a kind of information overload. Student-edited law journals provide two enormous services to the consumer of legal scholarship – a curatorial service through which we receive signals about what writing is worth reading, and an editorial service through which the quality of the writing is improved.

The inaugural issue of the *Transnational Law Review* offers a welcome taste of the exceptionally high quality we can expect to find in this new journal. Two student theses are featured, theses that reflect the enormous breadth of topics that properly fall within the concept of transnational law. The first is Li Jiangfeng's "Non-Performing Loans and Asset Management Companies in China: Legal and Regulatory Challenges for Achieving Effective Debt Resolution and Recovery." The second is Liu Xiaoping's "The French Muslim Headscarf Ban under the Context of International Law."

The issue also features two important public addresses on transnational law by eminent jurists with a connection to STL. In June 2012, Michael Greco, former President of the American Bar Association and Professor from Practice at STL, spoke at STL about the role that lawyers have played in social progress in the United States over the past two centuries. And in November 2012, Philip McConaughay, dean of the Dickinson School of Law at Pennsylvania State University, visited STL and delivered a lecture concerning the role of arbitration in economic development and the creation of transnational legal principles. Each address highlights the ways in which twenty-first century legal norms are being shaped by entities that stand independent of any single national sovereign.

We should also note the significance of the fact that this journal is being published in the city of Shenzhen, in the People's Republic of China. Only a few decades ago, during the period of the Cultural Revolution, China struggled to function as a society without legal norms, without legal institutions, and without any generalized commitment to being a society governed by the rule of law. In the intervening years China has built a significant portion of the infrastructure that the rule of law requires, but much work remains before the construction project is completed.

The creation of a true student-edited journal, committed to critical exploration of issues that bear directly on China's participation in the transnational legal community, furthers that project. Like the creation of STL itself, it establishes a new venue in which legal questions of central importance to the future relationship between China and the rest of the world can be analyzed and debated. In future years, I hope and expect that legal scholars from around the world who appreciate the significance of this opportunity will submit works of scholarship to the editors of the *Transnational Law Review* for possible publication.

To all those who have been involved in the preparation of this inaugural issue, I extend my heartfelt congratulations for a job well done. On behalf of all of us who will enjoy the benefits of reading this scholarship, I express our enduring gratitude.



## Fulfilling Jessup's Dream

Jack Goldsmith\*

“**T**ransnational Law is not likely to become a term of art for a new body of law, nor does Jessup so intend it,” wrote James N. Hyde in his review of Philip Jessup’s 1956 book, *Transnational Law*.<sup>1</sup> At first glance, Hyde’s prediction about Jessup’s term seems obviously wrong. Jessup was not the first to use the phrase “transnational law,” but he popularized it in the legal academy. Jessup famously defined “transnational law” as “all law which regulates actions or events that transcend national frontiers,” including law addressing disputes involving “individuals, corporations, states, organizations of states, or other groups.” He added: “Both public and private international law are included, as are other rules which do not whole fit into such standard categories.”<sup>2</sup> Jessup’s term, and the concepts it reflected, were important at the time and ever since, for they cut across the categorical distinctions of both public and private international law and local and foreign law. Jessup’s main point was that cross-border activities involve regulation by all of these elements and more, but are reducible to none of them.

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\* Jack Goldsmith is the Henry L. Shattuck Professor at Harvard Law School, where he teaches and writes about national security law, presidential power, cyber-security, international law, internet law, foreign relations law, and conflict of laws. Before coming to Harvard Law School, he served as Assistant Attorney General, Office of Legal Counsel from 2003-2004, and Special Counsel to the Department of Defense from 2002-2003. He taught International Economic Law and Conflict of Laws at Peking University School of Transnational Law in 2009 and 2011. He has also taught at the University of Virginia and the University of Chicago. He is a scholar of international law, and he is the author of *Power and Constraint: The Accountable Presidency After 9/11*, *The Terror Presidency: Law and Judgment inside the Bush Administration*, *The Limits of International Law*, *Who Controls the Internet? Illusions of a Borderless World* and other law textbooks.

<sup>1</sup> James N. Hyde, *Review*, 66 YALE L.J. 813 (1957) (reviewing PHILLIP C. JESSUP, *TRANSNATIONAL LAW* (1956)).

<sup>2</sup> PHILLIP C. JESSUP, *TRANSNATIONAL LAW* 1–2 (Yale Univ. Press 1956).

Hyde seems wrong in his prediction about Jessup's term because the term has become omnipresent in the international legal academy in the nearly six decades since Jessup gave the lectures on which his famous book was based. And yet perhaps Hyde was right after all. Jessup was not really proposing a new way of thinking about the law regulating cross-border transactions, but rather simply trying to describe accurately the rich and multitudinous forms of law that govern those transactions. Moreover, while the term "transnational law" is widely employed in the legal academy, the law and norms governing cross-border activity are still largely taught and written about within stilted categories that are remarkably similar to the ones that prevailed in Jessup's day. Jessup believed that the well-trained transnational lawyer must be fluent in and move easily between what we artificially call "public" and "private" and "local" and "foreign" law. And he worried about how transnational law was being taught, warning that if students "are nourished on the pap of old dogmas and fictions, it is not to be expected that they will later approach the solution of transnational problems with open-minded intelligence instead of open-mouthed surprise."<sup>3</sup>

The Peking University School of Transnational Law comes much closer than law schools in other countries (most notably, those in the United States) to Jessup's vision of how transnational law should be studied. STL students are fluent in the languages of the two most consequential nations in the world. They are taught the law of both the American and Chinese legal systems by experts in those systems in the language of those systems, and they immerse themselves in the cultural and conceptual assumptions of both. They are constantly comparing and moving between these bodies of law, and other important bodies of law, most notably the various forms of law that prevail in Europe. In addition, "public," "private," "local," and "foreign" law are studied simultaneously just as they present themselves in real-world contexts, with fewer artificial limitations than any other law school I know. STL students thus develop what

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<sup>3</sup> *Id.* at 108–09.

Jeff Lehman accurately describes in his Foreword as “a uniquely transnational perspective on legal problems.”

The Peking University Transnational Law Review promises to bring these extraordinary pedagogical innovations to the world of scholarship, understandably with a focus on China’s participation in the transnational community. In some ways this move is harder than the teaching side of the STL project, for the Law Review will be drawing on the work of scholars largely trained in traditional methods. My hope for the Law Review is that its editors keep Jessup’s original and very important project present in mind, both in their own student-written work, and (to the greatest extent possible) in the work by faculty members and practitioners that they publish. Having taught the amazing students at STL, I am confident they will succeed.

## **The Role of Arbitration in Economic Development and the Creation of Transnational Legal Principles**

*Philip J. McConnaughay\**

**M**y lecture today concerns two aspects of private commercial arbitration that have been the focus of much of my work and scholarship both as a practicing lawyer and as a law professor.

The first is private arbitration's unique potential to contribute to economic growth and development in nations without advanced legal systems – in other words, nations without fully-developed laws, an established legal profession, reliable courts, and other mature institutions involved in law making and the administration of justice.

The second is the unique potential of private arbitration for resolving disputes between parties from very different legal systems or legal traditions, and thereby for contributing to the development of new norms and practices for bridging transnational differences.

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\* This is a speaker's manuscript addressed by Philip J. McConnaughay at Peking University School of Transnational on November 7, 2012. Philip J. McConnaughay is the current Dean and The Donald J. Farage Professor of Law at The Pennsylvania State University's Dickinson School of Law. Previously, he was a Professor of Law at the University of Illinois College of Law. He was admitted to Illinois bar in 1978; 1979, California; 1983, District of Columbia; 1992 1994, Japan; 1994 1996, Hong Kong. Dean McConnaughay is the author of several scholarly articles and edited books concerning international commercial dispute resolution, the regulation of international commerce, and the role of arbitration in economic development. He has lectured on development and intellectual property issues in Vietnam, China, and Europe and has been a visiting professor at Northwest University in Xi'an, China. For ten years he was a resident partner in Tokyo and Hong Kong with Morrison & Foerster, an international law firm. Dean McConnaughay represented Fujitsu Limited in the celebrated multi-billion dollar IBM/Fujitsu Arbitration. He served as an advisor to a Government of Indonesia project to draft a new arbitration law, and he consulted with the U.S. Department of Justice in the antitrust prosecution of Microsoft Corporation. From 1982 to 1984, he also served as Special Deputy General Counsel to the United States Equal Employment Opportunity Commission. He is going to hold the Dean's position at Peking University School of Transnational Law from the summer of 2013.

### *The Role of Private Arbitration in Economic Development*

My interest in the potential of arbitration to contribute to economic development grew out of law reform work in which I was involved in Indonesia about twenty years ago. My task was to work with government and business leaders on solutions to the lack of foreign direct investment and economic growth, at the time, that many believed was caused, in part, by underdeveloped laws and unreliable legal institutions. More recently, I have been involved in a similar project in Jerusalem, where the objective is to promote Israeli-Palestinian economic exchange and commercial dispute resolution. Both projects focused on private arbitration as a potential solution.

A dilemma that is common to all emerging economies, including Indonesia twenty years ago and Palestine today, is how to provide the legal institutions upon which economic development depends, without the developed economy upon which effective legal institutions depend.

Let me repeat this because I know it is a question with which business and political leaders in developing countries struggle every day: how do we provide the reliable public legal institutions – laws, regulations, courts, lawyers, enforcement mechanisms – upon which economic development and a thriving economy depend, without the developed economy and resulting resources upon which these institutions depend?<sup>1</sup>

In certain important respects, the challenge faced by developing countries with respect to legal sector development is analogous to the challenge faced by the international community during the decade following World War II, when the international community desired cross-border trade and commerce but struggled with the challenge of devising transnational regulatory and judicial mechanisms that would facilitate

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<sup>1</sup> This section of my lecture draws upon ideas and themes first published in Philip J. McConaughay, *The Scope of Autonomy in International Contracts and its Relation to Economic Regulation and Development*, 39 COLUM. J. TRANSNAT'L L. 595 (2000) [hereinafter *The Scope of Autonomy*].

commerce across national boundaries rather than just within national boundaries.

Although the analogy is not perfect, developing countries today also need to devise regulatory and judicial mechanisms that transcend traditional methods of economic exchange within local communities and that instead facilitate exchange with strangers from outside the countries -- strangers who often bring with them very different commercial customs and legal traditions.

Just like the international community during the post-World War II period, developing countries need to devise legal institutions (i) that are not dependent on existing public institutions (which often are either non-existent or unreliable), (ii) that are capable of operating independently of existing public institutions, and (iii) that, preferably, are allowed to operate with a promise that national governmental and judicial institutions will *not* interfere unduly with their independent operation and decisions.

Developing countries also confront another analogous challenge: creating legal institutions that do not require a significant public financial investment but that, nonetheless, are somehow capable of immediately providing certain important regulatory and adjudicatory functions that otherwise would require years to develop.

Finally, and again like the nations that were members of the international trading community during the post-World War II period, developing countries need to achieve all of this without unduly sacrificing their sovereign powers, interests, and responsibilities.

The international community solved these challenges by creating a multinational treaty regime for international commercial transactions that is based on the private law principle of autonomy of contract – party autonomy – and, specifically, two of the most important creations of autonomy of contract: first, agreements to submit disputes that might arise dur-

ing the course of a commercial relationship to binding private arbitration; second, contractual terms designating the law that will apply to such disputes.

The treaty that accomplishes this is known as the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, or the 1958 New York Convention, for short.<sup>2</sup> Every nation that accedes to the treaty must make two fundamental promises:

The first promise is to honor written agreements to privately arbitrate matters that are capable of settlement by arbitration, which includes virtually all commercial and contractual matters. This promise means that, if one of the parties to a written arbitration agreement files a claim in a national court and the claim is within the scope of the written arbitration agreement, the court must decline to proceed with the claim and instead refer the parties to arbitration.

The second promise is that nations signing the New York Convention agree that their national courts will recognize and enforce awards made in arbitrations that are within the scope of the Convention, even if the award was made pursuant to some other nation's law, unless the award is infirm for one of a few very limited reasons.

It is these two promises, in my view, that have contributed so significantly to the dramatic growth of global commerce since the New York Convention first was promulgated.

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<sup>2</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 38.

146 of the world's 193 nation-states are parties to the New York Convention. These 146 nations include all of the world's major trading nations.<sup>3</sup>

This means that, even though the national courts of each of these nations enjoy the power under generally accepted principles of international law to adjudicate claims arising out of business transactions (i) that occur within the territory of the nation, or (ii) that have a substantial effect within the territory of the nation, or (iii) that include parties who are citizens of the nation,<sup>4</sup> the national courts of that nation nonetheless will refrain from exercising that power if a claim is within the scope of a written agreement to privately arbitrate the claim.

This also means that, even though each of these nations enjoys the power under international law to apply its own law to disputes arising out of business transactions (i) that occur within the territory of the nation, or (ii) that have a substantial effect within the territory of the nation, or (iii) that include parties who are citizens of the nation,<sup>5</sup> the national courts of that nation nonetheless will recognize and enforce an arbitration award within the terms of the New York Convention even if the award was made or determined under some other nation's law and even if the national court that is asked to enforce the award would have reached a different result.

In fact, it is private arbitration's relative independence of the legal institutions of any given nation, as guaranteed by the New York Convention, which accounts for arbitration's enormous contribution since 1958

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<sup>3</sup> The United Nations Commission on International Trade Law ("UNCITRAL") web site provides an updated list of all contracting states, *Status: 1958—Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, UNCITRAL, [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html). (There have been two more contracting states since this speech.)

<sup>4</sup> See, e.g., RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 401, 404 (1987).

<sup>5</sup> See, e.g., RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 401–03 (1987).



to the dramatic growth and success of commerce that crosses national boundaries.

As a general rule, (i) the more reliably a nation's national courts honor written arbitration agreements and refuse to hear claims within the scope of an arbitration agreement, (ii) the more clearly defined and limited the possible occasions of judicial involvement in arbitration proceedings, and (iii) the more reliably a nation's national courts recognize and enforce arbitration awards without reviewing or "second guessing" the merits of the award, *the better the business climate and reputation of the nation as a preferred destination for foreign direct investment.*

There are four key aspects of domestic (i.e., national) arbitration laws, in my view, that contribute most significantly to creating a legal environment that is favorable for economic investment:

First, the law should allow the greatest contractual autonomy possible to private parties to determine the procedures and terms of their arbitrations and to designate the law that will govern their contract and the resolution of any disputes.<sup>6</sup>

Second, the law should define as precisely as possible, and in as limited a way as possible, the occasions on which judicial involvement in an arbitration proceeding may be appropriate.

Third, the law should explicitly designate the specific court or courts that will be competent to hear and decide motions pertaining to arbitration proceedings; this is especially important in nations in which the

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<sup>6</sup> In *The Scope of Autonomy*, *supra* note 1, I argue that economic development would be promoted in developing nations if these nations would extend private contractual autonomy not only to private law issues traditionally within the scope of private contractual autonomy, but also to matters governed by public regulatory law, which are traditionally have been outside the scope of private contractual prerogative. I argue that the opposite effect is likely if developed nations extend contractual autonomy to matters governed by public regulatory law: in this case, the extension would increase the risk of precisely the public harm the regulatory law is intended to prevent.

range of capacities among courts is uneven, and certain courts clearly are more reliable than others in terms of their capacity to act fairly and quickly.

Fourth, the law should specify that the grounds for “setting aside” an arbitral award in an arbitration occurring in that nation are identical to – or at least nearly identical to – the grounds specified in the New York Convention for refusing to recognize and enforce a *foreign* arbitral award.

A reasonable benchmark of a national law that comes close to achieving these characteristics is the Model Law on International Commercial Arbitration published by UNICTRAL, the United Nations Commission on International Trade Law.

Let me conclude this portion of my talk by repeating my thesis: private commercial arbitration is capable of providing commercial transactions with several important regulatory and adjudicatory services typically provided by public legal institutions, and because of this, private arbitration can help provide the legal environment essential to economic development and prosperity even during the period before the public legal institutions fully develop and mature.

However, in order for private arbitration to succeed in this role, it must be supported by a domestic legal regime that approximates the legal environment afforded transnational commerce by the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which means that private commercial arbitration must be allowed to proceed largely independently of official regulatory and judicial interference.

### ***The Role of Private Arbitration in the Creation of Transnational Legal Principles***

The second aspect of arbitration about which I'd like to speak is the unique potential of international commercial arbitration for resolving disputes between parties from very different legal systems or traditions, and thereby for contributing to the development of new norms and practices that might bridge such differences. My interest in this topic arose from my work as a practicing lawyer representing mostly Japanese and Chinese companies involved in disputes with large American firms.<sup>7</sup>

As I suggested in my comparison of developing countries to the post-World War II international community of nations, there can be no question about international arbitration's extraordinary contribution to the promotion and growth of international commerce during the past 50 years.

Private arbitration offers a neutral forum for multinational parties free from the national interests of any single party to a cross-border transaction. There has been a proliferation of national laws hospitable to international arbitration that guarantee a wide choice of places the world over where international arbitrations can be conducted essentially free of interference or oversight by national courts. And, because of the New York Convention and the strong desire of most nations to appear supportive of international commerce, the awards made in international arbitrations have greater enforcement currency across national boundaries than ever before.

As a result, international commercial arbitration – and the New York Convention in particular – effectively provides a transnational system of justice that works as well as it does precisely because it is non-national

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<sup>7</sup> I first wrote about this topic in Philip J. McConaughay, *The Risks and Virtues of Lawlessness: A "Second Look" at International Commercial Arbitration*, 93 NW. U. L. REV. 453 (1999); and then developed the thesis more completely in Philip J. McConaughay, *Rethinking the Role of Law and Contracts in East-West Commercial Relationships*, 41 VA. J. INT'L L. 427 (2001); from which this portion of my lecture borrows liberally.

and treated with such deference by all of the world's major trading nations.

For the last few decades, nonetheless, there has been a growing feeling among many scholars and practitioners that arbitration would work even better at facilitating international commerce if only it were more predictable. As the late scholar of international arbitration, Martin Domke, declared, the "principal challenge" facing international commercial arbitration is achieving "predictability of result."<sup>8</sup> And clearly, the uncertain rules of procedure, elastic rules of evidence, highly limited discovery, secrecy, and untrained non-lawyer arbitrators characteristic of many arbitral proceedings do contribute to outcomes that are not "legally predictable," especially in comparison to the outcomes one would expect if the same issues were tried in a federal court in the United States or a national court of most of the nations of Western Europe.

This growing concern about the unpredictability of international arbitration is understandable in light of the very high value placed by both the civil law and common law traditions on the rule of law, and the resulting expectation within these traditions that commercial activities, like social and political activities, will be ordered and conducted in conformance with prescribed legal rules and obligations, whether specified by statute, regulation, or contract.<sup>9</sup>

In fact, in commercial contexts within these traditions, it is the presence or absence of text in a written contract that typically defines all rights and obligations and provides the standard against which the propriety of the parties' ensuing conduct is judged. Commercial parties write out and sign their commercial contracts and then order their affairs and

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<sup>8</sup> MARTIN DOMKE, *COMMERCIAL ARBITRATION* 14 (1965).

<sup>9</sup> See, e.g., Richard H. Fallon, Jr., "The Rule of Law" as a Concept in Constitutional Discourse, 97 *COLUM. L. REV.* 1 (1997); JOHN H. BARTON, *LAW IN RADICALLY DIFFERENT CULTURES* 9 (1983); A.V. DICEY, *INTRODUCTION TO THE STUDY OF THE LAW OF THE CONSTITUTION* 184–98 (10th ed. 1965); LON L. FULLER, *THE MORALITY OF LAW* 43 (Yale Univ. Press rev. ed. 1964).

performance accordingly. Any deviation from the precise terms of the agreement risks breach, blame and liability. Contract law in both the common law and civil law tradition essentially is founded on the assumption that the whole of a commercial relationship is embodied in the contract the parties conclude at the outset of their relationship.<sup>10</sup>

The primacy of written contracts in these traditions – in the Western tradition – is reflected in a variety of well-established rules of contract law that promote both the ever-increasing particularity of written contracts and the preeminent role of written contracts in resolving commercial disputes. The parol evidence rule is a good example. This rule essentially forbids the consideration in a commercial dispute of any prior or contemporaneous writings or statements of the parties that explain or contradict their contract as written. Thus, the rule places commercial parties at risk of losing the benefit of any term not explicit in the contract.<sup>11</sup>

The sanctity of written contracts also lies behind the doctrines of impossibility, frustration of performance, and force majeure. “Promises must be kept though the heavens fall,” is the essence of their commands.<sup>12</sup> A host of canons of construction within contract law have the same purpose and effect.

These rules and the values they express assume, as one would expect, that commercial disputes arise when one party or another to a transaction allegedly departs from some contractual or codified standard of conduct, and that the appropriate way to resolve such disputes is to compare the conduct or omission in question to the relevant contract term or code for purposes of determining breach, blame and liability. And the

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<sup>10</sup> See, e.g., Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U. L. REV. 854, 888 (1978) (“[C]ontract law [is] founded on the assumption that all of a [commercial] relation[ship] is founded in some original assent to it.”).

<sup>11</sup> See, e.g., Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533 (1988).

<sup>12</sup> JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 122 (4th ed. 1998).

procedures and rules that tend to make this comparison most accurately are those followed by the national courts of nations within the common law and civil law traditions, where strict rules of procedure, evidence, judicial impartiality, and transparency combine for the purpose and effect of yielding “legally correct” outcomes. Many believe this is especially true of the adversarial legal culture of the United States and the distinctive characteristics of that culture – party-dominated pre-trial discovery; party-selected expert witnesses; party-controlled direct and cross examination; and, a comparatively passive role for the trial judge, especially when contrasted with the inquisitorial civil law model.

These observations help explain why, in response to the challenge posed by Professor Domke of achieving greater “predictability of outcomes” in commercial arbitration, there has been a veritable chorus of scholars and practitioners urging the reform and standardization of arbitral rules and procedures to conform to the judicial rules and procedures common in highly-developed Western nations, and particularly the United States. Leading commentators urge (i) the replacement of arbitral privacy with greater transparency;<sup>13</sup> (ii) the standardization of arbitral rules of procedure and evidence;<sup>14</sup> (iii) greater discovery and more latitude in the examination of witnesses;<sup>15</sup> (iv) the elimination of equitable decision-making in favor of strict adherence to law and legal rules;<sup>16</sup> (v) the publication of reasoned arbitral awards;<sup>17</sup> (vi) the creation of a system of stare decisis;<sup>18</sup> and generally, (vii) the adoption of any similar “control mecha-

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<sup>13</sup> See, e.g., Richard M. Buxbaum, *Introduction*, 4 INT’L TAX & BUS. LAW. 205, 208 (1986).

<sup>14</sup> See, e.g., Charles N. Brower, *Evidence before International Tribunals: The Need for Some Standard Rules*, 28 INT’L LAW. 47, 58 (1994).

<sup>15</sup> See, e.g., Robert von Mehren, *The Future of Arbitration and Public Law*, 12 BROOK. J. INT’L L. 583, 626 (1986).

<sup>16</sup> See, e.g., F.A. Mann, *England Rejects “Delocalized” Contracts and Arbitration*, 33 INT’L & COMP. L.Q. 193, 196–97 (1984).

<sup>17</sup> See, e.g., Julian D.M. Lew, *The Case for the Publication of Arbitration Awards*, in THE ART OF ARBITRATION (Jan C. Schultz & Albert J. van den Berg eds., 1982).

<sup>18</sup> See, e.g., Thomas E. Carbonneau, *Arbitral Adjudication: A Comparative Assessment of its Remedial and Substantive Status in Transnational Commerce*, 19 TEX. INT’L L.J. 33, 39 (1984).

nisms” necessary to ensure “properly legal” results.<sup>19</sup> As Professor Rusty Park has explained, the desire of international commercial parties for a neutral arbitral forum does not mean they are “opting for the abandonment of legal rules” and procedures.<sup>20</sup>

But what if the arbitration is between or with parties who do not share the Western commitment to the strict “legal” rules and procedures necessary to yield “properly legal” results? What if these parties do not share a notion of justice that views a “legally proper” outcome as the only “just” outcome? What if these non-Western parties “clearly understand the terms of the written agreement into which they have entered,” but “hold entirely different conceptions [from their Western counterparts] of the meaning and effect of the contract,” as Professor Arthur von Mehren once observed of contracting parties throughout much of Asia?<sup>21</sup> Of what value then is the “Westernization” or “Americanization” of arbitral procedures in arbitrations charged with resolving disputes among or with these parties?

Law and contracts traditionally have not played the role in non-Western commercial relationships – those throughout most of Asia and Africa – that they have in Western commercial relationships. Many non-Western societies originated as public law regimes, with “law” representing little more than the regulatory commands of whoever ruled; there was no concept of law as a means of ordering private affairs, including private commercial affairs.<sup>22</sup> As Professor John Haley has observed, “there was a tendency in these societies to avoid legalistic approaches in the ordering of personal and corporate relationships ... and a reticence to rely on law,

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<sup>19</sup> See, e.g., W. MICHAEL REISMAN, SYSTEMS OF CONTROL IN INTERNATIONAL ADJUDICATION AND ARBITRATION 46 (1992).

<sup>20</sup> William W. Park, *Control Mechanisms in the Development of a Modern Lex Mercatoria*, in LEX MERCATORIA AND ARBITRATION 115 (Thomas E. Carbonneau ed., 1990).

<sup>21</sup> Arthur T. von Mehren, *Some Reflections on Japanese Law*, 71 HARV. L. REV. 1486, 1494 (1958).

<sup>22</sup> See, e.g., JOHN OWEN HALEY, AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX 198 (1991).

whether contract or code, as the primary instrument of social ordering.”<sup>23</sup> Personal relations prevailed over legal relations.

The primacy of relational considerations in the governance of non-Western commercial exchange resulted in a host of practices and expectations, still prevalent today, that are the opposite of those that developed in the Western legal tradition: (i) evolving situational and circumstantial considerations prevail over precise contractual prescriptions;<sup>24</sup> (ii) ongoing negotiations and compromise prevail over all-or-nothing adjudication;<sup>25</sup> (iii) group interests prevail over individual interests;<sup>26</sup> (iv) custom and usage prevail over written law.<sup>27</sup>

The result is a non-Western conception of “contract” that often is fundamentally different from the Western conception. In the Western legal tradition, a contract memorializes the “conclusion” of a business deal and embodies strict rights and duties enforceable in court; in many non-Western traditions, a contract signifies the “beginning” of a functioning business relationship that requires the parties to be prepared to accommodate future contingencies as they occur. In these traditions, the notion of assigning fixed consequences to conduct or events long before they occur is counter-intuitive; contract terms professing such an exercise are not accorded determinative weight.<sup>28</sup>

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<sup>23</sup> *Id.*

<sup>24</sup> See, e.g., PITTMAN B. POTTER, *FOREIGN BUSINESS LAW IN CHINA* 2 (1995); Stanley B. Lubman, *Dispute Resolution in China after Deng Xiaoping*, 11 *COLUM. J. ASIAN L.* 229, 375–76 (1997).

<sup>25</sup> See, e.g., HALEY, *supra* note 22, at 3.

<sup>26</sup> See, e.g., Chin Kim & Craig Lawson, *The Law of the Subtle Mind: The Traditional Japanese Conception of Law*, 28 *INT’L COMP. L.Q.* 491, 498 (1979).

<sup>27</sup> See, e.g., Anthony Hulwese, *Law as One of the Foundations of State Power in Early Imperial China*, in *FOUNDATIONS AND LIMITS OF STATE POWER IN CHINA* 14 (Stuart R. Schram ed., 1987).

<sup>28</sup> See, e.g., Dan Fenno Henderson, Preston M. Torbert & Xie Huaishi, *Contract in the Far East—China and Japan*, in 7 *INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW* 4 (Arthur von Mehren ed., 1992); Takeyoshi Kawashima, *The Legal Consciousness of Contract in Japan*, 7 *LAW IN JAPAN* 1, 6 (Charles R. Stevens trans., 1974); von Mehren, *supra* note 21, at 1496.



The “friendly negotiations” and “confer in good faith” clauses typical of both Western and non-Western commercial contracts illustrate these fundamentally different conceptions.

The typical Western view of such clauses is that they impose no real obligation at all. At most, they represent either a mechanism for making unenforceable requests, or the initial step of a multi-step dispute resolution process that culminates ultimately in a compulsory adjudication intended to enforce precise contractual terms.<sup>29</sup>

When viewed from relational perspectives outside of the Western legal tradition, these clauses, to use Western terms, represent executory obligations no less substantive than terms of price, payment and delivery. They embody and express the notion that a written contract is unfolding rather than static and subject to adjustment in favor of other values -- such as preserving the relationship, avoiding disputes, and reciprocating previous accommodations by the other party -- as contingencies arise during the course of contractual performance. Characterizing “friendly negotiations” and “confer in good faith” clauses as “merely procedural dispute resolution mechanisms” misapprehends their essential nature in most non-Western traditions, for no “dispute” exists if all of the parties understand the evolving nature of their contract and their substantive obligation to make reasonable adjustments to their performance or expectations in the face of changing circumstances.

This understanding of “friendly negotiations” and “confer in good faith” clauses, of course, does not mean that real disputes do not arise in relational commercial traditions outside of the Western legal tradition. The nonperformance of obligations, or performance outside of the relational values I mentioned, or refusals to adjust to reasonable demands for adjustment in the face of changed circumstances, or unreasonable demands for adjustment, all can give rise to disputes in these relationships

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<sup>29</sup> DAN FENNO HENDERSON, 2 CONCILIATION AND JAPANESE LAW: TOKUGAWA AND MODERN 195 (1965).

no less serious and potentially destructive of the mutual enterprise than those that arise in the West as a result of a party diverging from a strict contractual term. But the process by which the dispute is resolved, and the values that inform the resolution, once again are often fundamentally different in non-Western traditions from those that we know in the Western legal tradition. Just as contracts are relational in most non-Western traditions, so too is commercial justice.<sup>30</sup>

The objective of dispute resolution in many non-Western traditions typically is not the ascertainment of legal rights and the allocation of blame and entitlement, as it is in the West; the objective is a resolution, and hopefully a reconciliation, whatever the result. The merits of the dispute are not irrelevant, but “merits” outside of the Western legal tradition often have far more to do with relative status, actual circumstances, reciprocal adjustment, and maintaining the relationship, than with compliance or noncompliance with precise contractual terms that predate the dispute. Western and non-Western dispute resolution traditions may be alike insofar as both seek to achieve the “expectation interests” of the parties, but without an explanation of how fundamentally different the expectations of non-Western parties can be from those of Western parties, this comparison would convey a falsehood.

Commerce in non-Western traditions is as dependent as Western commerce on the “predictable” resolution of disputes; but “predictability” in many non-Western traditions derives not from “legal predictability,” as conceived in the common law and civil law traditions, it derives from the fact that there will be a resolution of the dispute, and in many cases, a resolution that allows the commercial relationship to continue.<sup>31</sup>

This version of commercial justice requires dispute resolution procedures and techniques different from those designed to yield the “legally

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<sup>30</sup> *Id.* at 174.

<sup>31</sup> See, e.g., Kim & Lawson, *supra* note 26, at 511; HALEY, *supra* note 22, at 23; Kung-Chuan Hsiao, *Compromise in Imperial China*, in PARERGA: OCCASIONAL PAPERS ON CHINA 6 (Univ. of Wash. Press 1979).

correct” outcomes favored by the Western legal tradition. Mediation and conciliation, for example, traditionally have been preferred strongly over arbitration or other compulsory adjudication.<sup>32</sup> And even when arbitration is commenced, arbitrators in non-Western settings routinely make intermittent efforts to mediate the dispute, often engaging in *ex parte* communications with each party and then resuming as arbitrators, without objection from the parties, if a mediation effort fails – thus confounding Western notions of judicial ethics.<sup>33</sup> The complete privacy and secrecy of the arbitration is critically important to this effort, as is the complete discretion of arbitrators not to issue written opinions attributing blame and explaining their awards.

Why then, would we ever want to “Americanize,” “Westernize,” or “standardize” an international commercial dispute resolution process in ways that would foreclose each of the features so important to so many non-Western parties? Isn’t the genius of the New York Convention precisely the fact that it permits complete party autonomy and flexibility with respect to most questions of arbitral procedure and conduct?

The conventional answer to these questions is that substantive law worldwide seems to be converging or harmonizing around common law and civil law principles, so it should follow naturally for dispute resolution procedures and rules to converge around the Western legal tradition as well.

And it clearly is true that nations and societies throughout Asia, Africa, the Caribbean, and South America, whose relational practices and traditions are not part of the Western legal tradition, have, over the course of the last century, adopted civil and commercial codes based very much

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<sup>32</sup> See, e.g., HENDERSON, *supra* note 29, at 235; Lubman, *supra* note 24, at 295–96; Jerome Alan Cohen, *Chinese Mediation on the Eve of Modernization*, 54 CAL. L. REV. 1201 (1966).

<sup>33</sup> See, e.g., POTTER, *supra* note 24, at 70; for the characteristic non-Western practice, see Lubman, *supra* note 24, at 337; for conventional Western objections, see J.D. Fine, *Continuum or Chasm: Can West Meet East?*, 6 J. INT’L ARB. 27, 30 (1989).

on common law and civil law counterparts. German civil code provisions are evident throughout the civil and commercial codes of China, Japan, Korea, and Taiwan; Dutch provisions can be found throughout the codes of Indonesia, Botswana, Sri Lanka, South Africa, and Zimbabwe; English common law principles are can be found throughout the codes of Ghana, Kenya, Jamaica, Malawi, Bahrain, and many other non-Western nations; and, of course, I could go on both expanding these lists and adding lists of non-Western nations whose civil and commercial codes essentially replicate the codes of Portugal, France and Belgium.

But it also is true that all of these nations, more accurately, should be described as having “mixed” legal systems, in which transplanted colonial or imperial codes exist alongside strong customary legal traditions and sometimes Islamic or other religious law as well.<sup>34</sup> In most non-Western societies, even today, I think it is fair to say that the penetration of common law and civil law principles is not deep. Commercial practices in these nations often remain deeply rooted in customary relational traditions. Practicing lawyers in these nations regularly observe, as Professor Dan Fenno Henderson once described, “[a] mix of [customary and transplanted]...legal institutions that is elusive to lawyers” who lack deep exposure to these societies.<sup>35</sup> As Professor William Shaw has noted with respect to China and Korea, “work is only now beginning on the study of how traditional legal systems met and often persisted under the ‘Westernizing’ reforms of [colonial or imperial influences].”<sup>36</sup>

The inevitability of a worldwide convergence of law and commercial practices around the Western legal tradition also is questionable on other grounds. Much of the growth of international commerce today is exclusively non-Western. Consider the burgeoning economic exchange

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<sup>34</sup> See, e.g., POTTER, *supra* note 24, at 3; Dan Fenno Henderson, *The Japanese Law in English: Some Thoughts on Scope and Method*, 16 VAND. J. TRANSNAT’L L. 601, 609–11 (1983).

<sup>35</sup> Henderson, *supra* note 34.

<sup>36</sup> William Shaw, *Traditional Korean Law and its Relation to China*, in *ESSAYS ON CHINA’S LEGAL TRADITION* 302, 318 (Jerome Cohen et al. eds., 1980).

between China and Africa, which has grown from \$10 million (U.S.) annually barely 20 years ago to well over \$100 billion annually today, with a remarkable growth rate of over 700 percent between 2001 and 2009 alone. Why should we presume the emergence of contract and dispute resolution rules reflecting Western values in the context of Africa-China trade that includes 53 African nations whose combinations of customary traditions and colonial codes still include relational commercial and dispute resolution practices remarkably similar to the relational practices that persist in China and the rest of Asia despite a similar “legal dualism” here?<sup>37</sup>

The growth and effectiveness of worldwide non-Western diasporas also casts doubt on the convergence thesis. The world is seeing that mass migration, the internet and affordable flights are preserving diversity around the world no less than they are promoting harmonization. *The Economist* reported recently that more Chinese live outside of China than French live in France. There are 22 million ethnic Indians scattered across every continent. Smaller diasporas tie West Africa to Lebanon, and Brazil and Peru to Japan. The world has 40 percent more first generation migrants today than in 1990. If migrants were a nation, they would be the world’s fifth largest. Diaspora ties are a way of business and a growing and highly lucrative means of cross-border business collaboration. These “diasporan” nations that cross national boundaries operate largely according to relational principles, not according to the formalistic Western legal mechanisms that proved so helpful in fostering economic exchange between parties of different nationalities within the Western legal tradition.<sup>38</sup>

Opinion surveys of non-Western parties confirm their preference for relational rather than legalistic commercial practices. Studies comparing the preferences of Chinese and Western subjects show a strong prefer-

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<sup>37</sup> See Philip J. McConaughay, *Foreword*, in Won Kidane, *China-Africa Dispute Settlement: The Law, Culture and Economics of Arbitration* (2011).

<sup>38</sup> See generally *The Magic of Diasporas*, *THE ECONOMIST* (Nov. 19, 2011), <http://www.economist.com/node/21538742>.

ence among Chinese for mediation and assisted voluntary settlements over adversarial disputing; Western subjects prefer adversarial dispute resolution and “legally correct” results.

A study published last year by Hong Kong University Professor Shahla Ali refines these preferences further.<sup>39</sup> Her survey was of parties, lawyers and arbitrators involved in international arbitrations in the principal North American, European and Asian arbitral institutions. The results revealed that respondents from Asian institutions prefer assisted settlements and flexible, secret proceedings; respondents from Western institutions prefer predictable legal outcomes and clear, predictable rules of procedure. Respondents from Asian institutions were most concerned about lawyers who are too adversarial and a process that focuses more on past facts and legal rights than on future creative settlement options; respondents from Western institutions preferred adversarial lawyers and strictly legal outcomes.

Given that most of the growth in international arbitration is occurring in the Asian institutions at which Professor Ali conducted her survey, I believe it is fair to question the “inevitability” of the “Westernization” or “Americanization” of international commercial arbitration. It has been well over a decade since the total number of international arbitrations filed annually in Hong Kong and CIETAC alone surpassed the total number filed annually in all North American and European institutions combined.

These trends leave the following question: if cross-border commercial practices and international arbitration rules are not destined to converge around Western or American standards, what is their destiny? Or, to pose the question somewhat differently, can contracting and dispute resolution terms and mechanisms be devised that account for the significant differences between Western and non-Western traditions with re-

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<sup>39</sup> SHAHLA F. ALI, *RESOLVING DISPUTE IN THE ASIA-PACIFIC REGION: INTERNATIONAL ARBITRATION AND MEDIATION IN EAST ASIA AND THE WEST* (2010).

spect to the role of contracts and the nature of dispute resolution in cross-border commercial relationships? This is a question that all lawyers involved in cross-cultural transactions and disputes should ask themselves and their clients.

I will conclude with a few thoughts about how I believe these questions might be answered.

In my view, the same three features of international commercial arbitration that have been responsible for the success of cross-border trade also are uniquely capable of supporting new paradigms of contracting and dispute resolution practices that might begin to bridge the major differences between Western and non-Western traditions. To reiterate, the first feature is the increasingly unfettered autonomy of parties to international transactions to designate whatever law or decisional rule they wish to apply to their dispute, to the exclusion of all otherwise applicable laws. The second is the virtually complete autonomy of these parties to agree to arbitrate their disputes according to dispute resolution procedures unconstrained by the peculiarities of national laws and practices. The third feature is the assurance that arbitral awards rendered pursuant to these party-determined laws and procedures will be readily recognized and enforced in virtually all of the world's trading nations.

Briefly, with respect to contracting practices, I foresee more frequent resort to terms that explicitly acknowledge duties of reasonable accommodation as unexpected contingencies arise. The existing concept of "good faith and fair dealing" in certain Western jurisdictions comes close to this. The Dutch understanding of "good faith" is a good example: it envisions that, "a rule binding upon the parties as a result of the contract does not apply to the extent that, in the given circumstances, this would be unacceptable according to the criteria of reasonableness and equity."<sup>40</sup>

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<sup>40</sup> See BURGERLIJK WETBOEK [BW] [CIVIL CODE] art. 6:248 (1992) (Neth.); for an English translation, see P.P.C. HAANAPPEL & EJAN MACKAAY, NIEUW NEDERLANDS BURGERLIJK WETBOEK art. 6:248, para. 2 (1990).

Utrecht University Law Professor Arthur Hartkamp explains that, under this rule, contract provisions do “not apply” to the extent they would be contrary to good faith.<sup>41</sup>

Other new terms might be modeled on the “adaptation and renegotiation” clauses typical of long-duration contracts in certain sectors of Western cross-border trade. Similar clauses also are found in some bilateral treaties between nations, where sunset provisions extinguish obligations after a certain limited period in favor of resumed negotiations. We might see adjustment obligations emerge in combination with a range of performance parameters instead of rigidly set terms, or in combination with new, more relaxed conceptions of contractual hardship or force majeure.

Choice of law provisions also might contribute to bridging West/non-West differences. Choices of “trade usage” or “lex mercatoria” or “general principles of law” might emerge as decisional standards in place of designations of a particular jurisdiction’s law. Empowering arbitrators to act “*ex aequo et bono*” or as “*amiable compositeurs*” might be used instead of, or in conjunction with, a specific applicable law. Both of these doctrines empower arbitrators to depart from the law if they believe it appropriate and to seek a resolution that enables potential adversaries to maintain a valuable commercial relationship.<sup>42</sup>

Procedural adjustments might include explicit multi-tiered dispute resolution obligations, or an increased blurring of performance and dispute resolution terms in the form of “friendly negotiations” or “confer in good faith” clauses. Western notions of arbitrator impartiality might relax in favor of the same individuals serving as both arbitrator and mediator. Presentational changes might emerge that are less adversarial.

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<sup>41</sup> Arthur Hartkamp, *The Concept of Good Faith in the UNIDROIT Principles for International Commercial Contracts*, 3 TUL. J. INT’L & COMP. L. 65, 66 (1995).

<sup>42</sup> See Louis B. Sohn, *Arbitration of International Disputes Ex Aequo et Bono*, in INTERNATIONAL ARBITRATION: LIBER AMICORUM FOR MARTIN DOMKE 332–33 (Pieter Sanders ed., 1967); RENÉ DAVID, ARBITRATION IN INTERNATIONAL TRADE 335 (1985).



All in all, international arbitration might begin to function more as the great comparative law scholar, René David, once envisioned, “not to apply law, but as a remedy against its insufficiency.”<sup>43</sup>

It bears remembering that none of these changes is really all that different from Western commercial traditions as practiced by the parties to business transactions rather than as litigated by lawyers. As Professor Karl Lewellyn wrote in 1931, “[T]he major importance of [a] legal contract is to provide a frame-work, ... a frame-work [that is] highly adjustable, ... which almost never indicates real working relations, but which affords a rough indication around which relations vary....”<sup>44</sup> Professor Stewart Macaulay’s work in the 1960’s highlighted the relational contracting practices of American businesses,<sup>45</sup> as did Professors Robert Ellickson’s and Lisa Bernstein’s work in the 1990’s.<sup>46</sup> The shift in focus may be to create enforceable obligations of reasonable adjustment in the future when none existed in the past, but the effect on actual commercial practices may not be all that different.

To sum up, the much heralded worldwide “Westernization” or “Americanization” of international commercial arbitration, in my view, is neither particularly likely nor particularly desirable. The principal challenge for West/non-West commerce, instead, is to somehow account in these relationships for contracting and dispute resolution traditions so different that law and contracts are determinative of performance and outcomes in one but subordinate to other values in the other.

Each of the mechanisms I have suggested as possible ways of achieving this accounting clearly increases risk in a commercial relation-

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<sup>43</sup> RENÉ DAVID, *CONTEMPORARY PROBLEMS IN COMPARATIVE LAW* 33 (1962).

<sup>44</sup> Karl N. Lewellyn, *What Price Contract? – An Essay in Perspective*, 40 *YALE L.J.* 704, 736–37 (1931).

<sup>45</sup> Stewart Macaulay, *Non-Contractual relations in Business*, 28 *AM. SOC. REV.* 55 (1963).

<sup>46</sup> See ROBERT C. ELICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 *J. LEGAL STUD.* 115 (1992).

ship to the extent that “risk” is defined, as it is in the West, as the likelihood of a party diverging from some precise, preordained contractual term or standard of conduct. But Western parties would do well, in my view, not to overlook the possibility that explicit promises to negotiate and adjust reasonably in West/non-West commercial relationships might be a far more effective way of managing risk than attempts to foreclose such obligations.

If the primary objective of drafting a contract in a cross-cultural commercial relationship is the success of the relationship, as it should be, and not simply the advantage of one party or the other in the event of the relationship’s failure, increasing rather than reducing the flexibility of contract terms and dispute resolution procedures actually might contribute to greater stability in West/non-West commercial ventures, contrary to conventional Western wisdom.

## “Are Lawyers Really Necessary?”

*Michael S. Greco\**

It is my pleasure to be with you today, and this week, and to have the opportunity to discuss the role of the lawyer in society. The title of my remarks is a question – “Are Lawyers Really Necessary?” It is a question that has been asked throughout history, often by critics of the profession, and there are those who ask it now.

I will share my perspective with you on this fundamental question by reflecting on my life and work experiences in the US as a trial lawyer, arbitrator and mediator with the global law firm K&L Gates, LLP, which has offices in five Asian cities, and also my experience as president of the 400,000 member American Bar Association and now as Chair of the ABA Center for Human Rights. Keep in mind that my perspective is that of a private lawyer with a western legal and cultural frame of reference, which may not be the same as in China.

Those who criticize lawyers and the legal profession in the United States are fond of quoting a line from a play by the English playwright William Shakespeare, *Henry the Sixth, Part 2*, which was written in the

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\* This is a speaker’s manuscript addressed by Michael Greco at Peking University School of Transnational on June 7, 2012. Michael Greco is a partner in the transnational law firm of K&L Gates. He studied at Princeton University and holds a Juris Doctor degree from the Boston College Law School. He has served as a Law Clerk for Judge Leonard Moore of the United States Court of Appeals for the Second Circuit and as a Fellow at the Institute of Comparative Law in Florence, Italy. Professor Greco has served as President of the Massachusetts Bar Association, President of the New England Bar Association, and President of the American Bar Association. He co-founded Bar Leaders for the Preservation of Legal Services for the Poor and currently serves as Chair of the ABA Human Rights Center. He has received many awards and honorary degrees for his work promoting human rights, access to justice, and the rule of law around the world. He teaches International Criminal Justice and International Human Rights Litigation as a Professor from Practice at Peking University School of Transnational Law.

year 1591. In Act 4, Scene 2, of that play one of the characters says, “The first thing we do, let’s kill the lawyers.” Some interpret those words as meaning that Shakespeare had low regard for lawyers, and that society can do without lawyers. But a careful reading of the scene in which those words are spoken and their context reveals that Shakespeare in fact was praising lawyers.

In the scene the characters are plotting to create upheaval and chaos in their community, for personal gain. Shakespeare, through the characters, is saying that in order to create instability in society, the first thing that needs to be done is to eliminate the rule of law. And since it is lawyers who protect the rule of law, and the rights of those whom the rule of law protects, it is necessary first to eliminate the lawyers. Stated differently, lawyers protect the justice system, and without lawyers there is no workable justice system.

It might interest you to know that the legal profession is the only profession named in the US Constitution. The Sixth Amendment guarantees that any citizen whose liberty is at stake in a criminal proceeding shall have the assistance of a lawyer, paid by the state.

There is a strong public interest culture in the US, going back to the American Revolution, of lawyers providing legal services to persons whose rights need protection and who are unable to pay a lawyer’s fee. John Adams of Massachusetts, a Founding Father of the new nation, and later the second US president, who drafted the Massachusetts Constitution upon which the US Constitution is based, set the example that all lawyers have followed for more than two centuries when he volunteered to represent the hated British soldiers who had fired upon and killed American colonists in Boston. His strongly held view was that no matter how horrible the crime or how despicable the accused criminal, in a democracy the right to liberty of each citizen must be protected with the assistance of a lawyer.

During my term as president of the American Bar Association I appointed the *ABA Commission on a Renaissance of Idealism in the Legal Profession*, in order to remind and persuade US legal employers to provide sufficient time for lawyers to perform public service of various kinds, and to provide legal services to poor persons without charging a fee – what is referred to as “*pro bono publico*” representation.

I also appointed the *ABA Task Force on Access to Civil Justice* to consider an idea that has been embraced in many parts of the world for more than a century: providing a lawyer to poor persons, at public expense, to protect rights in civil proceedings that are basic to human existence, such as child custody, shelter, health, sustenance and safety.

Now as the Chair of the *ABA Center for Human Rights* I oversee a number of human rights projects, including the *Justice Defenders Program*, which provides *pro bono* assistance to human rights activists in countries throughout the world who face governmental retaliation and persecution because of their advocacy efforts. Unfortunately, courageous lawyers who take up the cause of human rights often are themselves subjected to punishment and prosecution.

### ***I. The American Bar Association***

The American Bar Association was formed in 1878 and, unlike bar associations in many countries, it is not an agency, or part, of the US government. The ABA is an independent non-governmental organization. The ABA’s policy-making body is a broadly representative 550-member House of Delegates, where twice a year policy recommendations are debated and voted upon. The House of Delegates has adopted Four Goals for the ABA. Goal IV includes the objectives of advancing a just rule of law, protecting human rights and holding governments accountable for violations of human rights and the rule of law.

The ABA website provides an overview of the programs and issues to which ABA members – most of whom are lawyers in private practice throughout the US -- volunteer their expertise and time to work on, including these:

- protecting the independence of the judiciary;
- protecting the independence of the legal profession;
- evaluating the qualifications of individuals nominated by the US President to serve as judges on the federal court;
- improving legal education and accrediting law schools;
- protecting the civil rights of individuals and minority groups;
- providing legal services to the poor;
- advocating in the US Congress and state legislatures for necessary legislative reforms;
- opposing proposed legislation that is not in the public interest; and
- opposing and criticizing policies and conduct of the US government that violate the Constitution.

I could add many others to the list, but these give you an idea.

## ***II. ABA Collaboration with other bar Organizations***

The ABA has strong collaborations with bar associations in all fifty US states, and with other national bar associations around the world. It was my pleasure as ABA president to get to know and work with the leaders of those national bar organizations, especially my good friend Yu Ning, President of the All China Lawyers Association (ACLA). President Yu and I negotiated and executed a Memorandum of Understanding, between the ABA and ACLA that addressed subjects such as joint educational programs, exchanges of lawyers and information, and collaborations of many kinds. The MOU is still in force between the two national bar associations, and President Yu and I have stayed in touch and continued our friendship.

## ***III. The ABA Center for Human Rights***

The ABA Center for Human Rights is the entity within the ABA having primary focus and responsibility for the ABA's human rights activities. The Center's web site provides information about the many programs, projects and activities of the Center, including these:

- The Atrocity Prevention Network;
- The Anti-Human Trafficking Project;
- The Human Rights Teaching Project;
- The ABA Rule of Law Letter program;
- The Center's International Criminal Court (ICC) Project;
- The Justice Defenders Program.

As I have worked on human rights issues around the world, I have been encouraged by the increasing level of collaboration between lawyers across national borders, and the increasing prevalence of human rights law in domestic jurisdictions and the international arena. At the same time, I have seen an alarming rise in the use of judicial process and discriminatory legislation aimed at silencing and punishing lawyers and others who advocate for human rights.

For example, during pro-democracy protests last year in the Kingdom of Bahrain, a courageous lawyer named Mohammed al-Tajer found himself the subject of frivolous, trumped-up charges of "inciting hatred" in retaliation for his efforts to defend the rights of political dissidents. He was detained, held incommunicado, tortured and tried in a military court characterized by procedural irregularities that violated basic principles of international due process and fair trial rights.

The international community reacted with outrage to Mr. al-Tajer's case and numerous cases like his in Bahrain. Many organizations, including the American Bar Association, called on the government of Bahrain to, at minimum, provide him with a fair trial in a civilian court. In response to the outrage expressed by the international community, Mr. al-

Tajer’s case was transferred to a civilian court earlier this year, and the most serious charges against him were dismissed.

The al-Tajer case illustrates the importance of an independent legal profession on the one hand; and on the other hand the efforts of oppressive governments to curtail that independence, to intimidate and silence lawyers, to falsely charge and prosecute lawyers and imprison them, so that the government can stay in power and continue to violate human rights without being held accountable.

The ABA was involved in this case through the ABA Center’s *Justice Defenders Program*. The Center’s work occurs both outside and within a subject country, and once the Center learns from local defense counsel what is needed to help defend the human rights advocate, the ABA and its partners provide assistance. Often the assistance is providing international legal research and drafting that can be added to defense counsel’s domestic legal arguments. Other times, the ABA will submit written expert declarations or opinions on international law to be filed with the local, regional or international court.

The *International Criminal Court (ICC) Project* is the Center’s newest project, and it has grown quickly since its inception late last year. The ABA during the past thirty years has adopted a number of policies supporting the idea of an international criminal tribunal, and in 1998 endorsed the adoption of the Rome Statute, the international multi-lateral treaty that established the ICC. The Project’s purpose is to improve the relationship between the International Criminal Court and the United States through various forms of engagement. To date, 121 nations have ratified the Rome Statute. While China, Russia and the US have not yet ratified the Statute, the US does provide significant assistance to the operations of the Court.

To help expand the US-ICC relationship, the ICC Project – working closely with the leadership of the ICC, including the President, Prosecu-



tor and Registrar, as well as judges, lawyers and staff, and also with US government officials -- will implement three types of engagements to fulfill its mandate.

The first type of engagement is training, in which the Project will train ICC lawyers, judges and staff on necessary investigative and prosecutorial skills, and on specific areas of relevant law. The Project will also hold educational training programs for American and international criminal practitioners to engage on various legal skills and topics, such as oral trial advocacy, in order that the practitioners may learn from each other.

The second type of engagement of the Project is to convene in Washington, DC, educational programs where members of the US government, members of the ICC, and experts on international criminal justice can exchange candid views, debate differing viewpoints, and educate each other on issues such as the jurisdiction of the ICC to investigate, charge and prosecute crimes within the ICC's mandate, and to foster a clearer understanding of what the ICC is, and is not; and what the ICC does, and cannot do.

The third type of engagement of the Project is to advocate for greater involvement and support by the US for the International Criminal Court and its important work in protecting a just rule of law and human rights in the global community.

I mentioned earlier that the ABA has more than 400,000 members. Those members come from large global law firms such as mine, K&L Gates LLP, which has more than 2200 lawyers in 42 cities in the US, Asia, Europe, and Latin America; from medium-sized and small law offices; from corporate in-house law departments; from law schools, and solo lawyers.

ABA members practice or engage in every conceivable area of the law – including trial lawyers, prosecutors and defense lawyers, corporate

and transactional lawyers, intellectual property lawyers, tax lawyers, merger and acquisition lawyers, environmental lawyers, among many other areas.

These lawyers willingly volunteer their skills, expertise and experience in order to participate in the types of ABA public service projects and programs that I have described. While their backgrounds and legal expertise may differ widely, these lawyers all have something in common: a commitment to public service; a desire to use their training and experience for the public good; and a shared ethical responsibility to provide legal assistance free of charge to protect the rights of poor and vulnerable people.

Confucius, China's famous teacher, philosopher and political theorist, provided these words of guidance for all people, including lawyers:

He who exercises government by means of virtue may be compared to the north polar star, which keeps its place, and all stars turn towards it. ... To be able, under all circumstances, to practice five things constitutes perfect virtue: these five things are gravity, generosity of soul, sincerity, earnestness and kindness.

And so, Confucius who was born in China in 551 B.C., the Englishman William Shakespeare, who lived in the 16<sup>th</sup> Century, and the American John Adams who lived in the 18<sup>th</sup> Century, by their words and actions underscored the importance of lawyers performing public service and protecting the rights of people.

Today public service is a fundamental mission, a defining quality of the legal profession in most nations. Lawyers throughout the world every day perform public service in the communities where they live, for the good of all who live in those communities.

After you have completed your law studies at PKU STL you will become lawyers, no doubt hard-working, competent and skilled lawyers in your chosen fields of law. You will have opportunities to become successful, well-compensated lawyers, and you will do *well* for yourselves and your families.

As leaders in our profession and in your communities, you will also have opportunities to do *good* – to stand up to injustice, to protect the rights of fellow citizens. Do not turn your back on those opportunities, even if they place you in the center of controversy. The great lawyers throughout history have done both *well* and *good*.

Lawyers have ensured the survival of the now 236-year old “experiment” called democracy in America. Democracy in the US would have died many times but for the efforts of lawyers, and the legal process, in maintaining what in China today is referred to as the “harmonious society” and “societal balance.” At times when democracy has been at great risk in the US it has been the lawyers who have maintained stability in society.

How have the lawyers done it? By safeguarding the institutions that ensure that justice exists. And when justice exists, stability in society follows.

A good example illustrates my point: the 1960s period in the US.

In the first half of that decade I was a university student. My memories of the social upheaval in America, and of the violence relating to the civil rights movement, are still vivid in my memory. Black Americans and white Americans alike who were frustrated, angry and impatient that civil rights had been denied for centuries to people of color, to women, and to members of minority groups were now taking to the streets using violence and destruction to assert their rights and their dignity as human beings.

President John F. Kennedy recognized that the civil rights movement had to be a legal movement, one fought in the courts and not in the streets; that it had to be led by lawyers and not street fighters. He was upset because the legal profession was moving too slowly to recognize that fact. And so on June 21, 1963, he called a meeting at the White House to which he invited 250 leaders of the legal profession from throughout the United States, including the President of the American Bar Association.

At the meeting President Kennedy spoke bluntly about his disappointment and frustration that the civil rights movement was not yet a priority for lawyers, and he demanded that it become a priority; that the country needed the leadership and skills of lawyers to help stop the violence, to protect rights, and to help devise needed legislative solutions to the violent killings and social upheaval that was occurring. Within days of the meeting at the White House the legal profession responded. The Lawyers Committee for Civil Rights under the Law was established, as was the American Bar Association Committee (later the Section) on Individual Rights and Responsibilities, as well as other new legal entities throughout the US, to represent citizens in the civil rights movement, to calm the country, and to help devise pragmatic solutions to the national crisis.

These lawyers in the 1960s had role models who had been at work on civil rights issues during prior decades. The great civil rights and human rights lawyer Thurgood Marshall was one of those role models. A courageous trial lawyer during the 1930s, 1940s and 1950s, Marshall represented countless black Americans in numerous important civil rights cases in the federal courts, including the landmark US Supreme Court case *Brown v. Board of Education*, decided in 1954. Later to serve as the first black American appointed to the US Supreme Court, Marshall the trial lawyer recognized that the solution to discrimination in the US of blacks and other minority group members, and to the threat to the contin-

uation of democracy in America, was not violence in the streets but the use of law in the courts, and legislation enacted by Congress.

Thurgood Marshall and lawyers like him not only secured human rights for *all* Americans, but in a very real sense they saved the Republic from destruction – destruction not by foreign enemies, but from the boiling forces within the US itself that could have led to revolution. The efforts of those lawyers, and of courageous federal judges, particularly in the South, and of lawyers who drafted legislation that Congress enacted in the 1960s such as the Civil Rights Act and the Voting Rights Act, among others, were absolutely necessary in advancing rights, maintaining societal balance and preserving a harmonious society in the US.

Look to any area of social progress in the US during the past two centuries and you will find that it was lawyers – an independent legal profession, and judges – an independent judiciary, and lawyers in Congress who crafted legislative solutions – that made the social progress possible. The public service of lawyers is interwoven in the very fabric of America.

#### ***IV. Conclusion***

I conclude with this.

Seventeen centuries before Christ, in the first written Code of Law, Hammurabi wrote that “*the purpose of the law is to protect the powerless from the powerful.*” That is still the purpose of the law.

After leaving STL you will select an area of law in which to practice. Begin by deciding to become the most skilled, accomplished and hard working lawyer you can be. No matter what area law practice you choose, and no matter how successful and busy a lawyer you will become, powerless people will come to you for legal help to protect their rights; and many of them will not be able to pay for your services. Use

your legal training, your skills, and your caring, to help those people, to protect their rights and dignity as human beings. Such public service is the lawyer’s highest calling.

I began these remarks by posing the question, “Are lawyers really necessary?” I think you know my answer.

# **French Muslim Headscarf Ban Under the Context of International Law**

*LIU Xiaoping\**

## **ABSTRACT**

*In 2004, France passed a ban that prohibited any religious symbols in public schools. The ban incurred considerable criticism, such as infringing Muslim women's freedom of religious manifestation. However, Article 18(3) of the ICCPR provides that freedom to manifest one's religion may be subject to limitations based on several legitimate bases such as public order or the fundamental rights and freedoms of others. This article will examine the possible bases in the context of article 18(3) of ICCPR. This article will discuss the meaning of public order to find out whether the principle of secularism is covered by its scope. Then, this article will try to identify gender discrimination and consider whether gender equality could be used as a justification by French government. To resolve the tension between the state's aim and religious freedom, the ban is a good faith attempt, but may be not effective or even ultimately justifiable. The resort to law is not always successful. Dialogue and improvement of Muslims' status are ultimately critical and more effective to achieve both religious freedom and gender equality.*

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\* Liu Xiaoping, Associate at King & Wood Mallesons, J.D. & J.M. 2012, Peking University School of Transnational Law; B.A. & B.S. 2008, Peking University. The author would like to thank Professor Mark Rosenbaum for his invaluable comments and feedback, and Professor Sammy M. Mansour for his thoughtful suggestions. The author also would like to thank editors at Peking University Transnational Law Review for their editorial assistance. Remaining shortcomings are solely the author's responsibility. Please address correspondence to liuxiaoping125@gmail.com.

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## I. Introduction

In 2004, France passed a ban prohibiting all kinds of religious symbols in public schools, including Muslim headscarf. Public opinion polls showed that about 70 percent of the French supported the measure, and 49 percent of Muslim women in the French Muslim community favored such a ban.<sup>1</sup> At the same time, the ban incurred considerable criticism. The opponents claimed that the ban, though worded in a generally applicable way, targets the Islamic headscarf because compared with the other religious symbols, only Muslim women are obliged to wear the headscarf due to their religious belief.<sup>2</sup> In July of 2010, France passed another bill forbidding the wearing of face-concealing clothing in public spaces.<sup>3</sup> This bill, though worded in a neutral way, was known to primarily target at the Muslim full body- and face-concealing clothing, the “niqab” and the “burqa.”<sup>4</sup> From the 2004 headscarf ban to the 2010 full face-cover ban, the French government changed its legal basis from liberal democratic values to public order to seek a less controversial justification.<sup>5</sup>

This is not the first time that the Islamic headscarf has become an issue in Europe. Many European countries limit or have considered limiting the use of headscarf in some public spheres.<sup>6</sup> The European Court of Human Rights (“ECtHR”) also has approved the legitimacy of restrictions on the Islamic headscarf under the European Convention of Human Rights based on the principle of secularism and gender equality in several cases.<sup>7</sup> But this issue has not been discussed in the interna-

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<sup>1</sup> *France Backs School Headscarf Ban*, CNN (Feb. 10, 2004), [http://articles.cnn.com/2004-02-10/world/france.headscarves\\_1\\_conspicuous-religious-symbols-french-muslim-controversial-ban?\\_s=PM:WORLD](http://articles.cnn.com/2004-02-10/world/france.headscarves_1_conspicuous-religious-symbols-french-muslim-controversial-ban?_s=PM:WORLD).

<sup>2</sup> *France: Headscarf Ban Violates Religious Freedom*, HUM. RTS. WATCH (Feb. 27, 2004), <http://www.mafhoum.com/press6/183C31.htm>.

<sup>3</sup> Benjamin Ismail, *Ban the Burqa? France Votes Yes*, MIDDLE E.Q., Fall 2010, at 47, <http://www.meforum.org/meq/pdfs/2787.pdf>.

<sup>4</sup> *Id.* at 47.

<sup>5</sup> *Id.* at 49.

<sup>6</sup> *The Islamic Veil Across Europe*, BBC NEWS, <http://news.bbc.co.uk/2/hi/5414098.stm> (last updated June 15, 2010, 10:30 GMT).

<sup>7</sup> See *Leyla Sahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶¶ 111, 113. (“[W]earing

tional context. This article will examine whether the French headscarf ban can be justified under international human rights laws, especially under article 18(3) of the International Convention on Civil and Political Rights (“ICCPR”). Although the French 2010 ban on full-face covering is mainly based on public order and not gender equality, this article will still examine all the possible bases in the context of article 18(3) of ICCPR.

Article 18(3) of the ICCPR provides that “[f]reedom to manifest one’s religion or beliefs may be subject only to such limitations as are prescribed by law and are necessary to protect public safety, order, health, or morals or the fundamental rights and freedoms of others.”<sup>8</sup> Under the European Convention of Human Rights, the ECtHR interpreted the principle of secularism as within the scope of public order considering the state’s discretion in internal affairs. Part II of this article will discuss the meaning of public order under international human rights laws. The discussion will focus on a state’s discretion in defining public order and seek to construct international guidance on the definition.

Gender equality is frequently referred to by the ECtHR in several cases to justify a restriction on the wearing of Islamic headscarves.<sup>9</sup> But the court does not discuss in detail why gender equality is implicated in such situations. Moreover, to sanction the French ban by referring to gender equality is problematic because the French ban generally applies to all religious symbols, while gender equality is used specifically to justify the restrictions on Islamic headscarf. In Part III, this article will first discuss how to identify discrimination against woman and whether the Muslim woman’s religious obligation of wearing headscarf is discriminatory. Then the article will suggest a balance between Muslim women’s

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a headscarf ... appeared to be imposed on women by a religious precept that was hard to reconcile with the principle of gender equality.” (“[T]hat secularism, as the guarantor of democratic values, was the meeting point of liberty and equality...freedom to manifest one’s religion could be restricted in order to defend those values and principles.”); *see also* Dahlab v. Switzerland, 2001-V Eur. Ct. H. R. at 13, <http://religare-database.eu/PDF/ECHR-PDFbef2010/Dahlab.pdf>.

<sup>8</sup> International Covenant on Civil and Political Rights art. 18, Dec. 16, 1966, 999 U.N.T.S. 171 [hereinafter ICCPR].

<sup>9</sup> *Leyla Sahin*, 2005-XI Eur. Ct. H.R. ¶ 111; *Dahlab*, 2001-V Eur. Ct. H.R. at 13.

freedom of religious manifestation and the state's positive obligation to eliminate discrimination against women.

Article 18(3) of ICCPR also requires that any restriction on freedom of religious manifestation must be necessary. Namely, that the restriction must directly relate to specific aims, be proportionate and not to be applied in a discriminatory manner. However, there is no unified standard about what is meant by proportionality. The ECtHR, assuming a supervisory role, largely relies on each state's decision and keeps itself from replacing a state's policy with its own assessment. Accordingly, the state may in fact enjoy too much discretion. Although there is no unified standard, "not in a discriminatory manner" is implicitly incorporated in the proportionality criteria. After the adoption, the French ban has been criticized, then, mainly because it especially burdens the Muslim's religious manifestation. Part IV of this article will also discuss whether the French ban satisfies the ICCPR's proportionality requirements.

Although the French ban has caused considerable disapproval, the aims it pursues, such as public order and gender equality, are accepted widely. But the measure specifically designed for this objective interferes with significant other interests, such as the right to manifest one's religion freely and the parental right to exercise control of children's upbringing. Moreover, a ban is not sufficient to realize gender equality or eliminate discrimination, because the obligation of wearing a headscarf and the discrimination against woman are based as well on other complicated economic, social or cultural reasons, such as the marginalization of Muslim immigrants in France and women's status in Islamic culture. To resolve the tension between the state's aim and religious belief, the ban is a good faith attempt, but may not be effective or even ultimately justifiable; it may in fact be counterproductive to this goal. The resort to law is not always successful. Dialogue and improvement of Muslims' status are ultimately critical and more effective in achieving both religious freedom and gender equality.

## **II. Definition of Public Order in the International Context**

On March 15, 2004, the French Parliament enacted Law No. 2004-228 regulating the wearing or demonstration of religious symbols in public schools. Accordingly, Article L. 141-51 of the French Education Code provides that “In State primary and secondary schools, the wearing of signs or dress by which pupils overtly manifest a religious affiliation is prohibited.”<sup>10</sup> The main concerns of this legislation are “... signs ..., such as the Islamic headscarf, however named, the kippa or a cross that is manifestly oversized, which make the wearer’s religious affiliation immediately identifiable.”<sup>11</sup>

The UN Human Rights Committee (“HRC”) has pointed out that the “wearing of distinctive clothing or head coverings” is a recognized practice of religion.<sup>12</sup> While freedom of religion may not be subjected to any derogation<sup>13</sup>, freedom of religious manifestation can nonetheless be restricted in limited circumstances. Article 18(3) of the ICCPR thus provides that “Freedom to manifest one’s religion or beliefs may be subject only to such limitations as are prescribed by law and are necessary to protect public safety, order, health, or morals or the fundamental rights and freedoms of others.” Similarly, Article 9(2) of the European Convention of Human Rights (“European Convention”) provides that “Freedom to manifest one’s religion or beliefs shall be subject only to such limitations as are prescribed by law and are necessary in a democratic society in the interests of public safety, for the protection of public order, health or morals, or for the protection of the rights and freedoms of others.”<sup>14</sup>

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<sup>10</sup> Loi 2004-228 du 15 mars 2004 encadrant, en application du principe de laïcité, le port de signes ou de tenues manifestant une appartenance religieuse dans les écoles, collèges et lycées publics [Law 2004-228 of March 15, 2004 concerning, as an Application of Secularism, the Wearing of Symbols or Clothing That Indicate Religious Affiliation in Public Primary and Secondary Schools], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Mar. 17, 2004, at 5190.

<sup>11</sup> *Dogru v. France*, App. No. 27058/05, 49 Eur. H.R. Rep. ¶ 31 (2008).

<sup>12</sup> U.N. Human Rights Comm., General Comment No. 22: The Right to Freedom of Thought, Conscience and Religion (Art. 18): ¶ 4, U.N. Doc. CCPR/C/21/Rev.1/Add.4 (July 30, 1993) [Hereinafter General Comment 22].

<sup>13</sup> See ICCPR, *supra* note 8, art. 4, ¶ 2.

<sup>14</sup> European Convention on Human Rights art. 9, Nov. 4, 1950, 213 U.N.T.S. 221.

## 1. Public Order

Although the French ban on religious symbols is very controversial in both France and, more broadly, international society, the European Court of Human Rights (“ECtHR”) in the decision in *Dogru v. France*<sup>15</sup> recognized its legitimacy, mainly based on the principle of secularism.<sup>16</sup> In *Leyla Sahin v. Turkey*,<sup>17</sup> therefore, the ECtHR noted that the restrictions on religious symbols, particularly the Islamic headscarf, were necessary to maintain public order and the principle of secularism.<sup>18</sup> As prescribed then by both the ICCPR and the European Convention, public order is a legitimate basis to restrict religious manifestation. However, there is little guidance in the international society about the definition and scope of “public order.” The UN document provides:

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<sup>15</sup> In *Dogru*, the applicant, a Muslim aged eleven was enrolled in the first year of a state secondary school during 1998-1999. From January 1999 onwards she wore a headscarf to school. On seven occasions in January 1999 the applicant went to physical education and sports classes wearing her headscarf and refused to take it off despite repeated requests to do so by her teacher, who explained that wearing a headscarf was incompatible with physical education classes. At a meeting on 11 February 1999, the school’s pupil discipline committee decided to expel the applicant from the school for breaching the duty of assiduity by failing to participate actively in physical education and sports classes. The ECtHR said that “that pupils wearing signs in schools by which they manifest their affiliation to a particular religion is not in itself incompatible with the principle of secularism in so far as it constitutes the exercise of the freedom of expression and manifestation of religious beliefs, but that this freedom should not allow pupils to display signs of religious affiliation, which, inherently, in the circumstances in which they are worn, individually or collectively, or conspicuously or as a means of protest, might constitute a form of pressure, provocation, proselytism or propaganda, undermine the dignity or freedom of the pupil or other members of the educational community, compromise their health or safety, disrupt the conduct of teaching activities and the educational role of the teachers, or, lastly, interfere with order in the school or the normal functioning of the public service.” 49 Eur. H.R. Rep. ¶ 26.

<sup>16</sup> *Id.* ¶ 72.

<sup>17</sup> In *Leyla Sahin*, the applicant came from a traditional family of practicing Muslims and considers it her religious duty to wear the Islamic headscarf. In 1997 the applicant enrolled at Istanbul University for medical studies. She wore the Islamic headscarf during the four years until February 1998 when the university banned students from wearing clothes that symbolize or manifest any religion, faith, race, or political or ideological persuasion in any institution or department of the university, or on any of its premises. ECtHR found that “the State was entitled to place restrictions on the wearing of the Islamic headscarf if it was incompatible with the pursued aim of protecting the rights and freedoms of others, public order and public safety.” 2005-XI Eur. Ct. H.R. ¶ 111.

<sup>18</sup> *See id.* ¶¶ 113–15.

“The expression ‘public order (ordre public)’ as used in the Covenant may be defined as the sum of rules which ensure the functioning of society or the set of fundamental principles on which society is founded. Respect for human rights is part of public order (ordre public).

Public order (ordre public) shall be interpreted in the context of the purpose of the particular human right which is limited on this ground.

State organs or agents responsible for the maintenance of public order (ordre public) shall be subject to controls in the exercise of their power through the parliament, courts, or other competent independent bodies.”<sup>19</sup>

As indicated by the quoted excerpt, public order refers only to the fundamental principles based on which a society is founded and operated. It may therefore vary in different societies unless there are universal fundamental principles transcending nations in the international society. “Ordre public”, the French translation of public order, is also found in the English version of ICCPR. This translation is not perfectly faithful to the English version because “ordre public” in French can be translated closely to “public policy” in English.<sup>20</sup> Compared with the restrictive interpretation of public order, public policy is a much more vague and easily-abused concept. Absent a requirement to be “fundamental,” public policy may vary widely depending on different undefined circumstances.

Without a consensus on the definition of public order, then, the ECtHR necessarily gives discretion to each member state to interpret as it chooses. This is known as “margin of appreciation” under the framework of the European Union. The “margin of appreciation” is referred to as the “room of manoeuvre” given by the Strasbourg institutions to the member states while fulfilling their obligations under the European Convention.<sup>21</sup>

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<sup>19</sup> U.N. Comm’n on Human Rights, The Siracusa Principles on the Limitation and Derogation of Provisions in the International Covenant on Civil and Political Rights Annex, ¶¶ 22–24, U.N. Doc. E/CN.4/1984/4 (Sept. 28, 1984).

<sup>20</sup> Husserl Gerhart, *Public Policy and Ordre Public*, 25 Va. L. Rev. 37, 37 (1938).

<sup>21</sup> STEVEN GREER, THE MARGIN OF APPRECIATION: INTERPRETATION AND DISCRE

The term does not exist in the European Convention. It is a product of the Strasbourg institutions and was only first discussed in *Handyside v. The United Kingdom* in 1976.<sup>22</sup> Considering that under the European Convention, the member state bears the obligation to fulfill the convention, the ECtHR carries the duty of review and will not substitute its decision in place of the member state's domestic measures.<sup>23</sup> Thus, in practice, each member state enjoys almost unlimited discretion in its domestic affairs under the European supervision. The scope of the discretion on any specific issue therefore depends on the spectrum of a European consensus. When there is similar practice among member states, the scope of discretion is narrower, while the member state generally enjoys a broad scope of margin of appreciation absent a European consensus.<sup>24</sup> Specifically in the enforcement of European Convention, the member states always possess a broad margin of appreciation considering the restrictions imposed on the rights protected by the convention in the absence of a European consensus.

As discussed, public order, or *ordre public*, has no unified meaning in the ECtHR's cases. In other words, the ECtHR does not even attempt to give a single clear meaning to this term. The decision in *Sahin* indicates that meaning of public order may reasonably vary among states due to the different traditions.<sup>25</sup> However, at least a consensus on the broad principle of democracy,<sup>26</sup> rule of law and respect of human rights does exist, even if there is no consensus on the detailed meaning and content of democracy.<sup>27</sup> The ECtHR then takes this broad concept of democracy

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TION UNDER THE EUROPEAN CONVENTION ON HUMAN RIGHTS 5 (2000), [http://www.echr.coe.int/library/DIGDOC/DG2/HRFILES/DG2-EN-HRFILES-17\(2000\).pdf](http://www.echr.coe.int/library/DIGDOC/DG2/HRFILES/DG2-EN-HRFILES-17(2000).pdf).

<sup>22</sup> Michael R. Hutchinson, *The Margin of Appreciation Doctrine in the European Court of Human Rights*, 48 INT'L & COMP. L.Q. 638, 639 (1999).

<sup>23</sup> *Id.* at 639–40.

<sup>24</sup> *The Margin of Appreciation*, COUN. OF EUR., [http://www.coe.int/t/dghl/cooperation/lisbonnetwork/themis/ECHR/Paper2\\_en.asp](http://www.coe.int/t/dghl/cooperation/lisbonnetwork/themis/ECHR/Paper2_en.asp) (last visited Nov. 28, 2012).

<sup>25</sup> *Leyla Sahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶ 109.

<sup>26</sup> *United Communist Party of Turkey and Others v. Turkey*, 1998-I Eur. Ct. H.R. ¶ 45 (“[d]emocracy is without doubt a fundamental feature of the European public order”).

<sup>27</sup> *See* European Convention on Human Rights preamble, Nov. 4, 1950, 213 U.N.T.S. 221.

as a starting point and interprets public order as a necessary guarantee of a democratic country.<sup>28</sup> Pluralism, tolerance and broadmindedness have each been considered as a “hallmark” of a democratic country.<sup>29</sup> Compared with the definition of public order in the UN guidance in Siracusa principle, ECtHR’s practice is consistent with the international standard.

In the *Sahin* case, secularism, the fundamental principle written into the Turkish Constitution, the “guarantor of democratic values” and “the meeting point of liberty and equality” is thus considered as being contained in public order.<sup>30</sup> Moreover, ECtHR also pointed out that restrictions imposed based on secularism would meet a pressing social need.<sup>31</sup> This pressing social need should be considered and interpreted in the special context where a particular human right is restricted. However, does secularism, a public order in the Turkish context, constitute public order in French context or even in the international context? Namely, does France have similarly pressing social needs as Turkey?

## 2. Social Context in Turkey

Turkey is a Muslim country, as over 99 percent of the population is Muslim.<sup>32</sup> Secularization began in 1839 when Turkey was under the rule of Ottoman Empire.<sup>33</sup> In 1923, the Republic of Turkey was established based on the principle of secularization.<sup>34</sup> During the process, many western codes were introduced and thereby replaced prior religious laws based on Islam. Some laws were enacted to promote secularization, such as the Law on Compulsory Civil Marriage and the Law on Prohibition of Wearing of Certain Some Garments.<sup>35</sup> In 1937, the principle of secular-

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<sup>28</sup> See *Leyla Sahin*, 2005-XI Eur. Ct. H.R. ¶ 113.

<sup>29</sup> *Id.* ¶ 108.

<sup>30</sup> *Id.* ¶ 113.

<sup>31</sup> *Id.* ¶ 115.

<sup>32</sup> Ergun Özsunay, The Permissible Scope of Legal Limitations on the Freedom of Religion or Belief in Turkey, 19 EMORY INT’L L. REV. 1087, 1087 (2005).

<sup>33</sup> *Id.*

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

<sup>35</sup> *Id.* at 1088 (“the following laws were enacted to emphasize “secularization” as the basic principle of the State:....c. Law on Compulsory Civil;....g. Law on Prohibition of Wearing of Certain Some Garments”).



ism was formally written into the Constitution.<sup>36</sup> The Preamble of the Constitution explains the principle of secularism as ensuring “no interference whatsoever by sacred religious feelings in state affairs and politics.”<sup>37</sup>

Popular resistance against the principle of secularism rose and has continuously existed since the foundation of the secular Republic. “Islamic fundamentalism” is an example of such radical movements with the primary purpose of establishing a religious Turkey.<sup>38</sup> Nowadays, one of the manifestations of an active “Islamic Fundamentalism” movement in Turkey is the Islamic parties’ active participation in politics. Against Turkish laws regulating the wearing of religious clothing in public school, Islamic parties favor wearing Islamic scarves in the public spheres, such as universities, public buildings and courts in order to fulfill religious duty.<sup>39</sup> Islamic parties have broad supporters, including financial support from some Islamic corporations, associations and foundations,<sup>40</sup> and even ideological support from some fundamentalist Islamic countries such as Iran, Libya and Saudi Arabia.<sup>41</sup> In the general election in 2003, one Islamic party won 34.28% votes and obtained an “overwhelming majority” in the Turkish Grand National Assembly.<sup>42</sup> But considering their threat to secularism, some Islamic parties were dissolved.

Dissolution of the Welfare Party (Refah Partisi) is one such typical example of Turkey’s defense of the principle of secularism. In 1997, the Principal State Counsel at the Court of Cassation made an application to the Turkish Constitutional Court to dissolve Refah Partisi based on the grounds that it was a “centre” of activities contrary to the principles of secularism.<sup>43</sup> Although this appeared to be a clear interference of free-

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<sup>36</sup> *Id.* at 1089.

<sup>37</sup> The Constitution of the Republic of Turkey Nov. 7, 1982 preamble (as amended October 17, 2001).

<sup>38</sup> Faik Bulut, *İslamcı Örgütler* [Islamic Organizations] 789 (2d ed. 1994).

<sup>39</sup> Özsunay, *supra* note 32, at 1105.

<sup>40</sup> *Id.* at 1110.

<sup>41</sup> *Id.* at 1111–12.

<sup>42</sup> *Id.* at 1105.

<sup>43</sup> Refah Partisi (the Welfare Party) and Others v. Turkey, 2003-II Eur. Ct. H.R. ¶ 12.

dom of association, the ECtHR recognized the legitimacy of dissolution based on the principle of secularism which is “certainly one of the fundamental principles of the State which are in harmony with the rule of law and respect for human rights and democracy.”<sup>44</sup> Moreover, the ECtHR noted that there was a pressing social need that the Welfare Party has a “real opportunity” to restore the religious rule in Turkey even with recourse to force which might make “danger to democracy more tangible and more immediate.”<sup>45</sup>

Turkey’s situation is quite different from the other member states of the European Convention. Even without considering the fact that the majority of the Turkish population is Muslim, which is much more relevant to the proportionate issue discussed in Part IV, other member states may not face the same pressing social need as Turkey. In Turkey, as discussed above, there is a genuine possibility that a secular regime would be turned over by a religious party. By contrast, the social need in most of the other EU member states is related to helping the Muslims merge into the local society and the western culture. It is quite possible that Turkey’s restriction on some human rights based on secularism is an exceptional example and would not be consistent with the constitutional principles of some or even many of the member states of the European Convention.<sup>46</sup>

### 3. Social Context in France

The principle of secularism in France dates back to the French Revolution in 1789.<sup>47</sup> Article 10 of the Declaration of the Rights of Man and of the Citizen of 1789 provides that “[n]o one shall be disquieted on account of his opinions, including his religious views, provided their manifestation does not disturb the public order established by law.”<sup>48</sup> This

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<sup>44</sup> *Id.* ¶ 93.

<sup>45</sup> *Id.* ¶ 132.

<sup>46</sup> Roel de Lange, *The European Public Order, Constitutional Principles and Fundamental Rights*, 1 *ERASMUS L. REV.* 3, 17 (2007).

<sup>47</sup> *Dogru v. France*, App. No. 27058/05, 49 *Eur. H.R. Rep.* ¶ 18 (2008).

<sup>48</sup> Déclaration des Droits de l’Homme et du Citoyen de 1789 [Declaration of the Rights of Man and of the Citizen of 1789], *JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE* [J.O.] [OFFICIAL GAZETTE OF FRANCE], Aug. 26, 1789, art. 10.

complete secularism remained the rule until 1905 when the Law on the Separation between Church and State was passed, providing that “the Republic may not recognize, pay stipends to or subsidies any religious denomination.”<sup>49</sup> This principle of secularism was then enshrined in the Preamble to the Constitution of 27 October 1946.<sup>50</sup>

Issues around the practice of Islam gradually emerged after the Muslims migrated into France from the French former colonies, such as Algeria, Morocco and Tunisia. There are currently about 62.3 million Muslims and they constitute nearly eight to ten percent of the French population.<sup>51</sup> These immigrants experience many difficulties in merging into the French society even if they are documentarily accepted as citizens. The isolation, discrimination or hostility may be based on appearance, dress, or fear of an unknown culture. As a result of this social exclusion, the Muslims suffer discrimination in employment and are not able to freely involve themselves in French cultural and political life.<sup>52</sup>

Different from the United States’ melting-pot attitude toward immigrants, France upholds a unified cultural assimilation style, namely that each minority should give up its identifiable features and behave as real French.<sup>53</sup> The tension between Muslims and the non-Muslim French thus became fiercer when the Muslims tried to keep their own identity. Both the Muslims’ marginalized situation and the European Society’s Islamophobia have historically aggravated the tension. Especially after the inception of the war against terrorism, many people falsely mix and confuse the figures of terrorist, fundamentalist, Muslim and veiled woman.<sup>54</sup> Meanwhile, undoubtedly, some young Muslim people become rad-

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<sup>49</sup> *Dogru*, 49 Eur. H.R. Rep. ¶ 18.

<sup>50</sup> See *id.*

<sup>51</sup> *Muslims in Europe: Country Guide*, BBC NEWS, <http://news.bbc.co.uk/2/hi/europe/4385768.stm> (last updated Dec. 23, 2005, 19:57 GMT).

<sup>52</sup> Adrien Kaherine Wing & Monica Nigh Smith, *Critical Race Feminism Lifts the Veil?: Muslim Women, France and the Headscarf Ban*, 39 U.C. DAVIS L. REV. 743, 753–54 (2006).

<sup>53</sup> Ellen Wiles, *Headscarves, Human Rights, and Harmonious Multicultural Society: Implications of the French Ban for Interpretations of Equality*, 41 LAW & SOC’Y REV. 699, 703–04 (2007).

<sup>54</sup> Karima Bennoune, *Secularism and Human Rights: A Contextual Analysis of*

ical and are recruited by the groups of terrorists due to the culture shock and isolation they encountered in Europe.<sup>55</sup> Headscarves, a religious obligation for Muslim women, as a visible external symbol of Islam were involved in this tension and wearing them became considerably controversial.

In 1989, the French secularism principle confronted the Muslim headscarf for the first time. That year three pupils were suspended because they refused to remove headscarves at school. Upon the request of the Minister of Education, the Conseil d'Etat gave an advisory opinion which noted that the principle of secularism required that the students' freedom of religion should be respected and thereby prohibited any discrimination in education based on a pupil's religious belief.<sup>56</sup> However, the opinion nonetheless concluded that state should prohibit the pupils from displaying "signs of religious affiliation, which, inherently, in the circumstances in which they are worn, individually or collectively, or conspicuously or as a means of protest, might constitute a form of pressure, provocation, proselytism or propaganda, undermine the dignity or freedom of the pupil or other members of the educational community...interfere with the order in the school."<sup>57</sup> Finally, in 2004, as more similar cases involving wearing the headscarf in school arose, the general headscarf ban was enacted based on the report from "Stasi commission" established under the instruction of the President of the Republic.<sup>58</sup>

The French government claims as justification that the wearing of visible religious symbol in public school is contrary to the principle of secularism which is aimed to ensure that every pupil's freedom of religion will be respected and to maintain order of the school. According to the government's perspective, neutrality of religion in school is an essential part of public order. However, the social need in France is nowhere as

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Headscarves, Religious Expression, and Women's Equality under International Law, 45 COLUM. J. TRANSNAT'L L. 367, 394 (2007).

<sup>55</sup> Timothy M. Savage, Europe and Islam: Crescent Waxing, Cultures Clashing, 27 WASH. Q. 25, 33 (2004).

<sup>56</sup> *Dogru v. France*, App. No. 27058/05, 49 Eur. H.R. Rep. ¶ 26 (2008).

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

<sup>58</sup> *Id.* ¶ 21.

pressing as in Turkey where the Islamic Party has a genuine opportunity to undermine the principle of secularism once they seize power.<sup>59</sup> In France, even assuming that the Islamic Fundamentalists may undermine the principle of secularism, the number of Muslims who will actually support them is unclear.<sup>60</sup> More importantly, Muslims in France are a distinct minority and do not impose a danger to the French regime as serious as in Turkey. As the prior discussion shows, the question is not whether public order contains the principle of secularism but rather to what extent will the principle of secularism be necessary so as to restrict freedom of religious manifestation.

#### **4. Nation's Discretion vs. International Standard on Defining "Necessary"**

The principle of secularism is not universally recognized by every nation. To nations which incorporate the principle into their constitutions as a fundamental principle, it falls within the definition of public order because, as described in the Siracusa Principles, public order contains the fundamental principle based on which a society is founded. The problem is then regarding what the scope of secularism is and to what extent a country could invoke it as a basis of restriction. Are there any international standards to limit a country's discretion of interpretation of public order when it serves as a pretext for discrimination?

As previously noted, member states of the Council of Europe enjoy discretion to govern their domestic affairs under the Council's supervision. In *Sahin*, the ECtHR explicitly remarked that "having found that the regulations pursued a legitimate aim, it is not open to the Court to apply the criterion of proportionality in a way that would make the notion of an institution's 'internal rules' devoid of purpose."<sup>61</sup> In the international context, a sovereign state also enjoys full political independence to deal

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<sup>59</sup> *Refah Partisi (the Welfare Party) and Others v. Turkey*, 2003-II Eur. Ct. H.R. ¶ 102.

<sup>60</sup> *Savage*, *supra* note 55.

<sup>61</sup> *Leyla Şahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶ 121.

with its internal affairs.<sup>62</sup> As indicated by the UN document, people belonging to a religious group enjoy the right to practice their religion and states shall take measures to ensure such rights.<sup>63</sup> However, states are not obligated to ensure these rights when the “specific practices are in violation of national law and contrary to international standards.”<sup>64</sup> The scope of national law and international standards are left undefined.

ICCPR offers some guidance about how a restriction could be laid down by stating that the restrictions on the freedom to manifest one’s religion can be justified provided the restrictions are “prescribed by law and are necessary to protect public safety, order, health, or morals or the fundamental rights and freedoms of others.”<sup>65</sup> HRC’s general comment indicates that the restrictions are necessary if they are dictated by the ICCPR, “directly related to the specific needs”, and “proportionate and not for discriminatory purposes or in discriminatory manners.”<sup>66</sup> A state may be in the best position to decide for itself what kind of restriction, if any, is necessary, but still it must be consistent with the international standard, even if the criteria are somewhat unclear. The details of the international standard on the definition of “necessary” will be discussed in Part IV.

### III. Gender Equality

Although the French ban is a general ban applied to all religions, it is claimed to be applied as a discriminatory measure against Muslims because only their religious manifestation is obligatory and thus affected by the ban. Before discussing whether the French ban has a discriminatory effect against the Muslims, a preliminary question should be asked

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<sup>62</sup> Declaration on the Inadmissibility of Intervention and Interference in the Internal Affairs of States, G.A. Res. 36/103, U.N. Doc. A/RES/36/103, Annex, 2(I)(a) (Dec. 9, 1981).

<sup>63</sup> Declaration on the Rights of Persons Belonging to National or Ethnic Religious and Linguistic Minorities, G.A. Res. 47/135, U.N. Doc. A/RES/47/135, art. 2, ¶ 1. (Dec. 18, 1992).

<sup>64</sup> *Id.* art. 4, ¶ 2.

<sup>65</sup> ICCPR, *supra* note 8.

<sup>66</sup> General Comment 22, *supra* note 12, ¶ 8.

as to whether the proscription represents an inherent discrimination against women because only women are under the obligation to wear headscarves. ECtHR in its decisions has also expressed the concern that a religious obligation imposed specifically against Muslim women is hard to square with gender equality.<sup>67</sup> As one of the fundamental rights, gender equality is a justifiable ground for restrictions on the freedom of religions manifestation. HRC's general comment to ICCPR also notes that "Article 18 may not be relied upon to justify discrimination against women by reference to freedom of thought, conscience and religion."<sup>68</sup> Although gender equality has a much clearer boundary than the notion of public order, how to identify discrimination against woman still raises serious problems of construction and application.

### 1. The Headscarf in the Islamic Context

The wearing of a headscarf is a religious obligation laid down in the Koran, the word of Allah. There are some verses in the Koran describing the significance of dressing in a modest way which apply to both men and women: for example, "O children of Adam! We have indeed sent down to you clothing to cover your shame, and (clothing) for beauty and clothing that guards (against evil), that is the best. This is of the communications of Allah that they may be mindful."<sup>69</sup> Specifically to woman, some verses show the special significance in mandating a female to cover

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<sup>67</sup> Leyla Şahin v. Turkey, 2005-XI Eur. Ct. H.R. ¶ 111 (stressing that "powerful external symbol which her wearing a headscarf represented and questioned whether it might have some kind of proselytizing effect, seeing that it appeared to be imposed on women by a religious precept that was hard to reconcile with the principle of gender equality"); *See also* Dogru v. France, App. No. 27058/05, 49 Eur. H.R. Rep. ¶ 64 (2008); Dahlab v. Switzerland, 2001-V Eur. Ct. H.R. at 13 ("In those circumstances, it cannot be denied outright that the wearing of a headscarf might have some kind of proselytizing effect, seeing that it appears to be imposed on women by precept which is laid down in the Koran and which, as the Federal Court noted, is hard to square with the principle of gender equality.").

<sup>68</sup> U.N. Human Rights Comm., General Comment No. 28: Equality of Rights Between Men and Women (Art. 3): CCPR/C/21/Rev.1/Add.10, ¶ 21 (Mar. 29, 2000) [hereinafter General Comment 28]; *see also* Declaration on the Elimination of All Forms of Intolerance and of Discrimination Based on Religion or Belief, G.A. Res. 36/55, U.N. Doc. A/RES/36/55, art. 8 (Nov. 25, 1981).

<sup>69</sup> Qur'an 7:26.

her beauty before strange men:

“And say to the believing women that they cast down their looks and guard their private parts and do not display their ornaments except what appears thereof, and let them wear their head-coverings over their bosoms, and not display their ornaments except to their husbands or their fathers, or the fathers of their husbands, or their sons, or the sons of their husbands, or their brothers, or their brothers' sons, or their sisters' sons, or their women, or those whom their right hands possess, or the male servants not having need (of women), or the children who have not attained knowledge of what is hidden of women; and let them not strike their feet so that what they hide of their ornaments may be known; and turn to Allah all of you, O believers! So that you may be successful.”<sup>70</sup>

Moreover, men are instructed to ensure that their female family members to dress appropriately: “O Prophet! Say to your wives and your daughters and the women of the believers that they let down upon them their over-garments; this will be more proper, that they may be known, and thus they will not be given trouble; and Allah is Forgiving, Merciful.”<sup>71</sup>

There are various coverings from a simple headscarf to an entire covering with only a mesh screen for a woman to see through.<sup>72</sup> Hijab, a simple headscarf, is specifically involved in the debate about French ban. There may be various reasons for this wearing of a covering. Generally, women wear coverings to fulfill their religious obligation consistent with the teachings quoted above.<sup>73</sup> They may also wear coverings for political

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<sup>70</sup> Qur'an 24:31.

<sup>71</sup> Qur'an 33:59.

<sup>72</sup> *In Graphics: Muslim Veils*, BBC NEWS, [http://news.bbc.co.uk/2/shared/spl/hi/pop\\_ups/05/europe\\_muslim\\_veils/html/1.stm](http://news.bbc.co.uk/2/shared/spl/hi/pop_ups/05/europe_muslim_veils/html/1.stm) (last visited Aug. 23, 2012).

<sup>73</sup> New Zealand Human Rights Comm'n, *Muslim Women, Dress Codes and Human Rights: An Introduction to Some of the Issues*, N.Z. HUM. RTS. COMM'N, ¶ 3 (Dec. 22, 2005), <http://www.hrc.co.nz/news-and-issues/human-rights-in-new-zealand/muslim-women-dress-codes-and-human-rights/>.



conviction, cultural practice or as a way to avoid criticism or harassment from men.<sup>74</sup>

Historically, by the late 1960's, the hijab was removed by most Muslim women due to the conviction then spreading across the colonies that veils were symbolic of oppression against women.<sup>75</sup> However, in the late 1970s, a "re-veiling" movement arose when women wanted to use veil as a symbol of their resistance against colonialism.<sup>76</sup> Still, undeniably, many Muslim women wear coverings due to external pressure, such as the force of state law in Iran and Afghanistan or the threat of resulting physical violence in Algeria or other Muslim countries.<sup>77</sup> Today, Muslim women's views on the wearing of headscarfs reflect large divergence.<sup>78</sup> Without considering women's potentially different views about wearing of headscarves, both the ECtHR and the French ban presume that the headscarf is an oppression and discrimination against woman. Due to actual divergent views, to identify discriminatory treatment is very important.

## 2. Approaches to Identify Gender Discrimination

The French ban has been criticized as a pursuit of "formal equality" in disregard of the substantive outcome.<sup>79</sup> Formal equality is the application of a universal measure to everyone without considering possible disparities.<sup>80</sup> Formal equality thus does not take social, economic, cultural or religious points of view or differences into decision-making. The French ban is a general ban against all religious manifestations. It does not differentiate among the significance and meanings of religious practice among different religions or between man and woman. Formal

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<sup>74</sup> *Id.* at 2.

<sup>75</sup> Katherine Bullock, Rethinking Muslim Women and the Veil: Challenging Historical and Modern Stereotypes 85 (2002).

<sup>76</sup> *Id.* at 88.

<sup>77</sup> *Id.* at 85.

<sup>78</sup> See Wing & Smith, *supra* note 52, at 759–71.

<sup>79</sup> See Wiles, *supra* note 53, at 714–15.

<sup>80</sup> Martha Albertson Fineman, Equality Across Legal Cultures: The Role for International Human Rights, 27 T. JEFFERSON L. REV. 1, 3 (2004).

equality cannot guarantee equal outcome, and may even aggravate unequal outcomes in a situation where some groups have traditionally suffered significant discriminatory treatment.<sup>81</sup> Affirmative action is motivated by an aim of equal outcome and is used to compensate for historical unequal treatment. It is a manifestation of “substantial equality” which focuses on the substance of the ultimate goal instead of the procedure to achieve the goal.<sup>82</sup>

Specific to Islamic religious manifestation, France uses gender equality as a justification for the ban because Muslim women should not be forced to wear headscarves while Muslim men do not face any such obligation. To treat woman and man equally sounds in this instance like “formal equality.” Will then the French ban be helpful to achieve gender equality or lead to unequal outcome because of the limitation to Muslim women’s freedom of religious manifestation? To answer this question, one must first clarify the nature of the Muslim woman’s religious obligation. If the religious practice is discriminatory against woman, France is obligated to eliminate it in a proper way. If it is not discriminatory, French “formal equality” is not true equality and will result in unequal outcomes.

### **A. International View on Gender Discrimination**

The Convention on the Elimination of All Forms of Discrimination against Women (“CEDAW”) provides guidance on definition of gender discrimination based on the enjoyment of rights between woman and man. Article 1 provides that:

“For the purposes of the present Convention, the term “discrimination against women” shall mean any distinction, exclusion or restriction made on the basis of sex which has the effect or purpose of impairing or nullifying the recognition, enjoyment or exercise by women, irrespective of their marital status, on a basis of equality of men and women, of human

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<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 4.

rights and fundamental freedoms in the political, economic, social, cultural, civil or any other field.”<sup>83</sup>

CEDAW’s approach is consistent with “substantial equality.” It does not try to single out the similarity or difference between man and woman, but rather emphasizes the outcome: the equal enjoyment of human rights, should in actuality be equal. Article 1 not only eliminates intentional discrimination but also discriminatory effect even in the absence of a discriminatory purpose. CEDAW guarantees that women enjoy all equal human rights and fundamental freedoms with men in the political, economical, social, culture, civil or any other field. From article 7 to article 16, CEDAW lists many areas where women should be ensured enjoyment of the same rights or opportunities as men.<sup>84</sup> Moreover, both the ICCPR and the International Covenant on Economic, Social and Culture Rights (“ICESCR”) also include detailed descriptions about these rights and forbid any discrimination based on sex.<sup>85</sup>

Specifically as to the religious obligation of wearing a headscarf, the requirement may directly constitute a “distinction, exclusion or restriction” which thus “impair[s] or nullif[ies]” the woman’s right to choose an “adequate standard of living...including adequate clothing.”<sup>86</sup> By practicing such obligation, it may also impede women from equal enjoyment of other rights that men enjoy, such as the right of work. Many Muslim women confront more challenges than men in world.<sup>87</sup> The difficulties of finding a job tolerant of the Muslim headscarf were not directly imposed

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<sup>83</sup> Convention on the Elimination of All Forms of Discrimination against Women art. 1, Dec. 18, 1979, 1249 U.N.T.S. 13 [hereinafter CEDAW].

<sup>84</sup> *Id.* arts. 7–16.

<sup>85</sup> See ICCPR, *supra* note 8, art. 2, ¶ 1; see also International Covenant on Economic, Social and Culture Rights art. 2, ¶¶ 2–3, Dec. 16, 1966, 993 U.N.T.S. 3 [hereinafter ICESCR].

<sup>86</sup> ICESCR, *supra* note 84, art. 11, ¶ 1.

<sup>87</sup> See *Muslim Employee: Disney Banned Her Head Scarf*, CBSNEWS (Aug. 19, 2010), <http://www.cbsnews.com/stories/2010/08/19/national/main6786918.shtml> (reporting that Disney will not allow a Muslim employee appear before the customers while wearing a headscarf); See Sharmin Pirbhai, *Legal Corner: Muslim Employee Wins Religious Discrimination Against Muslim Employer*, THE MUSLIM NEWS (Mar. 25, 2011), [http://www.muslimnews.co.uk/paper/index.php?article=5169\\_](http://www.muslimnews.co.uk/paper/index.php?article=5169_) (reporting that a Muslim woman who refused to wear headscarf was dismissed by her Muslim employer).

by the religious obligation but caused by the third party's preference. However, CEDAW's definition of discrimination not only considers purpose but also effect. Even if the religious obligation itself has no discriminatory purpose, it still results in a discriminatory outcome.

## B. American Approach

When deciding whether existence of gender-based discrimination exists, CEDAW focuses on the ultimate position of men and women; in comparison, U.S. law considers the starting point of a policy, namely whether a gender classification is "based on clear differences between the sexes."<sup>88</sup> The Equal Protection Clause in the U.S. Constitution does not require the physiological differences between men and women must be disregarded.<sup>89</sup> However, the classification must be related to actual differences, not stereotypical or archaic classifications.<sup>90</sup> The judicial decisions from the U.S. Supreme Court show that legislations or practice based on gender classification is not *per se* suspicious provided that the gender difference plays a role and relates to the objectives.

These U.S. decisions all deal with the gender discrimination resulting from legislation or official administrative practice, while in the headscarf situation, women's religious duty of wearing headscarf is imposed by a private religion group. Article 5 of CEDAW provides that,

"States Parties shall take all appropriate measures:

(a) To modify the social and cultural patterns of conduct of men and women, with a view to achieving the elimination of prejudices and cus-

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<sup>88</sup> *Michael M. v. Super. Ct. of Sonoma Cnty.*, 450 U.S. 464, 479 (1981) (holding that California "statutory rape" law defining unlawful sexual intercourse as "an act of sexual intercourse accomplished with a female not the wife of the perpetrator, where the female is under the age of 18 years" did not unlawfully discriminate on the basis of gender because women and men are physiologically different and men alone could be held criminally liable); *See also* *Craig v. Boren*, 429 U.S. 190 (1976) (holding that statute setting different age limits for buying beer by men and women is a gender discrimination because no sufficient evidence supporting such a difference between men and women).

<sup>89</sup> *Michael*, 450 U.S. at 481.

<sup>90</sup> *Id.* at 469.

tomary and all other practices which are based on the idea of the inferiority or the superiority of either of the sexes or on stereotyped roles for men and women.”<sup>91</sup>

This article does not differentiate as to the cause of gender discrimination and it implies that discrimination could result from a private party's practice, especially those customary views or practices with broad social influence. Applying the U.S. approach in the headscarf situation, if there is no evidence showing that the differential treatment between Muslim women and men is based on gender difference and related to its objectives, this religious practice is very suspect as a constitutional matter. Moreover, the gender difference must be not just on the surface, it must in practice be critical. Perhaps only the physiological difference could then excuse a gender classification in U.S. law.<sup>92</sup>

### C. Contextual Approach

As Article 5 of CEDAW provides, discrimination against woman is based on “the idea of the inferiority or the superiority of either of the sexes.”<sup>93</sup> In other words, if in the society or a group, women are deemed inferior compared with men, any distinct treatment, let alone a compulsory obligation specifically referred to one gender, will be suspicious. The inferiority may be hard to identify directly from one practice. But all the circumstances taken together may lead to a sound inference that women are regarded as subordinated to men.

In many Muslim countries, woman's rights are largely restricted. One extreme example is in Afghanistan. Under the control of Taliban, Muslim women are forbidden from working and girls beyond 8 years old are prohibited from attending school.<sup>94</sup> They even cannot appear in pub-

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<sup>91</sup> CEDAW, *supra* note 83, art. 5(a).

<sup>92</sup> *Michael*, 450 U.S. at 481.

<sup>93</sup> CEDAW, *supra* note 83, art. 5(a).

<sup>94</sup> *Humanity Denied: Systematic Violations of Women's Rights in Afghanistan*, HUM. RTS. WATCH 7 (Oct. 29, 2001) <http://www.hrw.org/reports/2001/afghan3/afg-wrd1001.pdf> [hereinafter *Humanity Denied*].

lic unless accompanied by a close male relative.<sup>95</sup> A woman in violation of the dress code will suffer public beating or lashing by the Religious Police.<sup>96</sup> In Saudi Arabia and Sudan, women's political rights and the specific rights to work, drive and obtain an education are also denied.<sup>97</sup> In Kuwait, Nigeria and Syria, women suffer much discrimination and experience without recourse in the law violence in marriage, domestic and other private affairs.<sup>98</sup>

Moreover, the obligation to wear religious dress in public has been specifically criticized by the Special Rapporteur of the UN Commission of Human Rights who is appointed for one year to examine incidents and governmental action in all parts of the world inconsistent with the provisions of the Declaration on the Elimination of All Forms of Intolerance and of Discrimination Based on Religion or Belief, and to recommend remedial measures for such situations.<sup>99</sup> In certain countries, the Special Rapporteur has found that "women are among those who suffer most because of severe restrictions on their education and employment, and the obligation to wear what is described as Islamic dress."<sup>100</sup> One report, for example, documents that a Muslim woman who does not obey the obligation of Islamic dress code will be punished by whipping and/or a fine.<sup>101</sup> In Algeria, women are "attacked in the streets, threatened with death if they went out at night or because they were living alone, were divorced or were not wearing the hijab, and were kidnapped, raped and murdered in the most atrocious fashion."<sup>102</sup> There are a growing number

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

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

<sup>97</sup> See Janet Afary, *The Human Rights of Middle Eastern & Muslim Women: A Project for the 21st Century*, 26 HUMAN RIGHTS Q. 106, 111–12 (2004).

<sup>98</sup> *Id.* at 109–13.

<sup>99</sup> Special Rapporteur, *Implementation of the Declaration on the Elimination of All Forms of Intolerance and of Discrimination Based on Religion or Belief*, ¶ 1, U.N. Doc. E/CN.4/1998/6 (Jan. 22, 1998) (by Abdelfattah Amor).

<sup>100</sup> *Id.* ¶ 60.

<sup>101</sup> U.N. Secretary-General, *Implementation of the Declaration on the Elimination of All Forms of Religious Intolerance and of Discrimination Based on Religion or Belief*, ¶ 51, U.N. Doc. A/51/542/Add.2 (Nov. 11, 1996).

<sup>102</sup> Special Rapporteur on Freedom of Religion or Belief, *Civil and Political Rights, Including the Question of Religious Intolerance*, ¶ 59, U.N. Doc. E/CN.4/2003/66/Add.1 (Jan. 9, 2003) (by Abdelfattah Amor).

of women killed due to failure of following the religious dress code.<sup>103</sup> All the violence against women associated with the obligatory religious dress code demonstrates that women's rights and life are brutally disregarded. The other violations against women, such as forced marriage, early marriage or crime of honor also confirm women's inferior status in a society or group.<sup>104</sup>

However, this violence against woman exists in certain countries and can only be used at best as circumstantial evidence from which to infer the existence of gender discrimination in France. When dealing with the Muslim immigrants in France, all the aforementioned violence and attitudes may not exist, since no reports describe its prevalence there. In addition to the aforementioned context in Islamic countries, it is therefore still necessary to consider the deep implication of Islamic headscarf. But it should be noticed that it is hard for an outsider to appreciate and conclusions may vary based on time and place.

#### D. Implication of Islamic Headscarf

The implication of the Islamic headscarf has shifted as time and places change. Returning to the religious origin, the Koran contains clues for the reason for such a religious duty. Significantly, its teachings and directives have been interpreted by male scholars and theologians because women only receive little education or none at all.<sup>105</sup> This exclusive power of interpretation puts women at a distinct disadvantage. As the interpretation shows, although women and men are created equal, the Koran preaches that "due to their sexual, biological, physical and mental differences and limitations, a man is a degree superior in the areas of

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<sup>103</sup> Special Rapporteur, *Implementation of Declaration on the Elimination of All Forms of Intolerance and of Discrimination Based on Religion or Belief*, at 10, U.N. Doc. E/CN.4/1995/91 (Dec. 22 1994) (reporting that "Katia Benghana, a 17-year-old high school student, is said to have been shot to death at Blida on 28 February 1994 after being threatened for failing to wear the hijab") (by Abdelfattah Amor).

<sup>104</sup> See Special Rapporteur, *Specific Human Rights Issues: Women and Human Rights*, at 17–19, U.N. Doc. E/CN.4/Sub.2/2005/36, (July 11, 2005) (by Halima Embarek Warzazi).

<sup>105</sup> Nayer Honarvar, *Behind the Veils: Women's Rights in Islamic Societies*, 6 J.L. & RELIGION 357, 363 (1988).

domestic, economic and political affairs.”<sup>106</sup> Upon marriage, the wife shall obey her husband, be prohibited from going out or appearing in public and subject to her husband’s power of correction or even physical punishment.<sup>107</sup> One verse of the Koran directs women not to display themselves except to their husband or other male relatives.<sup>108</sup> This verse, together with the interpretation and practice in marriage, indicate that a woman may be deemed subordinated to her husband, like private property which should be concealed to keep its value.

As the notion of Islamic headscarf may change with the social development, the meaning associated with the ancient interpretation and practice may not be true today, or at least not universally so. As reviewed above, especially since the 1970’s, the wearing of the Islamic headscarf manifests various meanings.<sup>109</sup> In the Algeria fight for independence in the 1950’s and Iran’s fight in the 1970’s, women recovered themselves as a “symbol of resistance during anti-colonial and revolutionary struggle.”<sup>110</sup> The hijab has also been used as a symbol of political protest, as during the Egyptian Islamic movement, to declare an effort of seeking for Islamic identity and a rejection of the Western values.<sup>111</sup> Women chose to veil or re-veil believed that veiling is an “expression of adhering to true Islam.”<sup>112</sup> In addition to religious reason, many women chose veiling solely based on consideration of social and economic reality. By wearing headscarves, women have access to the public sphere because

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<sup>106</sup> *Id.*

<sup>107</sup> Abdul Kadir v. Salimaand And Anr., I.L.R. 8 (All). 149, ¶ 8 (1886) (India) (quoting Baillie’s Digest of the Muhammadan law: “[t]he legal effects of the marriage are that it legalizes the enjoyment of either of them (husband and wife) with the other in the manner in which this matter is permitted by the law; and it subjects the wife to the power of his restraint, that is, he becomes prohibited from going out and appearing in public; it renders her dower, maintenance, and [remain] obligatory on him and establishes on both sides the prohibition of affinity of and the rights of inheritance, and the obligatoriness of justness between the wives and their rights, and on her it imposes submission to him when summoned to the couch; and confers on him the power of correction, physical punishment, when she is disobedient or rebellious....”).

<sup>108</sup> Qur’an 24:31.

<sup>109</sup> BULLOCK, *supra* note 75, at 85.

<sup>110</sup> BULLOCK, *supra* note 75, at 87–88.

<sup>111</sup> *Id.* at 91–95.

<sup>112</sup> *Id.* at 96–98.



they can seek employment, gain respect and combat male harassment more easily.<sup>113</sup> Moreover, in the West, Muslim women may use the headscarf as a way to show their special personal identity and unique culture.<sup>114</sup>

Specifically as to the situation in France, the reasons and implications of the Islamic headscarf vary as well. A poll taken by *Elle* magazine shows that “fifty-three percent of women of North African background living in France are hostile to headscarves in schools, and eighty-one percent claim never to wear a veil.”<sup>115</sup> A survey of French Muslim women’s perspectives of headscarf, collecting various views from both the pro-headscarf and the anti-headscarf, shows that Muslim women choosing a headscarf considered wearing headscarf as a religious obligation which they should enjoy the freedom to practice.<sup>116</sup> They believe that wearing a headscarf can demonstrate that a female is pure and therefore protect her from harassment from Muslim males or even violence or murder.<sup>117</sup> Some wear a headscarf due to family pressure because they are not allowed to attend school or cannot gain the respect of their father and brother without being covered.<sup>118</sup> Some choose to wear based on individual choice because they believe wearing headscarf is an affirmation of Islamic identity and gives them the sense of “belonging to something reassuring.”<sup>119</sup>

To the contrary, many French Muslim women in support of the ban on the headscarf consider it as a symbol of oppression imposed by the family, community and religion because women not veiling will be deemed rebels and whores.<sup>120</sup> They also believe that the headscarf is a sign of sexism because women are under the obligation to protect them-

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<sup>113</sup> *Id.* at 99.

<sup>114</sup> *Id.* at 105–07.

<sup>115</sup> Janice Valls-Russell, *A Community Divided: Growing Up Muslim in France*, 87 *NEW LEADER* 6, 7 (2004).

<sup>116</sup> Wing & Smith, *supra* note 52, at 759–61.

<sup>117</sup> *Id.* at 761–63.

<sup>118</sup> *Id.* at 762.

<sup>119</sup> *Id.* at 765.

<sup>120</sup> *Id.* at 768.

selves from harassment from men while there is no limitation on men's behavior.<sup>121</sup> The obligation of wearing the headscarf thus leads to division among Muslim women because the headscarf is a highly visible symbol and unveiled women are scolded by the veiled.<sup>122</sup> Moreover, due to the emergence of Islamic extremism and its combination with the headscarf, it has been deemed "a symbol of extremist Islam-terrorism, extermination of apostates, suicide bombers."<sup>123</sup>

None of the aforementioned reasons of wearing headscarf relates to a critical or biological difference between men and women. If there is no significant difference requiring different treatment, why is it that Muslim women must obey a compulsory religious duty which even impairs their equal enjoyment of the right to work and education as men? Even if this distinctive treatment caters to religious obligation, religious belief does not mean it is *per se* right or just. However, this conclusion is based on an outsider's inference. As the opponents of the French headscarf ban claim, those not part of Islamic culture do not truly understand the meaning of headscarf. Accordingly, they should bear the burden of proof of whether the religious obligation of wearing headscarf constitutes a discrimination against women.

### 3. Conflict between Freedom and Equality

Despite the question as to whether the obligatory wearing of headscarf is a product of discrimination or not, some Muslim women nonetheless choose to wear headscarves motivated by their individual belief and choice. If this practice cannot be reconciled with gender equality, can a Muslim woman voluntarily choose to accept this discrimination? This question in fact raises two issues. One is whether a woman in that situation has genuine freedom to make a free choice of discriminatory treatment. The other is whether discriminatory treatment may be solely a personal matter.

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<sup>121</sup> *Id.* at 769–70.

<sup>122</sup> *Id.* at 771.

<sup>123</sup> *Id.* at 770.

First, free choice must be based on a free and independent mind. A person must make a choice solely based on individual decision without being directly or indirectly influenced by the others. A Muslim woman, who does not live in a vacuum, is easily influenced by her family or community's values.<sup>124</sup> Due to her family's values, she is exposed to an environment with a specific preferred value, and she may be easily and firmly convinced that the value shared by her community is also her own value. In the absence of a genuine independent mind, it is hard to claim a woman's choice of discriminatory treatment is "voluntary."

Secondly, even supposing that a woman has independently and voluntarily choosing to be treated in a discriminatory way, this choice is not just a personal affair in some circumstances. In the private sphere, a woman is free to wear a headscarf provided she will not interfere with others. However, in the public sphere, the state is obligated to maintain public order when a person's behavior will affect others. Article 4 of ICCPR provides that freedom of religion shall not be derogated in any circumstance. The freedom of religion is primarily a matter of individual conscience which is not visible as long as not being manifested.<sup>125</sup> However, the freedom or religious manifestation subject to restrictions as provided in article 18(3) of the ICCPR. A state possesses a positive obligation to eliminate discrimination and maintain a tolerant environment. Article 2 of CEDAW provides that:

"States Parties condemn discrimination against women in all its forms, agree to pursue by all appropriate means and without delay a policy of eliminating discrimination against women and, to this end, undertake...(e) To take all appropriate measures to eliminate discrimination against women by any person, organization or enterprise."<sup>126</sup>

Moreover, Article 5(a) of CEDAW provides that a state has a general

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<sup>124</sup> See Alison Stuart, *Freedom of Religion and Gender Equality: Inclusive or Exclusive?*, 10 HUM. RTS. L. REV. 429, 443 (2010) (arguing that the "free" choice of a Muslim woman is problematic because she may "value and respect the wishes of her parents, husband, children or others to conform to the cultural norms").

<sup>125</sup> See *Dogru v. France*, App. No. 27058/05, 49 Eur. H.R. Rep. ¶ 61 (2008).

<sup>126</sup> CEDAW, *supra* note 83, art 2(e).

obligation to eliminate any customary conception with the idea of female inferiority.<sup>127</sup> If the obligation of wearing the Islamic headscarf is discrimination against woman, a woman's wearing, even if based on her own choice, supports such discrimination. The state's silence on this conduct may be perceived as a tacit consent which is contrary to the state's obligation and a tolerance of the discriminatory custom.<sup>128</sup>

Moreover, two kinds of freedom of religious manifestation are involved. One is the positive freedom, namely that a person should have the freedom to manifest her religion. The other is the negative one, which refers to the freedom of not being forced to wear some religious symbols.<sup>129</sup> The ECtHR considers the headscarf as a powerful external symbol which may affect others, especially young children.<sup>130</sup> Women not wearing a headscarf may feel that they are under the obligation to conform to women choosing to wear it.<sup>131</sup> A state has a positive obligation to protect the free exercise of religion from coercion, fear and interference of non-state actors.<sup>132</sup> A person's freedom from being forced to wear a religious symbol should be protected as well as a person's freedom to voluntarily wear it. To respect the public arena shared by all citizens is within the meaning of secularism.<sup>133</sup> However, although article 18(3) of the ICCPR authorizes a state to restrict the freedom of religious manifestation based on the "fundamental rights and freedoms of others," how to tailor the restrictions within a necessary scope is also related to its

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<sup>127</sup> CEDAW, *supra* note 83, art 5(a).

<sup>128</sup> See *Leyla Sahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶ 12 (2005) (Tulken, J., dissenting).

<sup>129</sup> See Special Rapporteur on Freedom of Religion or Belief, *Civil and Political Rights, Including the Question of Religious Intolerance*, ¶ 60, U.N. Doc. E/CN.4/2006/5 (Jan. 9, 2006) (by Asma Jahangir) [hereinafter *Religious Intolerance 2006*].

<sup>130</sup> *Dahlab v. Switzerland*, 2001-V Eur. Ct. H.R. at 13; *Leyla Sahin*, 2005-XI Eur. Ct. H.R. ¶ 111; *Dogru*, 49 Eur. H.R. Rep. ¶ 40.

<sup>131</sup> *Bennoune*, *supra* note 54, at 418.

<sup>132</sup> U.N. Secretary-General, *Elimination of All Forms of Religious Intolerance*, ¶ 53, U.N. Doc. A/60/399 (Sept. 30, 2005); See also Special Rapporteur on Freedom of Religion or Belief, *Civil and Political Rights, Including the Question of Religious Intolerance*, ¶ 42, U.N. Doc. E/CN.4/2005/61 (Dec. 20, 2004) (by Asma Jahangir).

<sup>133</sup> *Dogru*, 49 Eur. H.R. Rep. ¶ 18.

legitimacy.<sup>134</sup>

#### IV. Restriction in a Necessary Manner

Even if the principle of secularism and gender equality are justifiable bases under article 18(3) of the ICCPR, the French ban still must meet some procedural requirements. Article 18(3) of the ICCPR requires that the “limitations are prescribed by law and are necessary to protect” the legitimate aims.<sup>135</sup> HRC, in the general comment, notes that:

“In interpreting the scope of permissible limitation clauses, States parties should proceed from the need to protect the rights guaranteed under the Covenant...Limitations imposed must be established by law and must not be applied in a manner that would vitiate the rights guaranteed in article 18. The Committee observes that paragraph 3 of article 18 is to be strictly interpreted...Limitations may be applied only for those purposes for which they were prescribed and must be directly related and proportionate to the specific need on which they are predicated. Restrictions may not be imposed for discriminatory purposes or applied in a discriminatory manner.”<sup>136</sup>

The main requirements of a permissible restriction are “directly related to the legitimate aims”, “proportionate” and “not in a discriminatory manner.”

##### 1. Proportionate

Considering that social need and social circumstance vary among different countries, a universal standard of proportion is not possible. It should therefore be examined on a case-by-case basis. The ECtHR’s decision of *Sahin* provides some guidance about the appropriate elements contained in proportionality. In *Sahin*, ECtHR examined proportionality mainly from two aspects: one is the balance of competing rights and in-

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<sup>134</sup> ICCPR, *supra* note 8, art. 18, ¶ 3.

<sup>135</sup> *Id.*

<sup>136</sup> General Comment 22, *supra* note 12, ¶ 8.

terests involved, and the other is the decision-making process in a state.<sup>137</sup> When balancing the competing interests, the court examined the meaning of a democratic society, recognized the significance of freedom to practice one's religion and discussed the circumstances when the freedom of religious manifestation has to be limited.<sup>138</sup> Then the court turned to discuss the appropriate procedures a state may take to limit the freedom of religious manifestation, namely that there must be "a reasonable relationship of proportionality between the means employed and the legitimate objectives pursued by the interference."<sup>139</sup> The court emphasized that the limitation was generally applied, the reason of limitation was noticed in advance and subjected to wide debates.<sup>140</sup> Moreover, the court clarified that the state was at the best position to decide the proper measure while the court "is not open to apply the criterion of proportionality in a way that would make the notion of an institution's 'internal rules' devoid of purpose."<sup>141</sup>

The ECtHR's review of proportionality to a large extent relies on the state's decision. On one hand, this approach does consider each state's specific situation. On the other hand, it gives each state too much discretion which may make the court's supervision devoid of purpose. There is no unified international standard of proportionality either. However, the Special Rapporteur of the UN Commission on Human Rights in the report of 2006 provided some criteria to balance competing human rights involved in the restriction of freedom to manifest one's religion. In review of a state's restrictions, the following questions were identified as needing an affirmative answer:

– Was the interference, which must be capable of protecting the legitimate interest that has been put at risk, appropriate?

– Is the chosen measure the least restrictive of the right or freedom

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<sup>137</sup> See *Leyla Sahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶¶ 104–21; See also *Begum v. Headteacher*, [2006] UKHL 15, [32] (Eng.).

<sup>138</sup> *Leyla Sahin*, 2005-XI Eur. Ct. H.R. ¶¶ 104–11.

<sup>139</sup> *Id.* ¶ 117.

<sup>140</sup> *Id.* ¶¶ 118–20.

<sup>141</sup> *Id.* ¶ 121.

concerned?

- Was the measure proportionate, i.e. balancing of the competing interests?
- Would the chosen measure be likely to promote religious tolerance?
- Does the outcome of the measure avoid stigmatizing any particular religious community?”<sup>142</sup>

Similar to the factors enumerated in ECtHR’s decision, the criteria in the report also include the balance of competing interests. When public order, gender equality and the freedom of religious manifestation are at stake, it is reasonable and justifiable to restrict the freedom of religious manifestation, especially when the HRC has explicitly said that “Article 18 [of ICCPR] may not be relied upon to justify discrimination against women by reference to freedom of thought, conscience and religion.”<sup>143</sup> Moreover, this report also lists the “least restrictive measure” as one indicator of proportionality. This criterion in theory limits the state’s discretion. However, similar to the broader discussion, it still does not clearly resolve the problem as to who should decide the meaning of “least restrictive measure.” It only emphasizes that the state’s discretion must be based on the international consensus that “all human rights are universal.”<sup>144</sup>

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<sup>142</sup> *Religious Intolerance 2006*, *supra* note 129, ¶ 58.

<sup>143</sup> General Comment 28, *supra* note 68, ¶ 21.

<sup>144</sup> *Religious Intolerance 2006*, *supra* note 129, ¶ 59 (“When dealing with the prohibition of religious symbols, two general questions should always be borne in mind: What is the significance of wearing a religious symbol and its relationship with competing public interests, and especially with the principles of secularism and equality? Who is to decide ultimately on these issues, e.g. should it be up to the individuals themselves, religious authorities, the national administration and courts, or international human rights mechanisms? While acknowledging that the doctrine of ‘margin of appreciation’ may accommodate ethnic, cultural or religious peculiarities, this approach should not lead to questioning the international consensus that ‘[a]ll human rights are universal, indivisible and interdependent and interrelated’, as proclaimed in the Vienna Declara-

One criticism of the French ban on headscarf is that it protects a group of women's right of not wearing headscarf at the cost of another group of women's right of religious manifestation. There could be alternatives which may protect both of the two groups of women's freedom, such as creating a report mechanism to deal with coercive religious practices contrary to a woman's will in a case by case manner or passing a ban prohibiting any family member or religious leader from forcing a woman to comply with religious obligation against her will. However, due to the consideration that a state is at the best position to lay down its own domestic rules, the aforementioned alternatives may be less restrictive, but may nonetheless not achieve the objectives.

In the absence of any unified international standard, the democratic process may be the second best choice to give legitimacy to a restriction. Moreover, the restriction passed by a majority should not cause a discrimination against the minority group. Turkey's headscarf ban does not result in as much debate as the French ban because 99 percent of the Turkey's population is Muslim.<sup>145</sup> The restriction on the Islamic headscarf is hard to be claimed as discrimination against the Muslim if it is passed based on the Muslim's choice.<sup>146</sup> However, in France "while ninety-two percent of French are registered to vote, only thirty-seven percent of Muslim citizens have registered to vote."<sup>147</sup> There is only one Muslim representative in the French National Parliament, but he has stated publicly that tries to not mix religion with his political life.<sup>148</sup> It is probable that many Muslim women whose rights are interfered with do not take part in the debate and vote.<sup>149</sup> France must therefore prove that

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tion and Programme of Action adopted by the World Conference on Human Rights in 1993.").

<sup>145</sup> Özsunay, *supra* note 32, at 1087.

<sup>146</sup> See Wiles, *supra* note 53, at 711 ("There is arguably an important difference between a law that results from a political consensus within the majority ethnic group in determining the treatment of a minority group, and a police that results from a political consensus within the majority group in determining the treatment of that same majority.").

<sup>147</sup> Wing & Smith, *supra* note 52, at 788.

<sup>148</sup> *Id.*

<sup>149</sup> See *id.* at 748 ("Most of the discussions regarding the French headscarf-ban debate were perpetuated by male voices, and the girls and women who were affected were



its ban is not in a discriminatory manner because the democratic process itself cannot naturally give the ban legitimacy.

## 2. Not in a Discriminatory Manner

The requirement of “not in a discriminatory manner” is significant to the justification of a restriction. The Special Rapporteur’s report also includes some criteria helping to examine whether a restriction is compatible to the international human rights laws or not. Those criteria indicating an incompatibility are called “aggravating indicators”, which include the following:

“– In practice, State agencies apply an imposed restriction in a discriminatory manner or with a discriminatory purpose, e.g. by arbitrarily targeting certain communities or groups, such as women;

– No due account is taken of specific features of religions or beliefs, e.g. a religion which prescribes wearing religious dress seems to be more deeply affected by a wholesale ban than a different religion or belief which places no particular emphasis on this issue;”<sup>150</sup>

In the Special Rapporteur’s report, there are also “neutral indicators” which do not by themselves constitute a violation of the international human rights laws, such as:

“– The language of the restriction or prohibition clause is worded in a neutral and all-embracing way;

– The application of the ban does not reveal inconsistencies or biases vis-à-vis certain religious or other minorities or vulnerable groups;

– The interference is crucial to protect the rights of women, reli-

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hardly ever allowed to voice their reasoning for choosing to wear the headscarf.”).

<sup>150</sup> *Religious Intolerance 2006*, *supra* note 129, ¶ 55(a).

gious minorities or vulnerable groups;”<sup>151</sup>

Accordingly, a state’s restriction on the freedom of religious manifestation cannot be designed to target one religion or merely affect one religion. The French ban is worded in a generally-applied way. Additionally, the French government uses the protection of women’s rights as a legitimate basis. Although the French ban satisfies two of those “neutral indicators”, it is still problematic under this standard. As examined above, one criticism of the French ban is that although it is worded in a generally-applied way, only the Muslim headscarf is affected because it is obligatory while the other religion’s symbols are not. Considering Islamophobia in history and the fear of Islamic Fundamentalism, this ban may also be claimed as having been enacted due to some political concerns related to the Islam. However, if the religious obligation of wearing a headscarf is proved to be discrimination against woman, then the claim that only the Muslim are affected cannot be sustained because the state has a positive obligation to eliminate such discrimination.

In international human rights laws, there is an exceptional situation where a measure targeting a certain religion may not be considered as discrimination. Article 1(4) of the International Convention on the Elimination of All Forms of Racial Discrimination provides that:

“Special measures taken for the sole purpose of securing adequate advancement of certain racial or ethnic groups or individuals requiring such protection as may be necessary in order to ensure such groups or individuals equal enjoyment or exercise of human rights and fundamental freedoms shall not be deemed racial discrimination, provided, however, that such measures do not, as a consequence, lead to the maintenance of separate rights for different racial groups and that they shall not be continued after the objectives for which they were tak-

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<sup>151</sup> *Id.* ¶ 55(b).

en have been achieved.”<sup>152</sup>

Although this article is about racial discrimination, the rationale is that specific measures designed to help a certain group secure advancement is not discriminatory provided that such measure is temporary and will not maintain separate treatment among different groups. Similar reasoning can be found in article 4(1) of CEDAW which provides that:

“Adoption by States Parties of temporary special measures aimed at accelerating de facto equality between men and women shall not be considered discrimination as defined in the present Convention, but shall in no way entail as a consequence the maintenance of unequal or separate standards; these measures shall be discontinued when the objectives of equality of opportunity and treatment have been achieved.”<sup>153</sup>

This exception shares the same consideration with affirmative action. Temporary distinctive treatment is permissible to correct the discrimination against some group in history. However, to apply this exception to the French ban is problematic. First, as discussed, whether the religious obligation of wearing headscarf is discrimination against woman is not clear. If this religious obligation is proved to be discrimination, it only justifies the ban on Muslim headscarf, but not a ban on the other religious symbols which have no implication on gender discrimination. A general ban should have a consistent aim and be justified on a same basis. A generally-applied ban targeting a specific group smaller than its originally designed scope will necessarily lead to a dilemma. In its 2010 full face-cover ban, France has given up gender equality as a basis but solely relies on public order to seek justification and lower the public debate.<sup>154</sup>

## V. Other Competing Interests

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<sup>152</sup> International Convention on the Elimination of All Forms of Racial Discrimination art. 1, ¶ 4, *opened for signature* Dec. 21, 1965, 660 U.N.T.S. 195.

<sup>153</sup> CEDAW, *supra* note 83, art. 4, ¶ 1.

<sup>154</sup> Ismail, *supra* note 3, at 49.

In addition to public order and gender equality, several rights involved in this issue, such as the protection of children, parental rights, and the right to education. The French ban to some extent competes with the parents' freedom of educating their daughters.

Article 18(4) of the ICCPR provides that "The States Parties to the present Covenant undertake to have respect for the liberty of parents and, when applicable, legal guardians to ensure the religious and moral education of their children in conformity with their own convictions."<sup>155</sup> The Convention on the Rights of Child ("CRC") also asks states to respect the parents' right of providing appropriate direction to the child provided that it is "in a manner consistent with the evolving capacities of the child."<sup>156</sup> The French ban restricts the parents' liberty of raising their daughter because a presumption of the ban is that Muslim girls are forced to wear headscarves under their parents' or community's pressure.<sup>157</sup> Some states take a stricter measure when the parental rights and the freedom to exercise religion mix together. U.S. courts, for example, will not interfere with the parents' liberty provided the parental decision will not "jeopardize the health or safety of the child."<sup>158</sup>

Article 3(1) of the CRC provides that "In all actions concerning children, whether undertaken by public or private social welfare institutions, courts of law, administrative authorities or legislative bodies, the best interests of the child shall be a primary consideration."<sup>159</sup> When the state's power competes with the parents' liberty, the critical question is what are the best interests of the child? The state's concern is to provide

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<sup>155</sup> ICCPR, *supra* note 8, art. 18, ¶ 4.

<sup>156</sup> Convention on the Rights of the Child art. 5, *opened for signature* Nov. 20, 1989, 1577 U.N.T.S. 3 [hereinafter CRC].

<sup>157</sup> See Christina A. Baker, French Headscarves and the U.S. Constitution: Parents, Children, and Free Exercise of Religion, 13 *CARDOZO J.L. & GENDER* 341, 360 (2007).

<sup>158</sup> *Id.* at 361 ("When the interests of parenthood are combined with a free exercise claim, more than a mere reasonable relation to the state's purpose is required to sustain the law's validity under the First Amendment. The only time such a hybrid right may be subjected to limitation is when the parental decisions appear to jeopardize the health or safety of the child, or have the potential for significant social burdens.").

<sup>159</sup> CRC, *supra* note 156, art. 3, ¶ 1; *Religious Intolerance 2006*, *supra* note 129, ¶ 56.

the child a chance to shape an independent mind because, “in general schoolchildren are generally considered vulnerable in view of their age, immaturity and the compulsory nature of education.”<sup>160</sup> Due to pressure from the parents, the school may be the only place where children can be protected from any coercion of religious manifestation. From the parents’ perspective, their specific way of life is not coercion but maintenance of their culture. Moreover, “children tend to naturally adopt their parents’ values and practices” which is far from “coercion.”<sup>161</sup> It is therefore necessary to make a choice on the definition of “best interest of the child” between liberty and religious culture. Due to different positions, it is hard to achieve a consensus on the meaning of the “best interest of the child.” People may easily agree that physical security, such as life, health or safety which is essential to survival should be the best interest. Liberty, the born right, compared with religious culture, the result of socialization, is much closer to the core of the best interest.

Finally, children’s right to education is functionally at stake dependent upon the French ban’s implementation. By 2005, only 639 students displayed their religious symbols in public school while about 1,500 students did so in 2004.<sup>162</sup> More than 550 of those cases were resolved through dialogue and girls agreed to remove the headscarves. But still another 60 students enrolled at private schools or in home schooling programs.<sup>163</sup> The parent has the freedom to choose between public school and private school, and this right should not be interfered with by the state. By asking a Muslim girl to remove her headscarf in public school, the ban may cause the parents to consider sending their daughters to private school or religious school in the first place. The resulting departure from public school may lead to a de facto segregation between Muslim children and others. That result is contrary to the state’s aim to create tolerance and plurality and a diverse environment. The lack of enough private schools may also impair the children’s right to education.

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<sup>160</sup> *Religious Intolerance 2006*, *supra* note 129, ¶ 56.

<sup>161</sup> Wiles, *supra* note 53, at 730.

<sup>162</sup> *French Schools Expel 48 Over Headscarf Ban*, WORLDWIDE RELIGIOUS NEWS (Jan. 20, 2005), <http://wwrn.org/articles/14144/>.

<sup>163</sup> *Id.*

Moreover, if all the Muslim girls wearing headscarf under parents' pressure are moved to private schools, the French ban will be devoid of purpose altogether.

## VI. Alternatives and Conclusion

As previous discussions show, both the principle of secularism and gender equality are legitimate under the international human rights laws. Compared with gender equality, the principle of secularism is a much more possible basis to justify French headscarf ban. Though the ban receives seventy percent support among the French population, it incurs worldwide criticism from both Muslims and non-Muslims.<sup>164</sup> The main criticism is that the ban is designed in a discriminatory manner against Muslims and affects Muslim girls disproportionately.<sup>165</sup> No matter what arguments each party puts forward, the debate turns out to be a struggle between two distinct cultures.<sup>166</sup> Each culture wants to maintain its unique future and refuse to compromise on this point.

The conflict between French government and the Muslim community is quite like a chicken game situation in the game theory. When two drivers drive toward each other, the one swerving will lose the game and be called as a coward. If no one yields, a collision will happen. When two cultures confront with each other, perhaps no one is ready to be assimilated by the other. The cause of this stalemate is hostility generated from misunderstanding and fear. When one party insists on its position, for example,, the Muslim woman's religious obligation of wearing headscarves, the other party has to choose between surrender and a tougher countermeasure. Even if the dilemma is ended finally with one party's victory and the other party's failure, the result is pathetic to the whole human society.

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<sup>164</sup> Wing & Smith, *supra* note 52, at 757.

<sup>165</sup> *France Backs School Headscarf Ban*, CNN (Feb. 10, 2004), [http://articles.cnn.com/2004-02-10/world/france.headscarves\\_1\\_conspicuous-religious-symbols-french-muslim-controversial-ban?\\_s=PM:WORLD](http://articles.cnn.com/2004-02-10/world/france.headscarves_1_conspicuous-religious-symbols-french-muslim-controversial-ban?_s=PM:WORLD).

<sup>166</sup> See Joan Wallach Scott, *France's Ban on the Islamic Veil Has Little To Do With Female Emancipation*, WORLDWIDE RELIGIOUS NEWS (Aug. 26, 2010), <http://wwrn.org/articles/34027/>; See also Wiles, *supra* note 53, at 712–13.

Thus, this dilemma cannot be resolved by rivalry, but rather must be solved by compromise. The proposed aims of the ban, such as coexistence, tolerance, liberty and equality, are universal value of human society. But the ban in fact leads to tension instead of tolerance.<sup>167</sup> Legal measures are a basic approach to regulate social structure and public order, but they are not one-size-fits-all. Sometimes it is arbitrary in practice, because it is always in a general-applied manner and may not be narrow-tailored to consider every individual situation. The Muslim headscarf issue cannot be easily resolved by a ban; it must be settled by a genuine dialogue, which can help each party to figure out its fears, misunderstandings and basis for co-existence.

Moreover, the legal measure may sometimes lose the point because it focuses on the behavior but fails to resolve the essential problems. The Muslim headscarf issue in France is not just an issue of secularism. It also reflects the deep social problems such as low employment and marginalization of the Muslim immigrants. Even the young Muslims who grow up in France feel rejected by the general public.<sup>168</sup> They are afraid of losing Muslim identity in the cultural assimilation.<sup>169</sup> The lack of acceptance cannot be resolved by a ban on the distinctive wearing.

The French ban, even if could it be justified under the international context, cannot achieve the aim of tolerance. The resort to law is not always successful. Dialogue and improvement of Muslims' status are ultimately critical and more effective to achieving both religious freedom and gender equality.

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<sup>167</sup> See *Leyla Sahin v. Turkey*, 2005-XI Eur. Ct. H.R. ¶ 1 (Tulken, J., dissenting).

<sup>168</sup> Savage, *supra* note 55, at 30.

<sup>169</sup> *Id.* at 31.

# **Non-Performing Loans and Asset Management Companies in China: Legal and Regulatory Challenges for Achieving Effective Debt Resolution and Recovery**

*LI Jiangfeng\**

## **ABSTRACT**

*This paper reviews the legal and regulatory regime for the resolution of non-performing loans (NPL) of state-owned banks in China. Currently, China's NPL market is comprised of two levels: the primary market (banks acting as the exclusive NPL sellers and asset management companies (AMCs) as the exclusive NPL buyers) and the secondary market (AMCs acting as the exclusive sellers and various types of investors as potential buyers). This paper finds that the current legal and regulatory regime imposes impediments to the effective functioning of the two-level NPL market.*

*With respect to the primary market, because of strong political influence, the historical practice of making policy loans continues to play a role in banks' practices. Moreover, the existing bankruptcy system is not practical for addressing the financial distress and/or failure of banks, thus causing the banks to rely on government bailouts for failures and thereby creating moral hazard in the financial system. As a result, the legal and regulatory reform does not help the banks avoid generating large amounts of new NPLs, especially following the lending spree during and following the 2008-2009 global financial crisis.*

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\* Ms. LI Jiangfeng, Foreign Legal Consultant at Kirkland & Ellis (Hong Kong), holds a Juris Doctor Degree in US law and a Juris Master Degree in Chinese law from Peking University School of Transnational Law, PRC. The author owes a debt of gratitude to Professor Steven T. Kargman who generously and patiently offered considerable and invaluable guidance, comments, discussion, inspiration and support in the writing of this paper. The author would also like to thank Professor ZHOU Wangsheng at Peking University Law School and Ted Obsorn at PricewaterhouseCoopers (Hong Kong) for their valuable suggestions during the research process. Needless to say, the author is responsible for any error expressed in the views of this paper. Contact information of the author: email: [lijiangf19@yahoo.com.cn](mailto:lijiangf19@yahoo.com.cn).



*With respect to the secondary market, the legal and regulatory regime has three major problems: first, there is a diversified supervisory structure, which creates problems such as overlapping supervision; second, there is no unified law for AMCs, which reduces predictability of legal risks for market participants; and third, there is an unsatisfactory judicial system in China which impedes AMCs' resolution of NPLs through court proceedings. As a result, as the major participant in the secondary market, AMCs have not performed very well since their establishment in 1999.*

*Based on the assessment of the current legal and regulatory regime for China's NPL market, this paper proposes to make reforms in two dimensions. In the short-term, China should focus on the internal improvement of AMCs' management and the external improvement of the judicial system and the legal environment for AMCs. In the long-term, China should try to enhance the banking system's adoption of market disciplines so as to avoid the new generation of NPLs. It is also suggested that China may allow banks to establish their own financial asset management companies for the purpose of resolving NPLs in a way that produces good recoveries for the banks.*

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**ABBREVIATIONS**

ABC:	Agricultural Bank of China
AMCs:	China Financial Asset Management Companies (including Orient Financial Asset Management Company, Huarong Financial Asset Management Company, Cinda Financial Asset Management Company, and Great Wall Financial Asset Management Company)
BIS:	Bank for International Settlements
BOC:	Bank of China
CBC:	China Construction Bank
CBRC:	China Banking Regulatory Commission
Cinda:	Cinda Financial Asset Management Company
CSRC:	China Securities Regulatory Commission
EBL:	Law of the People's Republic of China on Enterprise Bankruptcy (2007)
FAMC:	Financial Asset Management Company
Great Wall:	Great Wall Financial Asset Management Company
Huarong:	Huarong Financial Asset Management Company
ICBC:	Industrial and Commercial Bank of China
IMF:	International Monetary Fund
IPO:	initial public offerings
MoF:	Ministry of Finance
NDRC:	National Development and Reform Commission
NPC:	National People's Congress
NPL:	Non-Performing loans
Orient:	Orient Financial Asset Management Company
PBoC:	People's Bank of China
PRC:	People's Republic of China
PwC:	PricewaterhouseCoopers
SASAC:	State-Owned Assets Supervision and Administration Commission
SAFE:	State Administration of Foreign Exchange
SAT:	State Administration of Taxation
SCNPC:	Standing Committee of the National People's Congress

SETC:	The State Economic and Trade Commission
SOEs:	state-owned enterprises
SPV:	special purpose vehicle
UBS:	United Bank of Switzerland
UDIVs:	urban development investment vehicles

## Introduction

The problem of non-performing loans (NPL) has been a major concern for many countries since the 1990s.<sup>1</sup> NPLs can potentially undermine the soundness of a country's banking system, which in turn can adversely affect a country's financial and economic stability.<sup>2</sup> The issue of NPL has had a more far-reaching effect in East Asian countries, such as China, because in these countries, the financial sectors are concentrated in banks.<sup>3</sup> Specifically, in these countries, the banking system dominates the domestic financial system of the given country, with the individuals and enterprises heavily relying on the banks to provide funds for investment or to provide a vehicle for deposits.<sup>4</sup> For example, in 1990s, the big four banks in China held nearly 70% of the market share of China's financial business.<sup>5</sup>

In order to maintain the soundness of the financial system, it is important to promptly deal with the NPL problem in banks. For its part, China has made efforts since the 1990s to address its outstanding NPL problem. Since the establishment by the Chinese government of four state-owned financial asset management companies (AMCs)<sup>6</sup> in 1999,

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<sup>1</sup> See 周小川 (ZHOU XIAOCHUAN), 重建与再生—化解银行不良资产的国际经验 [RECONSTRUCTION AND REGENERATION — INTERNATIONAL EXPERIENCE OF RESOLVING NON-PERFORMING ASSETS OF BANKS] 1 (1999).

<sup>2</sup> He Fan, *How Far Is China Away from a Financial Crisis*, THAI DEV. RESEARCH INST. 2 (Sept. 2002), <http://dspace.cigilibrary.org/jspui/Bitstream/123456789/9209/1/How%20Far%20is%20China%20Away%20from%20a%20Financial%20Crisis%202002.pdf>. See also John Murchison, *Warning Signs from Increases in Non-Performing Loans*, 5 N. C. BANKING INST. 299, 299 (2001); 王丹娜 (Wang Danna), 关于降低我国商业银行不良贷款率的思考—基于不良贷款警戒率的分析 [Analysis of How to Reduce the NPL Ratio of Chinese State-Owned Banks], 金融和经济 [J. OF FIN. & ECON.], 2010, no. 2 at 26, 27.

<sup>3</sup> Ben Fung et al., *Public Asset Management Companies in East Asia: A Comparative Study* 12 (Bank for Int'l Settlements Fin. Stability Inst., Occasional Paper No. 3, Feb. 2004), <http://www.bis.org/fsi/fsipapers03.pdf>.

<sup>4</sup> NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION 16 (1998).

<sup>5</sup> Ben Fung et al., *supra* note 3, at 15.

<sup>6</sup> The four AMCs are: Huarong Asset Management Company ("Huarong"), Cinda Asset Management Company ("Cinda"), Great Wall Asset Management Company ("Great Wall") and Orient Asset Management Company ("Orient"). See Guonan Ma &

the NPL ratios of the Chinese commercial banks and the NPL amounts are both reported to be declining, which the China Banking Regulatory Commission (CBRC) has called as “double-decline.”<sup>7</sup> However, many observers still question whether China’s banking system has actually achieved such a “double-decline” in NPLs<sup>8</sup> and whether China’s NPL problem has been essentially resolved, as Chinese authorities have claimed.<sup>9</sup> In view of the impact of the 2008-2009 financial crisis and the massive new bank lending that followed, some scholars expect that China’s NPL problem will become more serious in the near future.<sup>10</sup>

With these questions in mind, this paper aims to discuss the actual situation of China’s track record in NPL resolution, with a focus on discussing the legal and regulatory challenges for achieving effective debt resolution and recovery. This paper will include the following sections: Section I will clarify what the concept of an “NPL” means under Chinese law; Section II will provide an overview of China’s legal and regulatory framework relating to NPL resolution; Section III will evaluate NPL market’s performance under the current legal regime; Section IV will discuss the obstacles imposed on the NPL market by the current legal regime; Section V will offer proposals on how to resolve the

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Ben Fung, *China’s Asset Management Corporations 1* (Bank for Int’l Settlements Working Papers No. 115, Aug. 2002), <http://www.bis.org/publ/work115.pdf>.

<sup>7</sup> 我国商业银行不良贷款余额和比例继续保持“双降” [The NPL Ratio and Amount Kept “Double-Decline”], CBRC (Oct. 29, 2009), <http://www.cbrc.gov.cn/chinese/home/docView/20091029.html>.

<sup>8</sup> 赵洪丹 (Zhao Hongdan), 丁志国 (Ding Zhiguo) & 赵宣凯 (Zhao Xuankai), 商业银行不良贷款真的实现“双降”了吗? [Have Commercial Banks Achieved “Double Decline” for the NPLs?], 廊坊师范学院学报(自然科学版) [J. OF LANGFANG TEACHERS COLL. (Nat. Sci. Ed.)], no. 5 at 71, 71 (2009) [hereinafter Zhao Hongdan].

<sup>9</sup> See Zdenek Kudrna, *Banking Reform in China: Driven by International Standards and Chinese Specifics* 2–3 (TIGER Working Paper No. 109, Oct. 1, 2007), <http://tiger.edu.pl/publikacje/TWP109.pdf>.

<sup>10</sup> See Ted Osborn, *China’s Good, Bad and Ugly Bank Loans*, WALL ST J. (Apr. 12, 2010, 11:28 AM ET), <http://online.wsj.com/article/SB10001424052702303828304575179161953849520.html>; Kevin Hamlin, *China at 60% Risk of Banking Crisis, Fitch Gauge Signals*, BLOOMBERG NEWS (Mar. 7, 2011, 11:39 PM PT), <http://www.bloomberg.com/news/2011-03-08/china-faces-60-risk-of-bank-crisis-by-2013-fitch-gauge-shows.html>; *Chinese Banks Face Rising Bad Debts: S&P’s*, THE CHINA POST (July 24, 2010, 8:37 PM TWN), <http://www.chinapost.com.tw/business/asia-china/2010/07/24/265836/Chinese-banks.htm>.

current problems faced by China's NPL market. Lastly, some concluding observations will be provided.

## 1. The Concept of NPLs under PRC Law

NPL, as one type of loans, starts from contractual relationships between civil subjects.<sup>11</sup> However, when there is a large scale of NPLs in the banking system, it involves a much wider range of legal and regulatory structure. Before engaging the detailed discussion of the wider legal regime, it is helpful to see how NPLs are defined under China's legal system.

### 1.1 The Nature of NPLs under Chinese Law

NPLs start from the debt (contractual) relationships between creditors (banks as lenders) and debtors (borrowers).<sup>12</sup> The lender-borrower relationship is generally based on debt instruments, normally loan contracts, which specify the obligations of the two parties: at its most basic level, the lenders are obliged to lend money to borrowers for a specific period of time, and, in return, the borrowers are obliged to repay the principal and pay the interest on time.<sup>13</sup>

In theory, when all the contractual relationships are formed according to commercial standards, a lender and a borrower can bargain for their rights on an equal footing. For example, the lender can require the borrowers to make true representations and warranties, to provide collateral or guarantees,<sup>14</sup> and to shoulder the liabilities in the event of a default.<sup>15</sup> Therefore, when lenders' loans to borrowers turn to NPLs, lenders and borrowers can resolve the NPLs by referring to the terms of

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<sup>11</sup> 中华人民共和国民法通则 [General Principles of Civil Law] (promulgated by the Nat'l People's Cong., Apr. 12, 1986, effective Jan. 1, 1987), CLI.1.2780, arts. 1 & 2. See also 中华人民共和国合同法 [Contract Law] (promulgated by the Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999), CLI.1.21651, ch. 12.

<sup>12</sup> General Principles of Civil Law, art. 84.

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

<sup>14</sup> Contract Law, arts. 198 & 199.

<sup>15</sup> *Id.* art. 201.



the original loan contracts.

However, in China, many loan transactions may involve considerable external interference, such as the political pressure of forcing banks to make policy loans.<sup>16</sup> In policy loans, lenders no longer make loan decisions according to commercial standards, but do so in compliance with government policies. Therefore, some borrowers who may be unable to make repayment of their loans under commercial standards may still receive new loans from banks. Consequently, when the policy loans turn bad, it may be difficult for banks to achieve recovery based on the original loan contracts because in most cases, the borrowers may be basically insolvent anyway and cannot make repayment.

In China, more than forty years of extensive policy lending have contributed to a high level of NPLs in the financial system.<sup>17</sup> When there are too many NPLs on the banks' balance sheets, the banks may have a liquidity stress because, on one hand, the cash flows from borrowers will be slowed down; on the other hand, the weak market entities need more money from banks. If this kind of situation spreads over the whole banking system, the financial system as a whole will become fragile, thus influencing the economic condition of the whole country, such as what had happened in the 1997 Asian financial crisis.

Therefore, in China, when viewed from a systemic perspective, the NPL problem is no longer a simple contractual issue. The country has to regulate the NPL issue at an upper level, namely, regulating the banking system and the NPL market as a whole. Furthermore, the resolution of NPLs necessarily affects a wider range of fields within a country's legal

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<sup>16</sup> Since 1977, the government has used Chinese banks as policy tools to facilitate economic growth, requiring the banks to lend more to state-owned enterprises and government investment projects. Since the establishment of the big four state-owned commercial banks, they have been required to lend to most of the projects belonging to their respective policy areas according to government policies and political demands. See VICTOR C. SHIH, *FACTIONS AND FINANCE IN CHINA: ELITE CONFLICT AND INFLATION* 31–32 (2008). See LARDY, *supra* note 4, at 15–17.

<sup>17</sup> Guonan Ma & Ben Fung, *supra* note 6.

structure, beyond simply contract law, such as finance law, tax law, property law and various types of administrative regulations, rules, notices or guidelines.

## 1.2 Defining NPLs under China's Loan Classification Mechanism

Currently, there is still no standard on loan classification which has been uniformly adopted by all countries in the world, so the meaning of NPLs largely depends on the regulatory framework of loan classification mechanism in different countries.<sup>18</sup> Although ninety days is normally considered the watershed of dividing line between loans that are classified as performing and loans that are classified as non-performing,<sup>19</sup> it is not a universal or binding standard for all countries around the world.<sup>20</sup> In order to understand China's NPL problem, it is necessary to first define what constitutes NPLs in the China's loan classification system.

Before 1994, there was no clear standard for classifying the assets of Chinese banks; and, therefore, it was unclear how many NPLs existed in Chinese banking system prior to that time.<sup>21</sup> In 1995, the People's Bank

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<sup>18</sup> *Bank Loan Classification and Provisioning Practices in Selected Developed and Emerging Countries*, WORLD BANK FIN. FORUM 11 (June 19–21, 2002), <http://info.worldbank.org/etools/docs/library/154927/financeforum2002/pdf/bankloanclassification.pdf> [hereinafter *World Bank Survey on Loan Classification*]. See also Sara wan Anglomkliwee, Jason George & Frank Packer, *Issues and Developments in Loan Loss Provisioning: the Case of Asia*, BIS Q. REV., Dec. 2009 at 70, [http://www.bis.org/publ/qrpdf/r\\_qt0912h.pdf](http://www.bis.org/publ/qrpdf/r_qt0912h.pdf).

<sup>19</sup> *World Bank Survey on Loan Classification*, *supra* note 18, at 12. See also Luis Cortavarria et al., *Loan Review, Provisioning and Macroeconomic Linkages* 11 (IMF WP/00/195, Dec. 2000), <http://www.imf.org/external/pubs/ft/wp/2000/wp00195.pdf>.

<sup>20</sup> Adriaan M. Bloem & Russel Freeman, *The Treatment of Nonperforming Loans, Clarification and Elaboration of Issues Raised by the December 2004 Meeting of the Advisory Expert Group of the Intersecretariat Working Group on National Accounts* 8 (IMF BOPCOM-05/29, June 2005), <http://Unstats.un.org/unsd/nationalaccount/AEG/papers/m3loans.pdf>.

<sup>21</sup> Xiaojun Allen WU, *An Examination of China's Non-Performing Loan Issue* 15 (Sept. 2002) (unpublished M.S. thesis, Massachusetts Institute of Technology) (on file with Rotch Library of Architecture & Planning, MIT), <http://dspace.mit.edu/bitstream/handle/1721.1/32235/51894913.pdf>.

of China (PBoC) set forth a “four-tier” loan classification standard and loans fell into one of the following four categories: pass, overdue, idle and loss.<sup>22</sup> (Loans with no overdue payments were classified as normal; those with less than two years’ overdue payments were classified as overdue; those with more than two or more years of overdue were classified as idle; and those with no possibility of recovery were classified as loss.)<sup>23</sup> Loans classified as overdue, idle and loss were deemed to be NPLs. This classification standard was too vague, because it did not specify what constituted “overdue”: the bank’s failure to collect principal or interest, or both.

In 1998, in order to comply with the international practice (as set forth in the Bank of International Settlements standard loan classifications),<sup>24</sup> PBoC issued the Guidance on Risk Classification of Loans (Pilot/Trial Implementation), which changed previous four tiers into five tiers, namely: pass, special-mention, substandard, doubtful and

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<sup>22</sup> Horst Loechel, Natalie Packham & Helena Xiang Li, *International Banking Regulation and Supervision After the Crisis — Implications for China* 9 (EU-China Bus. Mgmt. Training Project Working Paper Series, No. 013, Dec. 2010), <http://www.ceibs.edu/gcbf/images/20101223/29438.pdf>.

<sup>23</sup> 贷款通则(试行) [General Rules on Loans (Trial Implementation)] (promulgated by PBoC, effective July 27, 1995), CLI.4.12668, art. 34.

<sup>24</sup> Under BIS standard loan classifications, the five tiers are as follows:

“(1) Passed: Solvent loans; (2) Special Mention: Loans to enterprises which may pose some collection difficulties, for instance, because of continuing business losses; (3) Substandard: Loans whose interest or principal payments are longer than three months in arrears of lending conditions are eased. The banks make 10% provision for the unsecured portion of the loans classified as substandard; (4) Doubtful: Full liquidation of outstanding debts appears doubtful and the accounts suggest that there will be a loss, the exact amount of which cannot be determined as yet. Banks make 50% provision for doubtful loans. (5) Virtual Loss and Loss (Unrecoverable): Outstanding debts are regarded as not collectable, usually loans to firms that applied for legal resolution and protection under bankruptcy laws. Banks make 100% provision for loss loans.”

Yixin Hou, *The Non-Performing Loans: Some Bank-Level Evidences* 3 (The Fourth Int’l Conf. on Applied Fin. Econ.-Quantitative & Qualitative Analysis in Soc. Sci., July 12–14, 2007), <http://www.qass.org.uk/4thAFEQASSConferencePapers/Hou.doc>.

loss.<sup>25</sup> The In 2001, P BoC officially adopted the application of the “five-tier” loan classification through the issuance of Guidelines on Risk-Based Loan Classification (2001).<sup>26</sup> Unlike the prior four-tier classification, which used actual overdue time to classify loans into different tiers, this “five-tier” classification looks into the essence of whether the debtor will be able to honor the repayment obligations. Under this “five-tier” classification, NPLs are loans that fall under the last three levels, namely, substandard, doubtful and loss loans. When it is apparently doubtful that the debtor can serve the repayment obligation with the “normal business revenues” and the execution of guarantees, the loans start to be classified as substandard loans.<sup>27</sup> Even if there is no actual overdue status of a repayment obligation, a loan can still fall into the status of an NPL. Thus, this new classification standard covers a wider range of risky loans with the substandard classification tier.

### 1.3 The Vagueness of the NPL Concept under China’s Five-tier Loan Classification Standard

Under this five-tier NPL loan classification system, it is still difficult to grasp the exact meaning of what constitutes an NPL in practice. For example, the Guidelines on Risk-Based Loan Classification (2001) (“Guidelines”) do not explicitly rely upon the ninety days overdue standard, which is accepted by many countries. Instead, the Guidelines depend on the subjective judgments of the loan managers as to whether the debtor can serve the repayment obligations with the business revenues and guarantees. Because different banks in China are not required to follow the international standard,<sup>28</sup> the banks themselves are

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<sup>25</sup> 贷款风险分类指导原则(试行) [Guidelines on Risk-Based Loan Classification (Trial Implementation)] (promulgated by PBoC, effective Apr. 20, 1998), CLI.4.20251, art. 3 (repealed 2007).

<sup>26</sup> 贷款风险分类指导原则 [Guidelines on Risk-Based Loan Classification] (promulgated by PBoC, effective Dec. 24, 2001), CLI.4.38019, arts. 3 & 4.

<sup>27</sup> *Id.* art. 4, para. 3.

<sup>28</sup> See 魏国雄 (Wei Guoxiong), 对不良贷款的再思考 [Rethinking on the Non-Performing Loans], 银行家 [THE CHINESE BANKER], no. 1 at 70, 71 (2011). (The author is the Chief Officer of the Risk Management Department of Industrial and Commercial Bank of China.)

free to individually specify different numbers of days for a loan to be considered special-mention or substandard.<sup>29</sup> This practice results in disparity among different banks in deciding how many overdue days is the benchmark to classify certain loans as NPLs.<sup>30</sup>

Because of the unclear standard for defining NPLs in China, it is always a question whether the authorities accurately present the magnitude of China's aggregate NPL problem.<sup>31</sup> One can easily discern this in the disparity in the NPL ratios (total NPLs/total loans outstanding) that have been reported by CBRC on the one hand and the NPL ratios that have been put forth by international rating agencies on the other hand.

For example, as of December 31, 2005, the total amount of China's big four commercial banks' NPL was officially reported to be only approximately US\$133 billion.<sup>32</sup> However, in its 2006 Global Nonperforming Loans Report, Ernst & Young reached a far different conclusion and maintained that additional amounts should be added to totals set forth in the official government data. The extra amounts included: (1) the uncounted NPLs which were estimated to have been created because of 2004-2005 lending spree (US\$225 billion), (2) the uncounted NPLs which were transferred to AMC's but still unresolved (US\$230 billion), and (3) the NPLs which were estimated to exist in other financial institutions, apart from the major state-owned banks and AMC's (US\$323 billion).<sup>33</sup> As a result, the total NPL amount of Ernst & Young's report reached US\$911 billion, accounting for nearly 40% of

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<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> Han Bing, *The Ways of Dealing with Non-Performing Loans in China: Challenges and Problems*, 現代社会文化研究 [THE J. OF THE STUDY OF MOD. SOC'Y & CULTURE], no. 34 at 211, 215 (Dec. 2005), [http://dspace.lib.niigata-u.ac.jp:8080/dspace/bitstream/10191/916/1/18\\_0204.pdf](http://dspace.lib.niigata-u.ac.jp:8080/dspace/bitstream/10191/916/1/18_0204.pdf).

<sup>32</sup> Jonathan Richter, *Circumscribing China's NPL "Puzzle"*, WHARTON RES. SCHOLARS J. 5 (May 2008), [http://repository.upenn.edu/cgi/viewcontent.cgi?article=1057&context=wharton\\_research\\_scholars](http://repository.upenn.edu/cgi/viewcontent.cgi?article=1057&context=wharton_research_scholars).

<sup>33</sup> Richter, *supra* note 32, at 5-6.

China's GDP in 2005.<sup>34</sup>

Although Ernst & Young ultimately withdrew this report<sup>35</sup> after the Chinese government and PBoC expressed their anger with this report and criticized it as being “ridiculous and barely understandable,”<sup>36</sup> the report's author still maintained that the data in the report was a result of a “conservative” estimate of China's NPL situation.<sup>37</sup> Regardless of whether Ernest & Young's report was accurate or not, the controversy surrounding the report indicates the difficulty for observers to agree upon the exact magnitude of China's NPL problem.

## 2. China's Legal and Regulatory Framework with Regard to NPL Resolution

Like many other countries facing serious NPL problems, China resorted to the establishment of four financial asset management companies to address the problem of NPL. Chinese banks are not allowed by law to sell NPLs to investors directly, and the banks can only transfer NPLs to AMCs and then rely on the AMCs for final resolution of the NPLs. Because of this legal restriction, China's NPL market is divided into two levels: (1) the primary market, with the banks acting as the exclusive sellers and the AMCs as the exclusive buyers; and (2) the secondary market, with the AMCs acting as the exclusive sellers. China's legal and regulatory structure for NPL resolution focuses the regulation of the two-level NPL market.

### 2.1 Establishment of Four AMCs

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<sup>34</sup> *Id.* at 6.

<sup>35</sup> Richard McGregor, *E&Y Withdrew China NPL Report*, FIN. TIMES (May 15, 2006, 11:50 AM), <http://www.ft.com/intl/cms/s/0/11e4d368-e3c7-11da-a015-0000779e2340.html#axzz2D62eb6Qm>; see also *Ernst & Young: Sorry for NPL report*, CHINA DAILY, (May 15, 2006, 15:36), [http://www.chinadaily.com.cn/china/2006-05/15/content\\_590282.htm](http://www.chinadaily.com.cn/china/2006-05/15/content_590282.htm).

<sup>36</sup> Richard McGregor, *Beijing Attacks E&Y Report on Bad Debt As “Ridiculous”*, FIN. TIMES (May 13, 2006, 3:00 AM), <http://www.ft.com/intl/cms/s/0/21023a04-e21c-11da-bf4c-0000779e2340.html>.

<sup>37</sup> Richter, *supra* note 32, at 7.

In 1999, China set up four AMCs to acquire, manage and dispose of NPLs from the big four state-owned commercial banks. The four AMCs' financial resources initially consisted of the following three elements: (1) RMB 10 billion capitals provided by Ministry of Finance (MoF) for each AMC, (2) a new loan of RMB 548 billion from PBoC, and (3) RMB 846 billion of bonds (with 2.25% interest rate)<sup>38</sup> issued to state-owned banks by four AMCs.<sup>39</sup> Although not being explicitly stated, the bonds were implicitly guaranteed by MoF.<sup>40</sup> (See Table 2).

The four AMCs were established as wholly state-owned financial enterprises.<sup>41</sup> According to the articles of association of the AMCs, MoF, as the sole capital contributor of the four AMCs, is the sole shareholder of the four AMCs.<sup>42</sup> Because of the new loans made to AMCs, PBoC is the major creditor of the four AMCs, along with the big four commercial banks which bought bonds issued by AMCs. Apart from their other roles, MoF and PBoC are also part of the supervisory authorities for the AMCs.

At the time of establishment of the AMCs, the supervisory mechanism of AMCs was as follows: (1) PBoC was in charge of the overall supervision of AMCs' financial business transactions (such as setting forth the fees AMCs can pay to NPL servicing companies);<sup>43</sup> (2)

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<sup>38</sup> 金融资产公司管理条例 [Regulation on Financial AMCs] (promulgated by the St. Council, effective Nov. 10, 2000), CLI.2.34755, art. 14.

<sup>39</sup> Han Bing, *supra* note 31, at 219.

<sup>40</sup> SHIH, *supra* note 16, at 172.

<sup>41</sup> See 国务院办公厅转发人民银行、财政部、证监会关于组建中国华融资产管理公司、中国长城资产管理公司和中国东方资产管理公司意见的通知 [Notice of State Council Office on Circulating the Opinion of PBoC, MoF and CSRC to Establish Huarong Asset Management Company, Orient Asset Management Company and Great Wall Asset Management Company] (promulgated by the St. Council, effective July 21, 1999) CLI.2.23486, art. 1; 国务院办公厅转发人民银行、财政部、证监会关于组建中国信达资产管理公司意见的通知 [Notice of State Council Office on Circulating the Opinion of PBoC, MoF and CSRC to Establish Cinda Asset Management Company] (promulgated by the St. Council, effective Apr. 4, 1999), CLI.2.22626, art. 1 [collectively Notices to Establish AMCs].

<sup>42</sup> See, e.g., 中国长城资产管理公司章程 [Articles of Association of China Great Wall Asset Management Corporation], arts. 12 & 13, <http://www.gwamcc.com/Template/NormalInfo/TwoLevelPage.aspx?MenuID=82> (last visited Jan. 10, 2013).

<sup>43</sup> PBoC's supervisory power over AMCs' normal business was transferred to CBRC

other financial supervisory authorities, such as China Securities Regulatory Commission (CSRC), were responsible for the supervision of AMC's financial transactions which fell outside the scope of PBoC's supervision responsibility; (3) MoF was responsible for the supervision of financial management of AMC's; and (4) the Financial Working Committee of the Central Committee of the Communist Party of China was responsible for the supervision of AMC's relationship with Communist Party and human resources.<sup>44</sup> This old supervisory mechanism was changed with the establishment of CBRC in 2003, and in Section 2.3 below, the new supervisory mechanism will be discussed in more details.

## 2.2 Primary Market and Secondary Market of NPLs

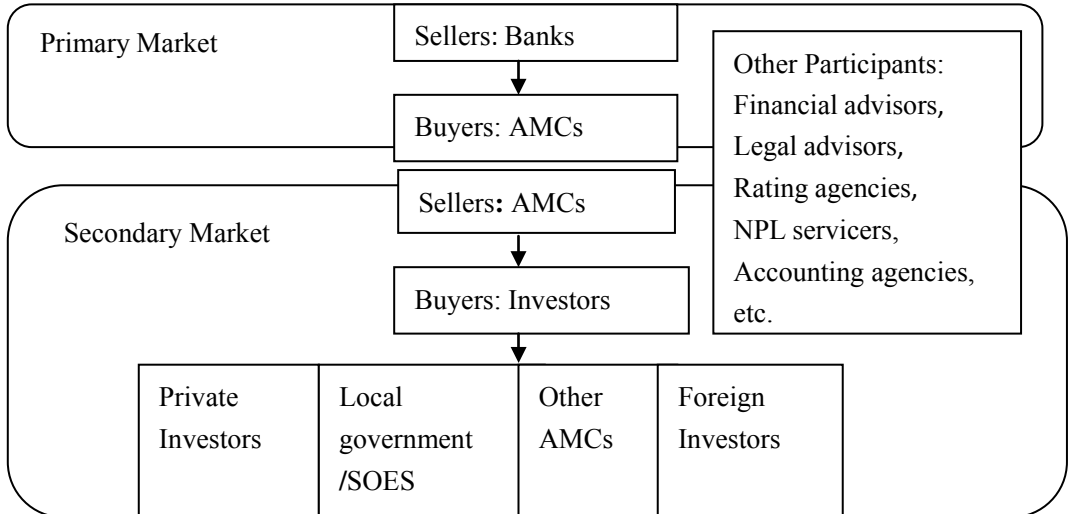
The primary market, the secondary market and the conduct of the participants in those markets are subject to a diverse set of laws and regulations in China. However, before we can discuss the relevant legal and regulatory structure, we must first understand how the two-tier NPL market operates in practice. Figure 1 below provides an overview of how the NPL market operates at the two levels.

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in 2003. *See* 全国人民代表大会常务委员会关于中国银行业监督管理委员会履行原由中国人民银行履行的监督管理职责的决定 [Decision of the Standing Committee of the National People's Congress on CBRC's Performance of the Regulatory Functions that Used to be Performed by PBoC] (promulgated by the Standing Comm. Nat'l People's Cong, effective Apr. 26, 2003), CLI.1.45597, art. 1.

<sup>44</sup> *See* Notices to Establish AMC's, *supra* note 41, art. 3.



**Figure 1: China's NPL Market: Key Players**

In China, banks are only allowed to sell certain “settled assets”<sup>45</sup> directly to investors, but they cannot sell NPLs directly to investors. Therefore, in the primary market, the key players are the banks acting as the sellers and the AMCs acting as the exclusive buyers. In the secondary market, AMCs are the only suppliers of NPLs to third-party investors.<sup>46</sup> The dynamics of the primary market and the interrelationships of the key players in the secondary market will be discussed in the following section.

### 2.2.1 Dynamics of the Primary Market

The seller-buyer relationship in the primary market has undergone three stages of evolution. The first stage (1999–2003) is “policy sales and

<sup>45</sup> Settled assets are generated from banks’ NPL-asset settlements with the debtor, in which the debtor reimburses its debt obligation to banks with some of the debtor’s assets rather than cash. Through this kind of settlement arrangement, banks are able to remove the credit risks of the NPLs from the balance sheet, but the banks have to shoulder the market risk and the liquidity risk of the settled assets. Banks can only wholly recover from its NPLs after the settled assets have been sold to other investors. See Hui Peng & Yulu Chen, *An Analysis of State-Owned Banks’ Behavior in NPL Disposition*, CHINA & WORLD ECON., no. 2, 2005 at 78, 79.

<sup>46</sup> SIMON GRIESER & JORG WULFKEN, PERFORMING AND NON-PERFORMING LOANS ACROSS THE WORLD: A PRACTICAL GUIDE, 183–84 (2009).

policy purchases”:<sup>47</sup> the four AMC’s were required by the government<sup>48</sup> to acquire the NPLs from their four corresponding banks at the book value of the NPLs, and the loss<sup>49</sup> incurred by AMC’s during the process of resolving these NPLs, would be borne by the government.<sup>50</sup> Generally, MoF would make up for the losses incurred by the AMC’s by issuing bonds or injecting government surplus.<sup>51</sup>

The second stage (2004–2005) is “policy sale and partially commercial purchase”:<sup>52</sup> the banks were required to reduce NPL ratios for the fulfillment of “shareholding system reform”<sup>53</sup> according to government policy,<sup>54</sup> but some market practices were brought in during

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<sup>47</sup> 张敏 (Zhang Min) & 沈洪涛 (Shen Hongpu), 中国处置银行系统不良资产的状况和经验 [China’s Situation and Experience in Resolving Commercial Banks’ Non-Performing Loans], 中国金融 [CHINA FIN.], no. 3 at 44, 44 (2010) [hereinafter Zhang Min & Shen Hongpu].

<sup>48</sup> Ben Fung et al., *Public Asset Management Companies in East Asia — Case Studies 3* (Bank for Int’l Settlements Fin. Stability Inst., Occasional Paper No. 3 Case Studies, 2004), <http://www.bis.org/fsi/fsipapers03cs.pdf> [hereinafter Ben Fung et al., *AMCs Case Studies*]. See also PricewaterhouseCoopers (PwC), *NPL Asia*, no. 1 at 2 (Oct. 2002), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_oct\\_2002.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_oct_2002.pdf). (Since 2002, PwC began to issue newsletters annually called “NPL Asia” concerning the NPL market in Asia. The newsletters are targeted at NPL sellers, investors and relevant advisors. PwC claimed that “[t]he information in NPL Asia is obtained from various sources in the market, and is believed to be accurate at the time of going to print.” PwC NPL Asia Newsletter, <http://www.pwc.com/gx/en/non-performing-loan-news/>.)

<sup>49</sup> Here, “loss” refers to the difference between AMC’s purchasing or acquiring price of NPLs from the matching banks and the ultimate selling price of the NPLs, plus the cost of managing the NPLs. See 财政部关于印发《金融资产管理公司资产处置管理办法》的通知 [Notice of MoF on Issuing “Measures for the Administration of the Asset Disposal of Financial AMC’s”] (promulgated by MoF, effective Nov. 8, 2000), CLI.4.35019, art. 4 (repealed and replaced by a revised version of July 9, 2008).

<sup>50</sup> The MoF will come up with measures to resolve the loss incurred by the four AMC’s, and then submit to State Council for approval; see Notices to Establish AMC’s, *supra* note 41, art. 5.

<sup>51</sup> SHIH, *supra* note 16, at 172.

<sup>52</sup> Zhang Min & Shen Hongpu, *supra* note 47.

<sup>53</sup> In early 1980s, China launched “shareholding system reform” in which a large number of state-owned enterprises were converted into shareholding companies. After 1993, this shareholding reform process was accelerated. See SHU-YUN MA, SHAREHOLDING SYSTEM REFORM IN CHINA: PRIVATIZING BY GROUPING FOR STONES 7–11 (2010).

<sup>54</sup> Zhang Min & Shen Hongpu, *supra* note 47.

the trading process. AMC's acquired these NPLs from the banks through fair competition in auctions.<sup>55</sup> However, the evaluation of bids from AMC's were still conducted and approved by MoF, PBoC and CBRC.<sup>56</sup>

The third stage (2005-onward) is "commercial sale and commercial purchase"<sup>57</sup>: under the general guidance of the central government of China to further promote the "shareholding system reform" of state-owned banks as a part of the government's overall financial reform policy,<sup>58</sup> many banks began to write off NPLs voluntarily, and the four AMC's could then acquire the NPLs by competing with other AMC's in the market or they could decide to not acquire the NPLs, but private investors are still not allowed to participate in this regard. At present, AMC's still operate consistently with the features of the third stage. However, because of the NPLs transferred in the first stage, AMC's were burdened with a huge amount of bad loans, which were mainly the result of policy loans to SOEs and were very hard for the AMC's to resolve.<sup>59</sup>

Although the primary market has evolved to adopt the market disciplines of the commercial sale and purchase of the NPLs, the current primary market, to some extent, still only serves the function of isolating the banks from NPLs and reallocating to AMC's. It is the secondary market that now bears the most important responsibility of truly resolving the NPLs with other methods, such as transferring them to other investors.

## 2.2.2 Interrelationship of Key Players in the Secondary Market

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<sup>55</sup> 唐奕 (Tang Yi), 对我国国有商业银行两次剥离不良贷款的反思 [Reflection on the Two Write-offs of the NPLs of Chinese State-Owned Commercial Banks], 经济管理 [ECONOMIC MANAGEMENT], no. 7 at 71, 71 (July 2006).

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

<sup>57</sup> Zhang Min & Shen Hongpu, *supra* note 47.

<sup>58</sup> 国务院关于 2005 深化经济体制改革的意见 [Opinion of State Council on Furthering the Economic System Reform in 2005] (promulgated by St. Council, effective Apr. 4, 2005), CLI.2.57803, art. 4.

<sup>59</sup> Jianbo Lou, *China's Bank Non-Performing Loan Problem: Seriousness and Causes*, 34 Int'l L. 1147, 1149-52 (2000).

In the secondary market, AMCAs are the only suppliers of NPLs to third-party investors, therefore they decide how the market operates. In China, the four AMCAs were given favorable treatments at the policy level in several respects. For example, the Chinese authorities issued two notices in December 1999 and February 2001 which exempted AMCAs from incorporation and registration fees as well as all kinds of taxes in the acquisition, management and disposal of the NPLs.<sup>60</sup> Therefore, AMCAs were relieved from the great tax burden relating to acquisition, management and disposal of the NPLs, including such as value-added tax on commodities (tax rate: 13% or 17%),<sup>61</sup> value added tax on gains from added value of transfer of land use right or the real estate on the land (tax rate: 30%-60%),<sup>62</sup> business tax (tax rate: 5%),<sup>63</sup> real estate tax (tax rate: 1.2% on property value after applicable deduction, 12% on rent value),<sup>64</sup> title deed tax (tax rate: 3%-5%).<sup>65</sup>

In addition, the AMCAs were also given considerable discretion in managing NPLs. By now, AMCAs have been allowed to use several methods of resolution,<sup>66</sup> namely, direct sale to investors, debt-for-equity swaps,<sup>67</sup> restructuring or liquidation, securitization of NPL portfolios<sup>68</sup> or

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<sup>60</sup> See 国家税务总局关于中国信达等四家资产管理公司有关税收政策问题的通知 [Notice of SAT on the Tax Policies of the Four Financial AMCAs] (promulgated by SAT, effective Dec. 8, 1999), CLI.4.65387, art. 1; 财政部, 国家税务总局关于中国信达等四家金融资产管理公司税收政策问题的通知 [Notice of MoF and SAT on the Tax Policies of the Four Financial AMCAs] (promulgated by MoF and SAT, effective Feb. 22, 2001), CLI.4.35389, art. 3 [collectively Tax Policies of AMCAs].

<sup>61</sup> 中华人民共和国增值税暂行条例 [Provisional Regulations of Value Added Tax] (promulgated by SAT, Dec. 13, 1993, effective Jan. 1, 1994), CLI.2.7686, art. 2 (revised 2008).

<sup>62</sup> 中华人民共和国土地增值税暂行条例 [Provisional Regulations of Land Value Added Taxes] (promulgated by SAT, Dec. 13, 1993, effective Jan. 1, 1994), CLI.2.7681, art. 7.

<sup>63</sup> 中华人民共和国营业税暂行条例 [Provisional Regulations of Business Tax] (promulgated by SAT, Dec. 13, 1993, effective Jan. 1, 1994), CLI.2.7684, app. (revised 2008).

<sup>64</sup> 中华人民共和国房产税暂行条例 [Provisional Regulations of Real Estate Tax] (promulgated by SAT, Sep. 15, 1986, effective Oct. 1, 1986), CLI.2.2972, arts. 3 & 4.

<sup>65</sup> 中华人民共和国契税法暂行条例 [Provisional Regulations of Title Deed Taxes] (promulgated by SAT, July 7, 1997, effective Oct. 1, 1997), CLI.2.18596, art. 3.

<sup>66</sup> Regulation on Financial AMCAs, art. 10.

<sup>67</sup> In debt-for-equity swaps, AMCAs replace their right to claim debt as creditors with

other methods.

Unlike the primary market, there are different types of investors (including other AMCs, private investors, local governments or SOEs, and foreign investors) in the secondary market. Different types of investors do not play the same role in the NPL market.

In an ideal market situation, these investors should be able to compete on an equal basis with each other. However, in China's current market, different kinds of investors were given different degree of preference by AMCs. For example, Orient AMC's market survey in 2009 revealed that most Chinese commercial banks thought that private investors had the highest capacity to dispose of NPLs because they have the flexibility of raising funds.<sup>69</sup> In reality, however, the AMCs still prefer local governments or SOEs.<sup>70</sup>

It can be explained by the following reasons: first, most of the NPLs transferred to AMCs involved loans to SOEs, and if AMCs sell these assets at too low a price, they may be accused of selling state-owned assets at lower price, thus subject to political punishment or criminal prosecution.<sup>71</sup> Second, selling NPLs to local SOEs or local governments

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an equity stake in the debtor company. See Ben Fung et al., *supra* note 3, at 14.

<sup>68</sup> In a securitization, AMCs select some assets from NPLs that are expected to generate some cash flow within a certain period of time and then put those assets into a pool, normally by establishing a special purpose vehicle ("SPV"). The SPV will then use the selected assets as mortgage to issue bonds to investors (issuing real estate mortgage bonds for real estate assets, and issuing equity mortgage bonds for equities obtained in debt-equity swaps). With the cash generated from investors' purchase of bonds, AMCs can help the debtor companies in debt-for-equity swaps to revitalize the production or operation, so as to promote the value of NPLs. See generally Johnny P. Chen, *Non-Performing Loan Securitization in the People's Republic of China* iii (May 2004) (unpublished thesis for Dpt. of Econ., Stanford University), (on file with author), [http://economics.stanford.edu/files/Theses/Theses\\_2004/Chen.pdf](http://economics.stanford.edu/files/Theses/Theses_2004/Chen.pdf).

<sup>69</sup> 中国东方资产管理公司研发中心 [CHINA ORIENT ASSET MGMT. CORP. R & D CTR.], 2009: 中国金融不良资产市场调查报告 [2009 REPORT OF CHINA'S NON-PERFORMING ASSETS MARKET] 40 (Apr. 2009), <http://www.coamc.com.cn/yjfx/dqbg/200904/P020090416334441825823.pdf> [hereinafter 2009 ORIENT REPORT].

<sup>70</sup> *Id.* at 40–42.

<sup>71</sup> 企业国有产权转让管理暂行办法 [Interim Measures for Management of the Transfer of the State-Owned Property Right of Enterprises] (promulgated by the St.

implies that the purchasers in many cases are associated parties or affiliated companies of the SOEs and local governments, which they regarded as “brother to brother” transactions. Therefore, this type of transactions needs much less transaction cost, such as less cost because of loose approval procedure. In addition, it also makes sure that all the costs are internalized within the state-owned system, which minimizes the exposure of information to the public.

In China, the foreign investors have also played a very limited role in China’s NPL secondary market.<sup>72</sup> Actually, foreign investors, such as Goldman Sachs and Morgan Stanley, were initially very involved in Chinese NPL market at the first few years of Chinese four AMC’s establishment. However, they withdrew gradually in recent years. In addition to the reasons listed above concerning the AMC’s preference of local SOEs and governments, other reasons to explain foreign investors’ limited role are: first, foreign investors are more sensitive to China’s political and legal risks, thus any change of law or market condition may influence their participation in China;<sup>73</sup> second, it is very difficult for foreign investors and AMC’s to agree upon NPL pricing, because AMC’s focus on their acquisition cost from banks, while foreign investors focus on the recovery value from NPLs;<sup>74</sup> and third, the approval process for foreign investors’ NPL acquisition is very unpredictable, because of the concern of protecting national assets.<sup>75</sup>

### 2.3 Current Legal and Regulatory Structure for Primary Market and Secondary Market of NPLs

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Asset Supervision & Admin. Comm’n, and MoF, Dec. 31, 2003, effective Feb. 1, 2004), CLI.4.51196, art. 32; *See also* 中华人民共和国企业国有资产管理法 [Law on the State-Owned Assets of Enterprises] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2008, effective May 1, 2009), CLI.1.109891, ch. 8, arts. 68–75.

<sup>72</sup> PwC, *NPL Asia*, no. 8 at 3 (Mar. 2007), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_mar\\_2007.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_mar_2007.pdf).

<sup>73</sup> *See, e.g.*, PwC, *NPL Asia*, no. 10 (Dec. 2008), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_dec\\_2008.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_dec_2008.pdf).

<sup>74</sup> PwC, *NPL Asia*, no. 11 at 3 (Oct. 2009), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_oct\\_2009.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_oct_2009.pdf).

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

Because of the different features of the dynamics and the interrelationships of players in the primary market and the secondary market, there is different focus of the legal and regulatory aspects on the two markets with regard to NPL resolution. In an effectively regulated market, there should be comprehensive laws and effective enforcement of laws in the judicial system. However, at present China lacks this kind of legal environment to guarantee the efficient resolutions.

### **2.3.1 Legal and Regulatory Framework for the Primary Market**

In the primary market, the regulatory subject is mainly banks which act as suppliers of NPLs, because AMC's, to some extent, are only passive recipients of NPLs. Since this place is the root or the source of NPLs, the regulatory mechanism should achieve three general objectives: (1) supervising banks to avoid generating large amount of new NPLs; (2) providing guidance for banks to classify and manage NPLs; and (3) providing guidance for banks to transfer NPLs to AMC's. In Section 1.2, this paper has introduced China's adoption of the five-tier loan classification system and the vagueness problem existing in the system. Therefore, the following part will mainly focus on (1) and (3).

#### **2.3.1.1 Legal Reforms for Regulation of Banks**

Since the 1990s, China's authorities have endeavored to gradually establish a legal regime to regulate banks' loan issuance. The efforts gradually build up some legal guidance for the issuance of loans.

In 1996, PBoC issued The General Provisions on Issuing of Loans, which specified requirements on loan's interest rate and terms, qualification of lenders and borrowers, and the supervision of NPLs.<sup>76</sup> For example, Article 17 listed six criteria to decide whether a borrower is qualified or not, including, for example, the borrower's ability to repay principals and interest based on the borrower's market performance, the

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<sup>76</sup> See 贷款通则 [General Rules on Loans] (promulgated by PBoC, June 28, 1996, effective Aug. 1, 1996), CLI.4.18161, chs. 3-5.

borrowers' liability to assets ratio, and the status of the borrower's saving accounts.<sup>77</sup>

In 2003, China's legislative authority issued a revised Law of the People's Republic of China on Commercial Banks ("PRC Commercial Banks Law 2003"), which further reinforced that banks should issue loans on a commercial basis after conducting due diligence evaluation of the borrowers.<sup>78</sup> Previously, in the 1995 version of Law of the People's Republic of China on Commercial Banks, although it required that Chinese commercial banks should follow general requirements of enterprise legal persons as stipulated by Company Law of the People's Republic of China,<sup>79</sup> it kept strong sense of political influence.<sup>80</sup>

For example, the 1995 Commercial Banks Law required:

"[t]he solely State owned commercial banks should issue loans to special projects which have been approved by the State Council. The State Council will adopt corresponding measures to make up for the losses of the banks because of issuing the loans. To adopt what measures is up to the decision of the State Council."<sup>81</sup>

However, in PRC Commercial Banks Law 2003, this provision was deleted and only the requirement that "[n]o unit or individual is allowed to force the commercial banks to issue loans or provide guarantees" was kept.<sup>82</sup>

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<sup>77</sup> *Id.* art. 17.

<sup>78</sup> 中华人民共和国商业银行法 (2003 修正) [Commercial Banks Law (2003 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003, effective Feb. 1, 2004), CLI.1.50978 [hereinafter Commercial Banks Law 2003].

<sup>79</sup> 中华人民共和国公司法 (2005 修订) [Company Law (2005 Revision)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), CLI.1.60597 [hereinafter Company Law 2005].

<sup>80</sup> 中华人民共和国商业银行法 [Commercial Banks Law] (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, effective July 1, 1995), CLI.1.11600, art. 2 [hereinafter Commercial Banks Law 1995].

<sup>81</sup> *Id.* art. 41.

<sup>82</sup> *Id.*



The issuance and revision of laws, together with the effort to adopt the five-tier loan classification standard, have provided some guidance for the banks to make better practice in loan issuance. However, the legal reforms can only essentially improve the performance of banks if these laws can be implemented as intended in their texts. After assessing the banks' performance in Section 3, we can see whether the legal reforms have achieved good results.

### 2.3.1.2 Impractical Bankruptcy Mechanism for Chinese State-Owned Banks

In China, there is no effective mechanism to ensure that state-owned banks will suffer the consequence of bad performance, namely bankruptcy. Although commercial banks have been brought into the general bankruptcy scope in PRC Commercial Banks Law 2003 as well as in the new Enterprise Bankruptcy Law adopted in 2007 (EBL),<sup>83</sup> in practice, it is still unlikely to make a Chinese state-owned bank to go bankrupt.

PRC Commercial Banks Law 2003 and EBL have different criteria for banks' bankruptcy determination. PRC Commercial Banks Law 2003 only requires one condition that "a commercial bank is unable to pay the debts due,"<sup>84</sup> which is referred to as "liquidity test" or "cash flow test."<sup>85</sup>

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<sup>83</sup> Under Chinese bankruptcy regime, only the financial supervision organs under the State Council can file an application with the people's court for revival or bankruptcy liquidation of banks, and the bankruptcy proceedings can be suspended when the financial supervision organs adopt measures such as take-over or custody to a financial institution with major business risks. See Commercial Banks Law (2003 Amendment), art. 71; 企业破产法 [Law on Enterprise Bankruptcy] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), CLI.1.78895, art. 134 [hereinafter Bankruptcy Law 2007].

<sup>84</sup> Commercial Banks Law 2003, *supra* note 78, art. 71.

<sup>85</sup> Steven T. Kargman, *Solving the Insolvency Puzzle: China's New Bankruptcy Law Could Bring the Country's Legal Framework Closer to International Norms — If It Is Implemented Effectively*, CHINA BUS. REV., Sept. –Oct. 2007 at 45, [http://www.kargmanassociates.com/Kargman-CBR\\_SO07.pdf](http://www.kargmanassociates.com/Kargman-CBR_SO07.pdf). See also Jingxia Shi, *Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy*, 16 J. BANKR. L. & PRAC. 5 Art. 2, Part III.B (Oct. 2007).

However, EBL 2007 requires not only the liquidity test, but also another condition that the bank's "assets are not enough to pay off all the debts or if it is obviously incapable of clearing off its debts,"<sup>86</sup> which is referred to the "balance sheet test."<sup>87</sup>

Accordingly, it can be noted that PRC Commercial Banks Law 2003 only adopted the "liquidity test" for bankruptcy, while EBL adopts dual criteria, namely, "liquidity test" and "balance sheet test." According to the principle that a new law takes priority over an old law, the dual requirements under EBL shall prevail. The dual standards are consistent with the international practice, such as what have been set forth in Article 23 to 26 of UNCITRAL Legislative Guide on Insolvency Law. However, it is still difficult to put these standards into practice in China.

First, with regard to the "liquidity based insolvency" requirement, when Chinese state-owned banks are confronted with liquidity problems, PBoC will provide help with new loans in order to maintain the overall financial stability,<sup>88</sup> thus banks will not easily be confronted with bankruptcy risks because of liquidity difficulty.

Second, with regard to the "balance-sheet insolvency" requirement, when banks' net worth is negative (liabilities exceeding assets), the regulatory authority will also come up with some methods to hide the bad effect. For example, in the 1990s, the four state-owned banks were all insolvent in the sense that they had a negative net worth as a group.<sup>89</sup> But the Chinese authority successfully renewed the balance sheets of banks by transferring NPLs to AMC's, and in exchange, gaining cash payment from AMC's for NPLs and adding assets to the balance sheets in the form of AMC's bonds.

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<sup>86</sup> Bankruptcy Law 2007, *supra* note 83, arts. 2 & 134.

<sup>87</sup> Jingxia Shi, *supra* note 85.

<sup>88</sup> 范湘凌 (Fan Xiangling) & 毛竹青 (Mao Zhuqing), 商业银行破产法律适用若干问题探析 [*Problems of the Application of Bankruptcy Laws for Commercial Bank*], 法学杂志 [L. SCI. MAG.], no. 6, at 140, 140 (2008).

<sup>89</sup> Nicholas R Lardy, *The Challenge of Bank Restructuring in China*, BIS POL'Y PAPERS, no. 7, Oct. 1999 at 17, 30, <http://www.bis.org/publ/plcy07.pdf>.

Therefore, the balance sheets of banks cannot adequately show the risks shouldered by banks,<sup>90</sup> and it is also unlikely for banks to go bankrupt because of “balance-sheet insolvency.”

### 2.3.2 Legal and Regulatory Framework for the Secondary Market

In the secondary market, four AMCs play the major role of NPL resolution, thus becoming the main subjects of regulation. Since the establishment of four AMCs, Chinese authorities have made great efforts to build up the legal framework for AMCs’ smooth operation. A series of notices, guidance, judicial interpretation or changes of laws were issued in the past eleven years. The special regulations concerning AMCs, along with other laws or rules, formed the legal framework for the secondary NPL market.

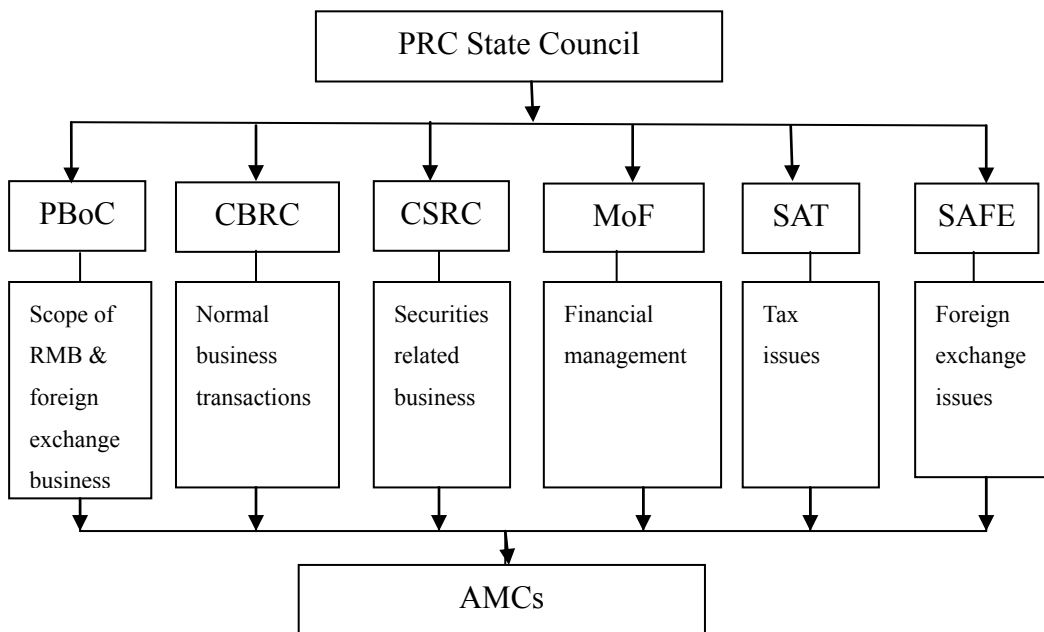
In an overall assessment, the current legal and regulatory regime for China’s secondary NPL market can be summarized into three features: (1) diversified supervision from different authorities; (2) lack of a unified and consistent legal framework; and (3) lack of a predictable judicial system.

#### 2.3.2.1 Diversified Supervisory Structure in the Secondary Market

As previously introduced in Section 2.1, some government entities, such as PBoC and CSRC, played different roles in supervising AMCs. In 2003, PBoC transferred some supervisory responsibility to the newly established CBRC. As a result, the new supervisory structure over AMCs was formed. (See Figure 2). However, it should be noted that in practice, the division of the supervision is not black-and-white. The following figure is just trying to provide an overview of the supervisory structure based on the policy level.

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<sup>90</sup> 吴敏 (Wu Min), 我国商业银行破产原因的法律规定研究 [*Analyzing the Legal Reasons for the Bankruptcy of Chinese Commercial Banks Bankruptcy*], 江淮论坛 [JIANGHUAI TRIB.], no. 3 at 44, 46 (2006).

**Figure 2 China's Supervisory Structure of AMC**

Generally speaking, under this new supervisory structure, the division of supervisory responsibilities of different bodies is as follows:

(1) PBoC is responsible for supervising the scope of AMCs' business relating to foreign exchange,<sup>91</sup> regulating AMCs' issuance of bonds,<sup>92</sup> making accounting and statistics standards for AMCs,<sup>93</sup> setting forth off-site monitoring indicators over AMCs (including e.g., the efficiency of asset disposal, the cash recovery rate of asset disposal, the overflow/discount rate of the price of asset disposal),<sup>94</sup> and supervising

<sup>91</sup> See 中国人民银行关于金融资产管理公司外汇业务经营范围的通知 [Notice of PBoC on the Scope of Foreign Exchange Business of Financial AMCs] (promulgated by PBoC, effective May 26, 2000), CLI.4.30888.

<sup>92</sup> See 中国人民银行关于金融资产管理公司支付债券和再贷款利息问题的通知 [Notice of PBoC on Financial AMCs' Obligation to Pay Interests for Bonds and Relending] (promulgated by PBoC, effective Apr. 8, 2002), CLI.4.62784.

<sup>93</sup> See 中国人民银行关于印发《金融资产管理公司统计制度》的通知 [Notice of PBoC on Circulating "Statistics Standard for Financial AMCs"] (promulgated by PBoC, Apr. 17, 2001, effective Jan. 1, 2001), CLI.4.46609.

<sup>94</sup> See 中国人民银行办公厅关于印发《金融资产管理公司非现场监管指标(试行)》的通知 [Notice of PBoC Office on Circulating "Off-site Monitoring Indicators for

other general RMB business.

(2) CBRC is responsible for supervising the normal business transactions of AMCs,<sup>95</sup> including such as regulating the business scope,<sup>96</sup> approving transaction methods such as asset securitization<sup>97</sup> and issuance of bonds.<sup>98</sup> In addition, in 2003 CBRC also inherited the responsibility of supervising the appointment of management members of AMCs from the Financial Working Committee of the Central Committee of the Communist Party of China.

(3) CSRC is responsible for supervising AMCs' business that is related to securities,<sup>99</sup> such as approving AMCs' acquisition of the debt companies' shares in debt-to-equity swaps.<sup>100</sup>

(4) MoF is responsible for supervising the general financial management of AMCs (such as setting forth that the fees payable by AMCs to third-party NPL servicing institutions should not exceed 5% of the total cash recovered on the disposed assets, and setting forth

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Financial AMCs (Trial Implementation)"] (promulgated by PBoC, Jan. 19, 2001, effective Jan. 1, 2001), CLI.4.40616.

<sup>95</sup> 中华人民共和国银行业监督管理法 [Law on Regulation of the Banking Industry] (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 27, 2003, effective Feb. 1, 2004), CLI.1.50976, app. & art. 12 (revised 2006).

<sup>96</sup> See 中国银行业监督管理委员会关于确认中国信达资产管理公司经营范围的批复 [Reply of CBRC on Confirming the Business Scope of Cinda Asset Management Company] (promulgated by CBRC, effective Dec. 3, 2004), CLI.4.103335.

<sup>97</sup> See 金融机构信贷资产证券化试点监督管理办法 [Measures for Supervising and Administrating the Pilot Securitization of Credit Assets by Financial Institutions] (promulgated by CBRC, Nov. 7, 2005, effective Dec. 1, 2005), CLI.4.60834 [hereinafter Measures for Pilot Securitization by Financial Institutions].

<sup>98</sup> See 中国银行业监督管理委员会关于中国东方资产管理公司开展银行间债券市场现有交易品种的现券和回购业务的批复 [Reply of CBRC on Approving Orient Asset Management Company to Conduct Trading and Repurchasing of Existing Trading Products in Interbank Bond Market] (promulgated by CBRC, effective Dec. 26, 2006), CLI.4.109667.

<sup>99</sup> See Notices to Establish AMCs, *supra* note 41, art. 3.

<sup>100</sup> See 中国证监会关于同意中国信达资产管理公司受让银建国际实业有限公司股权的函 [Letter of CSRC Regarding Approval of Cinda Asset Management Company's Acquisition of Yinjian International Industrial Company] (promulgated by CSRC, effective Sept. 11, 1999), CLI.4.63528.

punishment standards for the misappropriation of AMCs' money by AMCs' employees).<sup>101</sup> MoF also sets forth standards for AMCs' risk management (such as the risk management on AMCs' investment business, on AMCs' engagement in principal-agent business, and on AMCs' commercial acquisitions.)<sup>102</sup>

(5) State Administration of Taxation (SAT) is in charge of establishing special tax rules for AMCs and supervising AMCs' tax issues.<sup>103</sup>

(6) State Administration of Foreign Exchange (SAFE) is responsible for supervising AMCs' disposal of NPLs that involve foreign exchange administration.<sup>104</sup> Generally speaking, any foreign exchange income or payment as well as any foreign exchange transaction made by PRC domestic investors within or outside China and by foreign investors within mainland China shall be supervised by SAFE.<sup>105</sup> For example, when AMCs' NPL disposal is in the form of oversea investment or when foreign investors make investment within China in foreign currency, SAFE will come in and play its supervisory role.

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<sup>101</sup> See 财政部关于加强金融资产管理公司资产处置和财务管理有关问题的通知 [Notice of MoF on Enhancing AMCs' Asset Disposal and Financial Management] (promulgated by MoF, effective Jan. 22, 2002), CLI.4.39350. See also 财政部关于印发《金融资产管理公司有关财政财务政策的规定》的通知 [Notice of MoF on Circulating "Fiscal and Financial Policies Applicable to Financial AMCs"] (promulgated by MoF, effective Apr. 25, 2000), [http://sczjd.jl.gov.cn/fgdh/czbfj/ccjdl/jr qyzcjd/jrgs/200812/t20081216\\_505348.html](http://sczjd.jl.gov.cn/fgdh/czbfj/ccjdl/jr qyzcjd/jrgs/200812/t20081216_505348.html).

<sup>102</sup> See 财政部关于印发《金融资产管理公司有关业务风险管理办法》的通知 [Notice of MoF on Circulating "Measures for Risk Management for Financial AMCs"] (promulgated by MoF, effective Apr. 28, 2004), CLI.4.54314.

<sup>103</sup> Tax Policies of AMCs, *supra* note 60.

<sup>104</sup> See 国家外汇管理局关于中国信达资产管理公司对外处置不良债权有关外汇管理问题的通知 [Notice of SAFE on Relevant Issues Concerning Foreign Exchange Administration Relating to the External Disposal of Non-Performing Loans by Cinda Asset Management Company] (promulgated by SAFE, effective Apr. 20, 2004), CLI.4.122039.

<sup>105</sup> 中华人民共和国外汇管理条例 (2008 修订) [Regulation on Foreign Exchange Administration (2008 Revision)] (promulgated by the St. Council, effective Aug. 5, 2008), CLI.2.107240, art. 4.

Generally, the above-mentioned government entities together form the current supervisory and regulatory structure of AMCs in China.

### **2.3.2.2 Hierarchy of Laws and Regulations in the Current Legal Regime Regarding AMCs' NPL Resolution**

In the normal business transactions, AMCs are confronted with the application of many different laws. For example, a dispute based on loan contract involves such as contract law and/or guarantee law; the use of debt-for-equity swaps involves such as securities law, company law and tax law. When cases go to the courts, in order to resolve particular issues with regard to AMCs, the Supreme Court of People's Republic of China ("PRC Supreme Court") issued series of interpretations of laws or guidelines. In addition, because different government branches have different supervisory power, they issued different kinds of notices, guidelines or opinions to facilitate their supervision. Consequently, there are laws, administrative regulations, rules, guidelines, court interpretations or policies applicable to AMCs, which together form a patchwork of legal structure for AMCs.

However, laws, regulations, rules, guidelines, court interpretations or policies do not enjoy the same level of priority. According to PRC Legislation Law, laws made by PRC National People's Congress (NPC) and Standing Committee of the National People's Congress (SCNPC) are on the highest hierarchy, then followed (decreasing in the level of hierarchy) by administrative regulations made by PRC State Council, local regulations made by Local People's Congress or Standing Committee of the Local People's Congress, and rules made by ministries and commissions of PRC State Council, the PBoC, as well as the other organs endowed with administrative functions directly by the State Council.<sup>106</sup>

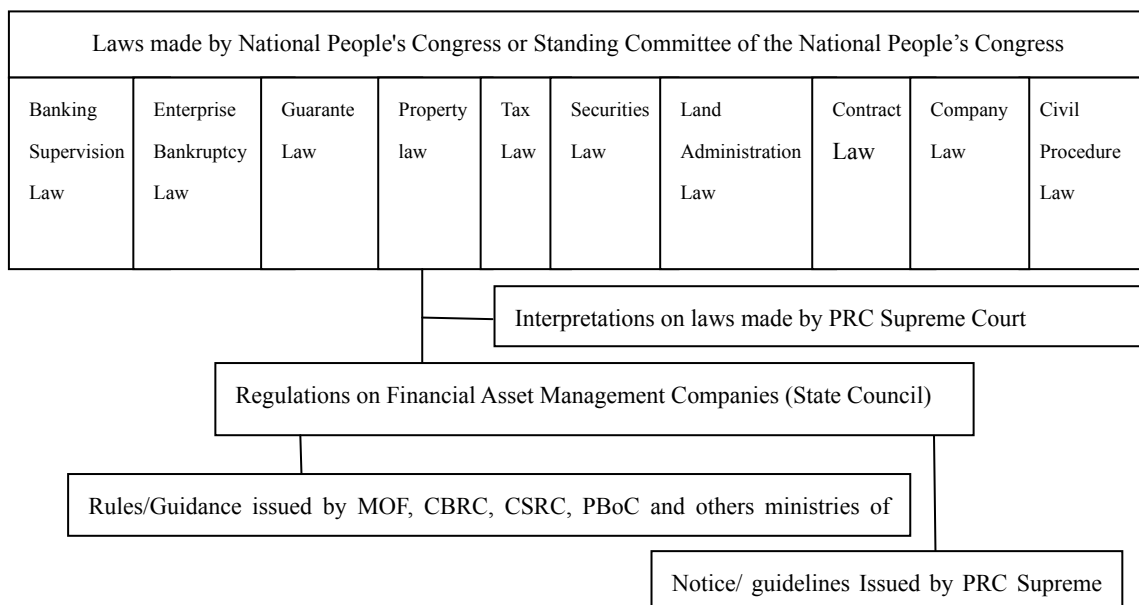
In addition, although the PRC Supreme Court was not entrusted

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<sup>106</sup> See 中华人民共和国立法法 [Law on Legislation] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 15, 2000, effective July 1, 2000), CLI.1.26942, chs. 2-4.

with the power to interpret laws under PRC Legislation Law, it was entrusted with such power by SCNPC,<sup>107</sup> but their interpretation cannot contradict with laws or interpretations made by NPC and SCNPC. Because of this division of hierarchy of different legal instruments, the current regulatory structure for AMCs can be illustrated with a hierarchy structure by Figure 3.

**Figure 3: Hierarchy of the Legal Structure for China's AMCs**



Underlying the hierarchy structure as showed by Figure 3, there are the following problems of the regulatory framework for AMCs:

(1) China lacks a unified legal regime for AMCs, with many scattered legal instruments such judicial interpretations, guidelines or notices from PRC Supreme Court, CBRC, MoF, PBoC, CSRC, and State Council. (2) China's legal instruments that apply to the management of AMCs occupy a very low position in the overall hierarchy of the legal

<sup>107</sup> See 全国人民代表大会常务委员会关于加强法律解释工作的决议 [Resolution of the Standing Committee of the National People's Congress on Improving Interpretation of the Law] (promulgated by the Standing Comm. Nat'l People's Cong., effective June 10, 1981), CLI.1.1006, art. 2.



structure, because they are mainly in the forms of administrative regulations, rules or guidelines. Unlike laws, which should undergo very comprehensive procedures to be revised or amended, administrative regulations or rules can be changed from time to time. This uncertainty creates unpredictability for the market, which may lead the investors to feel insecure or apprehensive about the legal risks associated with their investments.

(3) There are some grey areas left unregulated, or contradictorily regulated. The guidelines or notices issued by MoF, PRC Supreme Court or other ministries of State Council often contradict with each other or contradict with laws made by NPC or SCNPC in the higher hierarchy. For example, AMCs have adopted debt-for-equity swaps as an important method in NPL resolutions. According to PRC Company Law 2005, an investor's capital contribution does not include the contribution in the form of the right to claim in the debtor's company.<sup>108</sup> However, PRC State Council expressly stipulates in the administrative regulations regarding AMCs that AMCs can make equity contributions to the debt companies with the debt claims in the given debtor company.<sup>109</sup> Therefore, many observers dispute that AMCs' equity rights in the debtor companies after the debt-for-equity swaps are not legally protected, because State Council's administration conflicts with PRC Company Law 2005 and thus should be deemed as invalid by courts.<sup>110</sup> This kind of messy situation in the current legal structure creates difficulties for AMCs' operations.<sup>111</sup>

### 2.3.2.3 Current Situation of the Chinese Judicial System Concerning AMCs' NPL Resolution

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<sup>108</sup> Company Law 2005, *supra* note 79, art. 27.

<sup>109</sup> Regulation on Financial AMCs, art. 16.

<sup>110</sup> 李健男 (LI JIANNAN), 金融资产管理公司法律问题比较研究 [COMPARATIVE STUDY ON THE LEGAL ISSUES OF FINANCIAL ASSET MANAGEMENT COMPANIES] 223 (2006).

<sup>111</sup> 李伟杰 (Li Weijie) & 宋焱 (Song Yan), 金融资产管理公司法律问题解析 [Analysis of Legal Problems Concerning China's AMCs], 金融理论与实践, no. 3 at 44, 45 (2006) [hereinafter Li Weijie & Song Yan].

For most Chinese AMCs, judicial procedure is an important way for them to resolve NPLs or enforce their rights in NPLs.<sup>112</sup> However; the current judicial system is not effective and efficient from the following perspective:

First, the Chinese judicial system is not independent from the government. Judges are not independent from government and they are relying on the Party for judicial appointment and salaries as well as on local governments for funding and appointment of staffs.<sup>113</sup> Therefore, the People's Courts are often under the political influence from both the central and local governments.<sup>114</sup>

Second, the quality of the judges in China is greatly differentiated, and lower courts often disregard the laws and rules. For example, according to a notice of PRC Supreme Court, the AMCs should only pay half of the litigation fees of a normal litigant.<sup>115</sup> However, in practice, some courts charge very high fees and even require AMCs to prepay the fees for the opposing party, or use AMCs' assets to pay for the litigation fees even if the fees should be paid by the debtor after AMCs have won the cases.<sup>116</sup> These rent-seeking behaviors of the courts reduce AMCs' confidence to make recovery through court proceedings.

Third, it is very difficult to enforce courts' judgments. AMCs win in 70% of the involved cases, but only 30% of the awards can achieve

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<sup>112</sup> 安启雷 (An Qilei), 刘康宁 (Liu Kangning) & 封堃 (Feng Kun), 要重视解决国有商业银行不良资产形成的体制问题 [Pay Attention to the Systematic Problems Generated by Non-Performing Loans of China's State-Owned Banks], 经济研究参考 [REV. OF ECON. RES.], no. 28 at 16, 19 (2009) [hereinafter An Qilei et al.].

<sup>113</sup> See Chris X. Lin, *A Quiet Revolution: An Overview of China's Judicial Reform*, 4 ASIAN-PAC. L. & POL'Y J. 256, 295 (2003).

<sup>114</sup> An Qilei et al., *supra* note 112, at 16.

<sup>115</sup> 最高人民法院关于国有金融资产管理公司处置国有商业银行不良资产案件交纳诉讼费用的通知 [Notice of the Supreme People's Court on Litigation Fees for Cases Involving the Financial AMCs' Disposal of Non-Performing Assets of State-Owned Banks] (promulgated by People's Super. Ct., effective Oct. 25, 2001), CLI.3.38470, art. 1.

<sup>116</sup> 2009 ORIENT REPORT, *supra* note 69, at 43.

enforcement.<sup>117</sup> Moreover, even for the few judgments that reach the level of enforcement, it will take too long to finish the enforcement and AMCs have to input higher cost for the long duration of time.<sup>118</sup> For some cases, the courts even require some additional fees for the enforcement process, without issuing any receipts; otherwise, they will not give the assets to AMCs.<sup>119</sup>

For AMCs, litigation, as the last resort for NPL resolution, is still inefficient and ineffective. This general legal environment adds doubt to AMCs' performance. It can be demonstrated by evaluation of the performance of the NPL market in the next section.

### **3. Evaluating the Performance of the NPL Market under the Current Legal Regime**

In order to evaluate the effectiveness of the legal regime to regulate the primary market and the secondary market of NPLs, it is necessary to look to two criteria: (1) whether banks have avoided the generation of new NPLs; (2) whether the existing NPLs has been effectively resolved by AMCs. The following part will discuss the situation from the two perspectives.

#### **3.1 Banks: Illusionary “Double-Decline” in NPL Ratios and Amounts**

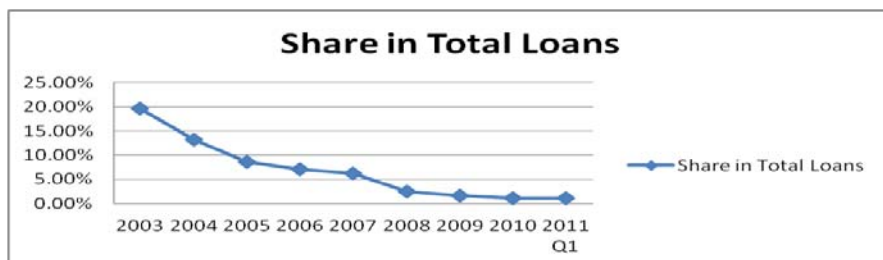
Since CBRC was established in April 2003 to supervise and monitor the banking system, it began to publish the NPL data annually or quarterly, and China's official NPL ratio and NPL amounts were reported by CBRC to be declining year by year, the so-called “double decline.” (See Figure 4).

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

<sup>118</sup> *Id.* at 44.

<sup>119</sup> *Id.*

**Figure 4: Official NPL Ratio of Chinese Commercial Banks**

Source: CBRC Annual Report (2003-2011). <http://www.cbrc.gov.cn/>.

However, this double-decline result is just superficial effect. It does not truthfully reveal the real condition of the NPL problem.

### 3.1.1 Uncover the Reality of China's NPL Condition behind the "Double-Decline"

The NPL "double-decline" effect can be attributed to four reasons: (1) transferring NPLs from banks to AMCs; (2) the increase of lending enlarged the denominator for total outstanding loans; (3) the balance sheets of banks may not correctly reflect the actual situation of the loan status; and (4) the influence of successful initial public offerings (IPO) of major commercial banks. The following part will explain the four reasons in more details.

#### 3.1.1.1 Separating NPLs from Banks through Transferring to AMCs

Since their establishments, the four AMCs began to receive several tranches of NPLs transferred from the commercial banks. For example, in 1999, it received the first tranche of RMB 1.4 trillion from the big four<sup>120</sup> state-owned banks.<sup>121</sup> Between 2004 and 2005, four AMCs received

<sup>120</sup> The big four are: Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC), and Agricultural Bank of China (ABC).

<sup>121</sup> PwC no.8, *supra* note 72.

another tranche from BOC, CCB and ICBC, amounting to RMB 1.3 trillion.<sup>122</sup> In recent years, there are scattered transfers that are not specifically tracked.

After NPLs were transferred to AMCs, such NPLs would no longer be reflected in the banks' books. Because CBRC's calculations were mainly based on the statistics reflected in the banks' balance sheets, these amounts of NPLs were not reflected in CBRC's report. However, simple separation of NPLs by transferring NPLs from commercial banks to AMCs did not mean that the banks were truly isolated from these NPLs.

### 3.1.1.2 The Loan Basis Enlarged by Increased New Lending

Since 2002, China's state-owned banks have increased lending year by year to facilitate the fast economic growth and the establishment of a "well-off society."<sup>123</sup> (See Figure 5). The new lending enlarged the outstanding loan pool, which in turn reduced the NPL ratio in the pool as a whole since it simply increased the denominator on which the NPL calculation was based. However, the declining NPL ratios do not mean that the NPLs have been essentially resolved, instead, it is in a sense a false image created by the method of calculating NPLs.<sup>124</sup> In other words, a larger outstanding loan pool can make the NPL ratio look smaller.

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<sup>122</sup> PwC, *NPL Asia*, no. 4 (Sept. 2004), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_sept\\_2004.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_sept_2004.pdf). See also Zhao Bing & Zhang Xiaolian, *Chinese NPLs: Three Issues Often Overlooked*, 25 INT'L FIN. L. REV., no. 9, Sept. 2006 at 79, 79.

<sup>123</sup> SHIH, *supra* note 16, at 161.

<sup>124</sup> PwC, *NPL Asia*, no. 12 (May 2011), [http://www.pwchk.com/webmedia/doc/634423649406905454\\_nplasia\\_newsletter.pdf](http://www.pwchk.com/webmedia/doc/634423649406905454_nplasia_newsletter.pdf). See also 赵卿 (Zhao Qing), 中国银行业不良资产与金融体系的风险 [The Risk of Non-Performing Assets in Chinese Banking and Financial System], 商场现代化 [MARKET MODERNIZATION], no. 9 at 133, 134 (Mar. 2010); 姜占华 (Jiang Zhanhua), 银行不良贷款的处置方式及法律简析 [Ways of Resolving Banks' Non-Performing Loans and Relevant Legal Issues], 法律与实践 [LAW & PRACTICE] no. 4 at 167, 167 (June 2009).

**Figure 5: Change of Loan Balance (2003-2011.Q1)**

Source: annual reports issued on PBoC's official website

### 3.1.1.3 Discrepancy between the Reality and the Banks' Balance sheets

Since CBRC's calculation is based on the banks' balance sheets, the accuracy of the calculation largely depends on each banks' presentation of the balance sheets. However, in China's banking system, there are many possible ways of hiding large amount of NPLs from the balance sheets. One example of hiding NPLs from the banks' balance sheet is through the transfer of NPLs to AMCs, such as the transfer that occurred in 1999. After this transfer, the banks could show on their books interest-bearing bonds issued by the AMCs instead of the NPLs that used to sit on their books but had now been transferred to the AMCs.<sup>125</sup>

Another way for the banks to disguise their actual NPL position was through the process of discretionary loan classifications. As discussed in Section 1.3, the classification system of China does not provide a very clear standard for the banks to follow, and the banks still possess a large amount of discretion in how they classify loans.<sup>126</sup> Many banks and financial institutions even set aside the five-tier loan classification system,

<sup>125</sup> Patrick Chovanec, *Big Losses Are Hidden on China's Bank Balance Sheets*, SEEKINGALPHA.COM (Sept. 23, 2009), <http://seekingalpha.com/article/162913-big-losses-are-hidden-on-china-s-bank-balance-sheets>. (The author is an associate professor at Tsinghua University's School of Economics and Management in Beijing, where he teaches in the School's International MBA Program.)

<sup>126</sup> See Kudrna, *supra* note 9, at 10–12, 37.

which resulted in the failure of truly reflecting the asset quality of the banking system.<sup>127</sup>

According to the market survey conducted by the asset management company Orient in 2009, more than half of the commercial banks themselves believed that the risks reflected on the banks' books was underestimated.<sup>128</sup> Furthermore, most of the banks surveyed admitted that it was most likely that for the loans classified under "substandard" and "special-mention," there was discrepancy between the real risk and the risk reflected on the books.<sup>129</sup> Therefore, it is impossible to know the exact degree to which NPLs are hidden from the balance sheets.

#### 3.1.1.4 NPLs Offset by Increased Funds from Major Banks' IPO

China's major commercial banks benefited greatly from successful IPOs.<sup>130</sup> In the pre-IPO stage, each bank was provided an opportunity to clean up the large amount of NPLs sitting on their balance sheets by transferring them to AMCs.<sup>131</sup> For example, with the support of Chinese government, ABC successfully dropped its NPL ratio from 24% in 2007 to 3% in 2009.<sup>132</sup>

Following the writing-off of NPLs, the banks were able to succeed in their IPOs. The successful IPOs injected in these banks substantial new funds. For example, the IPOs of CCB, ICBC and BOC were all "heavily oversubscribed by institutional as well as individual investors," and thus

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<sup>127</sup> *CBRC Urges to Further Five-Category Loan Classification System*, ACCESS (May 24, 2005), <http://www.accessmylibrary.com/article-1G1-137215454/cbrc-urges-further-five.html>.

<sup>128</sup> 2009 ORIENT REPORT, *supra* note 69, at 34–36.

<sup>129</sup> *Id.*

<sup>130</sup> Paul B. McGuinness & Kevin Keasey, *The Listing of Chinese State-Owned Banks and Their Path to Banking and Ownership Reform*, CHINA Q., no. 201, Mar. 2010 at 125, 126.

<sup>131</sup> *Id.* at 129–130.

<sup>132</sup> *Agricultural Bank of China — Listing or Capsizing?* THE ECONOMIST (June 10, 2010), <http://www.economist.com/node/16319645>.

raised far more funds than originally expected.<sup>133</sup> The injection of new funds increased the ability of the banks to earn profits. In 2010, ICBC, CCB and BOC were even ranked by Banker Magazine as the first, second and seventh most profitable banks from all over the world.<sup>134</sup>

In conclusion, all of the four reasons outlined above together help cast doubt on whether the official NPL statistics fully or properly reveal the extent of the NPL problem in the Chinese banking system.

### **3.1.2 Banks' Invisible Generation of New NPLs Post 2008-2009 Financial Crisis**

In addition to the mystery of understanding the reality behind the officially reported double-decline of NPLs, the banks are now expected to generate large amount of NPLs because of the loose extension of credits during and after the 2008-2009 financial crisis.

#### **3.1.2.1 Chinese Banks' Lending Spree Post 2008-2009 Financial Crisis**

In order to cushion the Chinese economy from the impact of the financial crisis, the Chinese government implemented a stimulus program in late 2008. Following this program, Chinese banks made new RMB loans of approximately RMB 29.92 trillion from 2008 to 2011. (See Table 3).

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<sup>133</sup> See Kudrna, *supra* note 9, at 2.

<sup>134</sup> *China's Banks Emerge Most Profitable, But for How Long?* INCHINCLOSER (July 1, 2010), <http://inchincloser.com/2010/07/01/chinas-banks-emerge-most-profitable-but-for-how-long/>.





borrow directly from the banks according to the National Budget Law,<sup>137</sup> they have established these UDIVs to indirectly get financing from banks.

At the time when Chinese central government began to implement the RMB four trillion stimulus program, the local governments initiated similar stimulus projects, with most of this funding coming through UDIVs.<sup>138</sup> UDIVs got funds mainly through borrowing from Chinese state-owned banks and policy banks (reaching 79.01% in 2010).<sup>139</sup> By the end of 2010, UDIVs had a loan balance of RMB 7.38 trillion Yuan.<sup>140</sup> More than 50% of these loans to UDIVs were used to finance long-term projects with a maturity of over five years and were invested in government-supported projects (reaching 86.54% in 2010), such as transportation projects.<sup>141</sup>

However, the ability of local governments' ability to repay the loans is in doubt. By the year of 2009, local governments had debt of RMB 10.7 trillion; for 62.62% of the debt the local governments have obligation to make repayment and another 21.8% of the debt is guaranteed by local governments.<sup>142</sup>

Nevertheless, because most of the invested long-term projects have

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<sup>137</sup> 中华人民共和国预算法 [Budget Law] (promulgated by the Standing Comm. Nat'l People's Cong., Mar. 22, 1994, effective Jan. 1, 1995), CLI.1.8925, art. 55.

<sup>138</sup> 江俊龙 (Jiang Junlong), 邹香 (Zou Xiang) & 狄运中 (Di Yunzhong), 我国地方政府债务及其风险控制研究 [*Studies on the Debt on Local Governments and Its Risk Controlling in China*], 经济问题 [ON ECON. PROBS.], no. 2 at 31, 31 (2011).

<sup>139</sup> 中华人民共和国审计署审计结果公告: 全国地方性债务审计结果 [*National Audit Office of People's Republic of China: Audit Report of the Debt of Local Governments*] (no. 35, June 27, 2011), <http://www.audit.gov.cn/n1992130/n1992150/n1992500/2752208.html> [hereinafter *2010 Audit Report on PRC Local Governments' Debt*].

<sup>140</sup> See 中国东方资产管理公司研发中心 [CHINA ORIENT ASSET MGMT. CORP. R & D CTR.], 2011: 中国金融不良资产市场调查报告 [2011 REPORT OF CHINA'S NON-PERFORMING ASSETS MARKET] 12 (Sept. 2011), <http://www.coamc.com.cn/yjfx/dqbg/201109/P020110919357902100810.pdf> [hereinafter *2011 ORIENT REPORT*].

<sup>141</sup> *2010 PBoC Regional Financial Report*, *supra* note 136, at 7; See also *2010 Audit Report on PRC Local Governments' Debt*, *supra* note 139.

<sup>142</sup> *2010 Audit Report on PRC Local Governments' Debt*, *supra* note 139.

a lack of money to repay the loans, the local governments have to get new loans to repay the old debts. For example, near 54.64% of the matured debts in express transportation projects of 2010 were paid back by the new loans.<sup>143</sup> If the local governments are unable to get new loans, then they have to default. It is estimated by some observers that about 20% of the UBIV debts (or near RMB 2.4 trillion) will turn to bad loans.<sup>144</sup> Because of this potential serious consequence, Chinese government has decided to order banks to roll over the loans to UDIVs, with more than half of the loans being scheduled to roll over for another three years.<sup>145</sup>

The second factor affecting the quality of the loans is that most of the loans still went into the SOEs.<sup>146</sup> In the past, policy lending to SOEs was the major source of NPLs. Under the influence of Chinese government, banks did not follow the market principles to make lending decisions to SOEs.<sup>147</sup> However, according to a survey conducted in 1997 of 14,923 large and mid-sized SOEs, 40.5% of the SOEs were losing money.<sup>148</sup> By the end of 2007, State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council had put 2,116 problematic SOEs into policy bankruptcy, with another 698 SOEs waiting on the list for policy bankruptcy in 2008.<sup>149</sup> The failure of large SOEs was followed by banks' NPLs in the balance sheets.

More seriously, SOEs are generally connected with each other in financial matters; so when one SOE has liquidity problems, it will influence other connected SOEs' liquidity status, which is called by

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<sup>143</sup> *Id.*

<sup>144</sup> *The Gathering Storm: How Much Credit Risk Is China's Banking System Facing?* CHINA ECON. REV. (Apr. 1, 2010, 1:00 PM), <http://www.chinaeconomicreview.com/node/25391>.

<sup>145</sup> Simon Rabinovitch, *China Tells Banks to Roll Over Loans*, FIN. TIMES (Feb. 12, 2012, 3:50 PM), <http://www.ft.com/cms/s/0/dc7035dc-553b-11e1-b66d-00144feabdc0.html>.

<sup>146</sup> Adrian Ineichen, *China's Financial Markets: Their Problems and Options for Further Development*, GEO. PUB. POL'Y L. REV. (Dec. 31, 2009, 10:09 PM), <http://gppreview.com/2009/12/page/2/>.

<sup>147</sup> Jingxia Shi, *supra* note 85, Part II.A.II.2.

<sup>148</sup> Charles D. Booth, *The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over*, 20 SAFLJ 275, 278 (2008).

<sup>149</sup> *Id.* at 287.

observers as “triangular debt” problem.<sup>150</sup> In order to solve this problem, China emphasized the importance of reforming SOEs in recent years. However, in the meantime, the government further promoted the banks to make policy lending to SOEs, such as the “closed loans” (during 1999-2007),<sup>151</sup> which were specifically issued to loss-making SOEs under the instruction of The State Economic and Trade Commission (SETC).<sup>152</sup> This continuance of policy-lending practice implicates reasonable worry of potential NPLs, which may be generated from the unsatisfactory performance or failure of SOEs.

A third issue affecting loan quality is the extensive lending to the real estate market, which has also become a major problem for China’s banking industry. In the past few years, Chinese banks regarded real estate loans as high quality and highly profitable,<sup>153</sup> and most market participants regarded them as the most resilient type of loans.<sup>154</sup> Bank loans accounted for 80% of the commercial funding used for land purchases and real estate development in 2009.<sup>155</sup> By March 2009, the real estate loan balance for all Chinese banks’ was RMB 5.67 trillion, accounting for one-sixth of the banks’ whole loan balance, thus making real estate as the industry where Chinese banks had their largest loan balance.<sup>156</sup>

Moreover, more than half of all the loans made by the banks are secured by real estate,<sup>157</sup> which means that any major fluctuation in the real estate market may have a great impact on the whole financial system.<sup>158</sup> It is reported by the IMF that most Asian countries’ real estate

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<sup>150</sup> Jingxia Shi, *supra* note 85, Part II.A.II.2.

<sup>151</sup> See generally 封闭贷款管理暂行办法 [Interim Administration Measures for Closed Loans] (promulgated by Nat’l Dev. & Reform Comm’n. & PBoC, July 26, 1999), CLI.4.23234, (repealed 2007).

<sup>152</sup> Victor C. Shih, *Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China*, 2004 CHINA Q. 922, 930.

<sup>153</sup> Zhao Qing, *supra* note 124, at 135.

<sup>154</sup> 2009 ORIENT REPORT, *supra* note 69, at 13.

<sup>155</sup> Zhao Qing, *supra* note 124, at 135.

<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

<sup>158</sup> *Id.* See also 姬长春 (Ji Changchun), 浅谈金融危机对商业银行信贷管理的启

markets are facing the issue of potential real estate bubbles that risk bursting at some point in the future.<sup>159</sup>

The lending spree since 2008 has changed China's financial landscape in the way that China's economic growth relies more on loose credit extension, which in turn causes the high inflation and property bubble in China.<sup>160</sup> In China, many real estate purchasers expected that the prices on their real estate would appreciate, so their purchase was not simply made for dwelling purposes but rather with an investment or even speculative intention. Observers regard this as a typical feature of a housing bubble.<sup>161</sup> Along with the Chinese government's goal of reducing the housing bubble, the purchasers may withhold their prospective investment, which in return may put the real estate market into gloomy situation.<sup>162</sup>

Mainly for the above reasons, it is expected that China's NPLs will increase significantly in the coming years. For example, Victor Shih<sup>163</sup> has stated that the lending spree in 2009 could return China's banking system to the dysfunction and inefficiency of the pre-reform 80's and 90's situation.<sup>164</sup>

In addition, the credit rating agency Standard & Poor's estimated that over the next few years, China's bad loans would reach between

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示 [Lessons from Financial Crisis of], 中国市场 [Chinese Market], no. 1 at 35, 35 (2011); *Chinese Banks Face Rising Bad Debts: S&P's*, THE CHINA POST (July 24, 2010, 8:37 PM TWN), <http://www.chinapost.com.tw/business/asia-china/2010/07/24/265836/Chinese-banks.htm>.

<sup>159</sup> *Global Financial Stability Report*, INT'L MONETARY FUND 35 (Apr. 2010), <http://www.imf.org/external/pubs/ft/gfst/2010/01/pdf/text.pdf>.

<sup>160</sup> Minxin Pei, *Are Chinese Banks Hiding "The Mother of All Debt Bombs"?*, *The Diplomat* (Sept. 10, 2012), <http://thediplomat.com/2012/09/10/are-chinese-banks-hiding-the-mother-of-all-debt-bombs/>.

<sup>161</sup> *Global Financial Stability Report*, *supra* note 159.

<sup>162</sup> 2009 ORIENT REPORT, *supra* note 69, at 13.

<sup>163</sup> Victor C. Shih is an assistant professor in Department of Political Science in Northwestern University. He has on-going projects on the performance of Chinese banks, singling in elite politics and elite selection in China. See <http://faculty.wcas.northwestern.edu/~vsh853/>.

<sup>164</sup> Osborn, *supra* note 10.

RMB1.8 trillion and RMB 2.7 trillion, which will be nearly five times greater than the amount reported for 2009.<sup>165</sup> Fitch Ratings also predicted that China faces a 60% probability of banking crisis in 2013.<sup>166</sup> In view of this situation, China will likely face great financial pressure in the next few years. Therefore, NPL resolution will remain an important task for China's financial system. Considering that AMCs have played a major role in NPL resolution in China, the following section will assess the performance of AMCs since their establishment.

### 3.2 Assessment of AMCs' Performance under the Current Legal Regime

Since their establishment in 1999, AMCs have made some achievements during their more than twelve years' existence. However, considering the remaining seriousness of the NPL situation, AMCs have not worked out efficiently and effectively. This is mainly due to the existing impediments faced by AMCs, which have hindered their development and performance.

#### 3.2.1 AMCs' Achievements

It should be admitted that, since their establishments, the four AMCs have made many achievements. Their achievements include:

First, they have helped major banks remove the high NPL ratios from their balance sheets and thus enabled them to succeed in IPOs.<sup>167</sup> In 2005, Bank of Communications was successfully listed on the Hong Kong Stock Exchange, marking the first Hong Kong IPO of Chinese state-owned commercial banks.<sup>168</sup> Then, its footsteps, other major Chinese banks followed with their own IPOs, such as ICBC listed in 2006,<sup>169</sup> and most recently ABC listed in July 2010.<sup>170</sup> The IPOs for

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<sup>165</sup> *Id.*

<sup>166</sup> Hamlin, *supra* note 10.

<sup>167</sup> McGuinness & Keasey, *supra* note 130, at 127.

<sup>168</sup> *Id.* at 126.

<sup>169</sup> Bank of China Limited, Global Offering Prospectus (Stock Code: 3988), HONG

both ICBC and ABC broke the record for largest IPOs ever at their listing time,<sup>171</sup> raising US\$19 billion<sup>172</sup> and US\$22.1 billion<sup>173</sup> respectively.

Second, AMCs have contributed to create conditions for the successful corporate restructuring of some SOEs.<sup>174</sup> Up to the year of 2010, the four AMCs have carried out many debt-for-equity swaps for SOEs, amounting to a value of more than RMB 405 billion.<sup>175</sup> With these debt-for-equity swaps, the SOEs have been able to restructure their balances-sheets into a more sustainable state. In addition, they also helped more than 50 companies conduct reorganization and restructuring.<sup>176</sup> It is estimated that these measures released the burden of SOEs by reducing the debt ratio of these companies by 30% to 40%, which also helped some SOEs' IPOs.<sup>177</sup>

Third, through over twelve years' practice in the NPL market, AMCs have built up some relatively strong teams of NPL resolution professionals.<sup>178</sup> At the time of its establishment, there were few employees in the four AMCs who really understood how to resolve NPLs. However, in the past years, AMCs actively cooperated with other international experts and legal, financial or accounting experts. Through this process, they gradually cultivated some of their own professional

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KONG STOCK EXCHANGE (May 18, 2006), <http://www.hkexnews.hk/listedco/listconews/sehk/2006/0518/LTN20060518000.htm>.

<sup>170</sup> Agricultural Bank of China, Global Offering Prospectus (Stock Code: 01288), HONG KONG STOCK EXCHANGE (June 30, 2010), <http://www.hkexnews.hk/listedco/listconews/sehk/2010/0630/LTN20100630015.HTM>.

<sup>171</sup> See Brian Bremner, *China's ICBC: The World's Largest IPO Ever*, BLOOMBERG BUSINESSWEEK (Sept. 26, 2006), [http://www.businessweek.com/globalbiz/content/sep2006/gb20060927\\_356775.htm](http://www.businessweek.com/globalbiz/content/sep2006/gb20060927_356775.htm).

<sup>172</sup> *Id.*

<sup>173</sup> *ABC's \$22.1 Billion IPO is World's Largest*, CHINESE GOVERNMENT'S OFFICIAL WEB (July 7, 2010), [http://english.gov.cn/2010-07/07/content\\_1647744.htm](http://english.gov.cn/2010-07/07/content_1647744.htm).

<sup>174</sup> 2009 ORIENT REPORT, *supra* note 69, at 11.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at 11–12.

<sup>178</sup> *Id.* at 13.

teams.<sup>179</sup>

Fourth, through AMC's operation, China also built up a quite mature NPL market relative to where China was a decade ago.<sup>180</sup> Before AMC's establishment, there was no NPL market, thus no legal framework for the NPL market. During the last few years, Chinese authorities have issued a series of rules, notices, guidance or judicial interpretations to eliminate some obstacles of NPL resolution. Therefore, the current NPL market is much more predictable and efficient compared to the early years of AMC's establishment.

Despite the achievements made by AMC's as above-mentioned, more serious problems still remain with AMC's, namely, the AMC's still have not effectively resolved the NPLs in the essence. In other words, AMC's still fail to prevent China's financial system from the aftermath of the large scale of NPLs generated by the banking system in the past years.

### 3.2.2 AMC's Unsatisfactory Resolution of NPLs

At the time of the establishment of four AMC's, major commercial banks bought bonds issued by AMC's, which amounted to RMB 846 billions.<sup>181</sup> The Chinese government did not explicitly guarantee these bonds (government entities are not allowed to make guarantees according to Law of Guarantees), though many observers believed that these bonds were implicitly guaranteed by the government.<sup>182</sup> Therefore, the banks are still relying on AMC's performance to fulfill the 2.25% interest payment and the ultimate principal repayment: 1) AMC's are on the hook to the banks for interest and principal payment, and 2) the main source of revenue to repay bonds held by the banks is income derived by the AMC's from resolution of the NPLs that were transferred to the AMC's from the banks.<sup>183</sup> Therefore, bonds can only be repaid if the AMC's generate

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<sup>179</sup> *Id.* at 14.

<sup>180</sup> *Id.* at 13.

<sup>181</sup> Han Bing, *supra* note 31, at 215.

<sup>182</sup> SHIH, *supra* note 16, at 172.

<sup>183</sup> Guonan Ma & Ben Fung, *supra* note 6, at 11.



adequate cash flow, but that depends on NPL resolution.

However, to some extent, AMC's were insolvent at the time of their inception. The four AMC's paid the price of book value for the first NPL transfer of RMB 1.4 trillion in exchange of banking purchase of bonds, but most of these NPL's were bad loans, which should have been valued far less than the book value.<sup>184</sup> According to PricewaterhouseCoopers (PwC), in the market, it was even difficult for some AMC's to reach the targeted cash recovery rate of 9%–18% set forth by Chinese authorities<sup>185</sup> or the overall recovery rate of 30% set forth by MoF.<sup>186</sup>

The speed of resolution was also slow. By the end of 2005, the AMC's had only disposed of 27% of all the NPL's they have acquired from the major commercial banks since 1999,<sup>187</sup> with a reported cash recovery rate of 20.3 percent.<sup>188</sup> Therefore, even these bonds were originally supposed to mature in 2009 and 2010,<sup>189</sup> MoF, as the sole shareholder or owner of the AMC's, has allowed AMC's to roll over these NPL bonds for another ten years.<sup>190</sup> There was no indication that the state owned commercial banks, as the major creditors for the bonds, or the banks' supervisor PBoC had been consulted to give their consent on the rollover decision. The rollover decision indicates the difficulties encountered by AMC's in resolving NPL's. Even with the ten-year extension, it is still unclear whether AMC's will ultimately be able to repay the bonds at maturity. Therefore, although the official reported NPL ratios achieved a double-decline, the real situation is not so promising.

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<sup>184</sup> Chovanec, *supra* note 125. See also Andrew Peaple, *The Chinese 10-Year Plan For Bad Debt*, WALL ST. J. (Sept. 23, 2009), <http://online.wsj.com/article/SB125361482592230449.html#articleTabs%3Darticle>.

<sup>185</sup> PwC, *NPL Asia*, no. 7 at 1–2 (May 2006), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/nplasiaissue7may2006.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/nplasiaissue7may2006.pdf).

<sup>186</sup> PwC no. 1, *supra* note 48, at 2.

<sup>187</sup> PwC, *NPL Asia*, no. 6 at 2 (Nov. 2005), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_nov\\_2005.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_nov_2005.pdf).

<sup>188</sup> Min Xu, *Resolution of Non-Performing Loans in China*, N.Y.U. FACULTY DIGITAL ARCHIVE 9 (Apr. 1, 2005), [http://archive.nyu.edu/bitstream/2451/25948/2/Xu\\_2005.pdf](http://archive.nyu.edu/bitstream/2451/25948/2/Xu_2005.pdf).

<sup>189</sup> PwC, *NPL Asia*, no. 9 at 2 (May 2008), [http://www.pwc.com/en\\_GX/gx/non-performing-loan-news/pdf/npl\\_asia\\_may\\_2008.pdf](http://www.pwc.com/en_GX/gx/non-performing-loan-news/pdf/npl_asia_may_2008.pdf).

<sup>190</sup> PwC no. 11, *supra* note 74, at 4.

Moreover, following the lending spree post 2008-2009 financial crisis, the AMCs may eventually be entrusted with the more serious task of resolving the newly-generated NPLs. Considering the current performance of the AMCs, it is uncertain whether AMCs can shoulder such a significant new task in resolving a new wave of NPLs in the secondary market.

In order to figure out ways to improve the NPL market, it is necessary to see how the current legal regime imposes legal impediments on AMCs and thus influences AMCs' operation.

#### **4. Problems of the Current Legal Regime Reflected by the Unsatisfactory Performance of the NPL Market**

The expected generation of the new NPLs following the lending spree in recent years reinforces the weakness of the regulation over the primary NPL market, while the unsatisfactory performance of the AMCs reflects the impediments imposed by the current legal regime for the secondary NPL market. The following part will discuss these impediments in details.

##### **4.1 Legal Impediments for Banks' Performance in the Primary Market**

Section 3.1 reveals that the current legal regime does not achieve the regulatory goals for the primary NPL market, namely, the current legal regime does not successfully help banks to avoid generating large amount of new NPLs. This situation reflects the problems of the current legal regime for the primary NPL market: first, the laws are not well implemented because of political influence; and second, the impractical bankruptcy regime for banks creates moral hazard for the banks.

###### **4.1.2 Political Influence over Banks' Practice**

The legal reforms for regulation of banks recognized the importance of following the market disciplines for banks in operation. However,

there is still strong political influence over banks' issuance of loans and disposition of settled assets. This strongly impedes the banks' ability to avoid generation of significant amounts of new NPLs as well as any further loss in the settled assets.

First of all, because the political influence on bank loans' issuance had been a common practice, which was recognized by previous Commercial Banks Laws, it is still very difficult to change this type of practice. From the problem of the massive lending in recent years to UDIVs, it can be noticed that banks' credit extension is still under great political influence. The banks are still political tools to facilitate the various needs of the government. As a result, the banks cannot follow commercial standards in making business judgments or in disposal of NPLs. For example, according to a report issued by PBoC, the loans issued by China's commercial banks in 2009 in response to the global financial crisis were still concentrated in the long-term projects, which were supported by the government.<sup>191</sup>

Moreover, because of the strong political influence in banks' lending practice, there are some practices of the banks that are directly in conflict with laws. For example, Law of Guarantees expressly states that state organs and public institutions like schools, kindergartens, and hospitals cannot act as guarantors.<sup>192</sup> However, in practice, when making loans for government — supported projects like infrastructure construction, banks often require the government entities to issue a letter of commitment with respect to repayment of loans and then regard the letter as one kind of guarantee.<sup>193</sup> As a result, when the loans turn bad, banks' claims on

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<sup>191</sup> 中国人民银行货币政策分析小组 [PBoC Monetary Pol'y Res. Grp.], 2010 年中国区域金融运行报告 [2009 General Report of China's Regional Financial Performance] 3 (June 2010), [http://www.pbc.gov.cn/image\\_public/UserFiles/bangongting/upload/File/《2009年中国区域金融运行报告》主报告.pdf](http://www.pbc.gov.cn/image_public/UserFiles/bangongting/upload/File/《2009年中国区域金融运行报告》主报告.pdf).

<sup>192</sup> 中华人民共和国担保法 [Law of Guarantees] (promulgated by the Standing Comm. Nat'l People's Cong., June 30, 1995, effective Oct. 1, 1995), CLI.1.1241 8, arts. 8 & 9.

<sup>193</sup> 黄林煌 (Huang Linhuang), 试论商业银行不良贷款清收的法律风险 [Legal Risks for NPL Resolution in China], 中国农业银行武汉培训学院学报 [J. OF AGRIC. BANK OF CHINA WUHAN TRAINING C.], no. 1 at 42, 44 (2009).

guarantees based on the letters of commitment from government entities should not be supported by the law.

Furthermore, even for banks' own resolution of settled assets, there is also strong political influence, which is even recognized by law. Article 42 of PRC Commercial Banks Law 2003 expressly stipulates that commercial banks have to dispose of the property or share rights (collectively, "debt-expiated assets") obtained from settlement with debtors within two years from the date of acquiring the relevant rights.<sup>194</sup> MoF further requires that moveable properties have to be disposed of within one year.<sup>195</sup> If banks are unable to meet these time requirements, they will be punished by regulatory authorities at their discretion or be prosecuted for criminal offences.<sup>196</sup>

However, in practice, the two-year requirement is quite short for banks in some situations, especially for the disposition of certain real properties or land use rights.<sup>197</sup> Therefore, in order to fulfill the time requirement, banks will try their best to achieve the fastest resolution for settled assets even if doing so within short time frames may not produce the best recovery for the banks on these assets. Consequently, this kind of political pressure on banks' practice may accumulate more loss to banks.

#### 4.1.3 Moral Hazard Created by an Impractical Bankruptcy Regime

The lack of an effective bankruptcy regime for banks creates a general moral hazard issue among banks. The historical practice of PBoC acting as a savior for troubled banks makes the commercial banks cultivate a psychological reliance on help from PBoC whenever there is a serious problem. Because the banks do not need to worry the bankruptcy consequence of failure, they do not have the incentive to truly act

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<sup>194</sup> Commercial Banks Law 2003, *supra* note 78, art. 42.

<sup>195</sup> 财政部关于印发《银行抵债资产管理办法》的通知 [Notice of MoF on Circulating "Measures for the Administration of Debt-Expiated Assets in Banks"] (promulgated by MoF, May 5, 2007, effective Jul. 1, 2005), CLI.4.58681, art. 18.

<sup>196</sup> *Id.* art. 30.

<sup>197</sup> Huang Linhuang, *supra* note 193, at 44.

according to commercial standards. Consequently, banks are not motivated to ensure the soundness of their loan issuance.

Therefore, in China, it is necessary to make efforts to implement the bankruptcy law. Without effective implementation, the law offers no useful guidance. This explains why China's EBL has legal provisions on banks' bankruptcy, but there is no real application in practice of these provisions.<sup>198</sup>

## 4.2 Legal Impediments for AMC's Current Performance in the Secondary Market

Generally speaking, AMC's unsatisfactory performance reflects the problems of the current diversified supervisory system, the lack of a unified legal structure and the lack of an effective judicial system.

### 4.2.1 Problems Caused by the Diversified Supervisory Mechanism

As introduced in Section 2, AMC's are currently under supervision of different government entities, such as PBoC, CBRC and CSRC, which have different regulatory powers regarding different aspects of AMC's and their operations. However, AMC's business is in conjunction with different supervisory scopes in practice, which results in overlapping supervision from different authorities.<sup>199</sup> Since different authorities have different supervisory standards, this situation creates a great burden for AMC's and also put AMC's into some difficult situations.<sup>200</sup>

For example, currently, the securitization of NPLs, which AMC's in China might consider as a potential tool for resolving NPLs, is now regulated under the scope of trust law.<sup>201</sup> Securitization had been used as

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<sup>198</sup> *Id.* at 45.

<sup>199</sup> Li Weijie & Song Yan, *supra* note 111, at 45.

<sup>200</sup> *Id.* See also 蒋丽霞 (Jiang Lixia) & 高丙芳 (Gao Bingfang), 我国金融不良资产处置相关法律问题探析 [*Legal Issues of Resolution of China's Non-Performing Loans*], 经营管理者 [MAG. OF ENTERPRISE MANAGERS], no. 8 at 211, 211 (2010).

<sup>201</sup> 信贷资产证券化试点管理办法 [Pilot Administrative Measures for the

an important tool in other countries' NPL resolution, because securitization can accumulate certain types of NPLs together and then put them into a pool to generate new profits for AMCs. However, the supervision of AMCs' securitization is not clear under China's current supervisory structure.

According to the division of supervisory power set forth by laws issued by SCNPC, CBRC is responsible for the supervision of the normal business transactions of financial institutions, including trust entities,<sup>202</sup> and CSRC is responsible for the overall supervision of securities market, also including trust entities.<sup>203</sup> It can be noted that CBRC and CSRC have overlapping supervisory power over AMCs' securitization. From the language of the relevant laws, it is difficult to tell the exact division of the supervisory power of CBRC and CSRC. Therefore, in reality, CBRC and CSRC may have the incentive to enlarge their supervisory power by enacting supervisory rules in those unclear areas, which results in different or contradictory supervisory standards for AMCs.

Moreover, even in the areas where the supervisory responsibilities have been clarified, there is still confusion. For example, according to the notice issued by PRC State Council in 2001, CSRC, jointly with PBoC, has the power to approve the engagement of trust business by corporate entities or natural persons.<sup>204</sup> However, in the present legal regime, the approval power regarding whether AMCs can engage in securitization in accordance with Trust Law has been held by CBRC and PBoC. Currently, the governing legal instruments regarding AMCs' engagement of

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Securitization of Credit Assets] (promulgated by PBoC & CBRC, effective Apr. 20, 2005), CLI.4.57934, art. 1.

<sup>202</sup> 中国人民银行银行业监督管理法 (2006 修正) [Law on Regulation of the Banking Industry (2006 Amendment)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 31, 2006, effective Feb. 1, 2004), CLI.1.80997, art. 2.

<sup>203</sup> 中华人民共和国证券法 (2005 修订) [Securities Law (2005 Revision)] (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), CLI.1.60599, arts. 6 & 7.

<sup>204</sup> 关于院办公厅关于“中华人民共和国信托法”公布执行后有关问题的通知) [Notice of State Council Office on Clarification of Certain Issues Regarding The Implementation of “Trust Law of the People's Republic of China”] (promulgated by St. Council Office, effective Dec. 29, 2001), CLI.2.39206, art. 2.

securitization are mainly two rules issued by CBRC<sup>205</sup> or jointly issued by CBRC and PBoC in 2005.<sup>206</sup> CSRC, which should act as the legitimate supervisory entity, was taken out of the whole picture of enacting supervisory standards for securitization by AMCs.

Although CBRC and PBoC disregarded CSRC and PRC Securities Law to set forth their own standards for AMCs' securitization, in practice, the AMCs cannot escape the legitimate supervision of CSRC over the trust business. Consequently, AMCs have to abide by two different sets of standards on the same issue and inevitably need to make a difficult decision regarding whose standards they should follow when there is a conflict between rules set forth by CSRC and CBRC. This uncertainty imposes legal risks for AMCs, because violation of either set of rules may incur political penalties.

Furthermore, local governments also exert an influence on AMCs when AMCs have established local branches in their respective governing territories. Because the local governments are responsible for most of the local governments' spending, local governments have the incentive to maintain whatever kind of profitable economic positions of local enterprises, which resulted in local protectionism.<sup>207</sup> Therefore, when the NPL asset is related to local SOEs, the local governments will have the incentive to keep or to seek benefits for these SOEs (such as protecting them from being put into bankruptcy proceedings or put into the normal litigations as defendants). This in turn will influence the AMCs' ability to act in accordance with market disciplines and may also affect the ability of AMCs to achieve high recovery on NPLs.<sup>208</sup>

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<sup>205</sup> See generally Measures for Pilot Securitization by Financial Institutions, *supra* note 98.

<sup>206</sup> See generally Pilot Administrative Measures for the Securitization of Credit Assets.

<sup>207</sup> Brent T. Yonehara, *Enter the Dragon: China's WTO Accession, Film Piracy and Prospects for the Enforcement of Copyright Laws*, 9 UCLA ENT. L. REV. 389, 403–04 (2011).

<sup>208</sup> JANOS KORNAL, HIGHWAY AND BYWAYS: STUDIES ON REFORM AND POST-COMMUNIST TRANSITION 141–60 (1994).

Furthermore, the supervisory entities have considerable discretion to set forth their own regulatory standards, and thus they have brought in many political standards (such as certain political goals to be achieved from the governor's perspective) to govern AMCs. Because of the flexibility of the political standards, they often place much burdens on AMCs. For example, the government entities emphasize that the NPLs transferred by the state-owned banks to the AMCs are still state assets, which are commonly owned by the public as a whole, thus the government do not want to be accused of selling state assets too cheaply.<sup>209</sup> Therefore, whenever AMCs dispose of certain NPLs, it is possible for them to receive scrutiny from the political authorities. Consequently, no matter how reasonable the price of selling NPLs to third-party investors, as long as the price is too low, the employees at AMCs are very reluctant to engage in such kind of deals so as to avoid being accused of selling common property or state-assets too cheaply.<sup>210</sup>

In addition, the AMCs' employees also try to avoid any situation that investors, especially foreign investors, publicly announce that they have made a large profit following a portfolio purchase of Chinese NPLs. Such a situation makes the sellers, particularly the responsible AMC officials, look incompetent in originally pricing of the NPLs.<sup>211</sup> This kind of worry about accountability of AMCs' employees also affects AMCs' pricing or choice of targeted buyers. AMCs become overly cautious in going to auction with NPL assets and/or they price the assets too aggressively (i.e., too high). Consequently, this reduces the speed of NPL resolution.

#### **4.2.2 Obstacles Created by Lack of a Unified and Consistent legal Framework**

The current scattered legal and regulatory framework creates

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<sup>209</sup> Jack Rodman, *Progress Toward the Resolution of Nonperforming loans*, in CORPORATE RESTRUCTURING: LESSONS FROM EXPERIENCE 171, 178 (Michael Pomeriano & William Shaw eds., World Bank Publications, 2005).

<sup>210</sup> PwC, *NPL Asia*, no. 3 at 3 (Dec. 2003), [http://www.pwc.com/en\\_GX/gx/no-n-performing-loan-news/pdf/npl\\_asia\\_jan\\_2004.pdf](http://www.pwc.com/en_GX/gx/no-n-performing-loan-news/pdf/npl_asia_jan_2004.pdf).

<sup>211</sup> *Id.*



obstacles for AMCs in the following ways:

First, the conflict of different laws or regulations in the patchwork legal and regulatory framework poses difficult challenges for AMCs with regard to some important issues. For example, the Law of Guarantees stipulates that “the creditor’s rights in the principal contract of the maximum mortgage<sup>212</sup> cannot be transferred.”<sup>213</sup> However, in 2001, the PRC Supreme Court issued a notice and stated that when the creditor’s right is confirmed by the court, the transfer of the rights in the maximum mortgage can be regarded as legally effective.<sup>214</sup> This notice was clearly in conflict with the Law of Guarantees. According to the level of hierarchy, the interpretation of PRC Supreme Court is at a lower level and thus should not trump the Law of Guarantees.

In theory, the civil activities should follow the requirement of Law of Guarantees. However, in practice, the courts frequently refer to PRC Supreme Court’s interpretations for guidance. Consequently, the AMCs have to make a choice between obeying the laws or the interpretations, which reduced the predictability for their judgments.

Second, the scattered legal and regulatory framework leaves some legal issues unaddressed, thus causes uncertainty for AMCs’ transactions. For example, debt-for-equity swaps have been used as one of the methods for AMCs to resolve NPLs, in which AMCs replace their rights to claim debt as creditors with an equity stake in the debtor company. However, the current legal framework in China does not provide any guidance on how AMCs can exit from the equity obtained in

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<sup>212</sup> The maximum mortgage refers to “an agreement between the mortgagor and the mortgagee to use objects of pledge to guarantee consecutive creditor’s rights during a set period within the limit of the maximum of the debts.” Law of Guarantees, art. 59.

<sup>213</sup> *Id.* art. 61.

<sup>214</sup> 最高人民法院关于审理涉及金融资产管理公司收购、管理、处置国有银行不良贷款形成的资产案件适用法律问题的若干规定 [Provisions of the Supreme People’s Court on the Application of Law in the Hearing of Cases Involving the Purchasing of, Managing or Disposing of NPL Assets of State-Owned Banks by Financial AMCs] (promulgated by Sup. People’s Ct., Apr. 11, 2001, effective Apr. 23, 2001), CLI.3.35570, art. 8.

debt-for-equity swaps.

According to the experience of Poland and Korea, the major exit channels for AMCs are: the IPO of the debt company after AMCs' subscription of equity, the repurchase of AMCs' shares by the debt company, the repurchase of AMCs' shares by the original shareholders of the debt company, or sales of shares to the public investors.<sup>215</sup>

However, these exit methods are not practical in China. First of all, most companies involved in debt-for-equity swaps have financial problems, and thus they are not qualified to meet the IPO standards under PRC Securities Law.<sup>216</sup> Moreover, even if the debt companies succeed in IPOs, under PRC Company Law, the debt companies are not allowed to repurchase the shareholders' shares except in very limited situations.<sup>217</sup> Furthermore, the original shareholders of the debt company, as the new shareholders of the new company reorganized with AMCs, are not allowed to make promise to repurchase AMCs shares under PRC Company Law,<sup>218</sup> thus they also lack incentive to purchase AMCs' shares in the new company unless the debt company is making good profit. Thus, when AMCs engage in debt-for-equity swaps, it is uncertain how and when they can exit from the new company. The current legal framework provides no clear guidance on this point.

Third, the political feature of the legal structure regarding AMCs causes moral hazard for AMCs in performance. When the four AMCs were established, the State Council expressly stated that the loss of AMCs incurred in NPL resolution would be resolved by measures proposed by the MoF.<sup>219</sup> As a result, the AMCs lack incentive to perform

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<sup>215</sup> LI JIANNAN, *supra* note 110, at 75–76.

<sup>216</sup> Securities Law, arts. 50 & 55.

<sup>217</sup> The situations include: decrease of capitals, merging with other companies, conducting employee incentive plans or requested by any shareholder to purchase his shares because “this shareholder objects to the company’s resolution on merger or split-up made by the assembly of shareholders.” Company Law 2005, *supra* note 79, art. 143.

<sup>218</sup> *Id.*

<sup>219</sup> Regulation on Financial AMCs, art. 32.

as well as competitive market participants in the sense that MoF or other organs of the Chinese central government will ultimately shoulder the loss of the four AMCs.

Fourth, the lack of clear guidance on the legal status of AMCs leaves uncertainty for the future of the four AMCs, thus creates difficulty to incentivize the employees. The AMCs were originally set for the existence of 10 years. For the employees of AMCs, the faster they resolve NPLs means that the sooner they will lose their jobs. Consequently, they lack incentive to efficiently engage in NPL resolution.<sup>220</sup> Moreover, this also creates problem for AMCs to attract qualified employees. Although the four AMCs obtained the extension of another ten years for existence, for the employees, it is still not an ideal job compared to other jobs in SOEs because of the uncertainty of AMCs' future. Therefore, it is difficult for AMCs to attract high-level professionals as well as to incentivize their current employees. While the employees are the key participants in the NPL resolution process, their negative attitude would in turn influence the efficiency of AMCs' performance.

#### **4.2.3 Burdens Imposed by Lack of an Effective Judicial System**

The inefficiency in judicial system imposes an extra burden on AMCs in the following ways:

First, it increased transaction costs for AMCs. AMCs' NPL resolution in China involves many different kinds of fees or costs.<sup>221</sup> Some of them, such as normal management fees, ordinary salaries to AMC employees, auction fees and lawyer fees, are necessary standard fees and expenses. However, some other operational fees incurred by AMCs are increased because of the inefficient legal regime for AMCs, such as management fee for real estate, cost for enforcement of court judgments, cost for enforcing collaterals on real estate and cost for reallocating of SOEs' employees.

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<sup>220</sup> 2009 ORIENT REPORT, *supra* note 69, at 15.

<sup>221</sup> See Table 4.

Furthermore, because of the difficulty of enforcing judgments, the AMCs have to spend more time and money to manage the real estate and other assets, which serve as collaterals for the NPLs. Even if the collaterals could be enforced, the high fees on real estate transfer also imposes high financial burden on the AMCs.

**Table 4: Cost and Fees for AMCs in practice**

(%: Cost or prepayment/Value of target Asset)

Categories	%
Litigation fee: (to courts or notary)	5%
Cost for Enforcement of Judgment	1%
To auction agencies	5%
To rating agencies	1%
Fees paid to lawyers	2-3%
Management fee for real estate	Uncertain
For SOEs: cost for reallocating employees	Uncertain
For state allocated lands, prepayment of land transfer fees by AMCs:	40% of the land value
For real property transfer	1.05-1.25% transaction fee, 2.1%-2.5% (AMC and buyer pay 50% each). and other housekeeping fees
Normal management cost/salaries	Uncertain

Source: 2009 Orient Market Survey, at 45-46.

In addition, as previously introduced in Section 2.3.2.3, some local governments or local courts sometimes even set forth other kinds of fees or require submitting some unspecified fees,<sup>222</sup> which put very high financial burdens on AMCs. Generally, it has already been very difficult for AMCs to dispose of low-quality NPLs of SOEs. With the additional

<sup>222</sup> 2009 ORIENT REPORT, *supra* note 69, at 44, 47.

operational burden, it is more difficult for AMCs to operate. Because on one hand, they have to meet the investors' requirement of setting reasonable prices; on the other hand, they have the pressure of meeting the recovery rate set forth by the MoF.

Second, the inefficient judicial system affects AMCs' use of legal measures to collect debts. For example, PwC observed that since 2007, China's courts adopted a self-imposed "three suspension policy," particularly in cases relating to state-owned assets.<sup>223</sup> The three suspension policies are "the suspension of filing of new NPL-related cases, obtaining judgments on existing cases and execution of decisions made pending according to the Supreme Court guidance."<sup>224</sup> This politically oriented policy impedes AMCs' ability to resolve NPLs through judicial system.

Moreover, the Chinese government often forces the courts to maintain the harmony of the society under the command of "maintaining stability [as the] top priority."<sup>225</sup> Thus, this leads the courts to dismiss AMCs' motions, or to accept the suit but delay the hearing, or to start the hearing but delay the issuing of decision.<sup>226</sup>

Furthermore, in 2009, the PRC Supreme Courts issued a guidance on the cases concerning AMCs ("2009 PRC Supreme Court Guidance") which requires the courts not to accept cases brought by AMCs against state-owned or state-controlled companies if the debtor is subjected to reorganization or bankruptcy proceedings, or if the dispute is about policy-related financial asset assignment agreements.<sup>227</sup> This guideline

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<sup>223</sup> PwC no. 11, *supra* note 74, at 3–4.

<sup>224</sup> *Id.*

<sup>225</sup> *Maintaining Stability: Top Priority for Chinese Judiciary, Police in 2012*, XINHUA ENGLISH (Dec. 23, 2011, 18:22:58), [http://news.xinhuanet.com/english/china/2011-12/23/c\\_131324108.htm](http://news.xinhuanet.com/english/china/2011-12/23/c_131324108.htm).

<sup>226</sup> An Qilei et al., *supra* note 112.

<sup>227</sup> 最高人民法院印发《关于审理涉及金融不良债权转让案件工作座谈会纪要》的通知 [Notice of the Supreme People's Court on Issuing the "Summary of the Symposium on Hearing Cases About Assignment of Distressed Claims Involving Financial Institutions"] (promulgated by Sup. People's Ct., effective Mar. 30, 2009), CLI.3.116008, art. 2(1)–(2) [hereinafter 2009 PRC Supreme Court Guidance].

also states that the sale of NPLs can be regarded as invalid if public or national interest is affected (such as the situation when “the debtor or the guarantor is a state organ,” or when the assets transferred are concerning the sensitive information about national security or monetary).<sup>228</sup> Since most of NPLs are related to SOEs, this guideline greatly impedes AMC’s ability to collect debts.

Third, the ineffective judicial system creates difficulty for AMCs to activate investors. According to the market survey made by Orient AMC in 2010, the lack of a sound judicial system has become an important obstacle for investors to invest in Chinese NPL market.<sup>229</sup> Nearly 57% of the investors (including investment banks, funds, SOEs and foreign investors) responded that the unsatisfactory legal environment influenced their participation in the NPL market.<sup>230</sup>

The influence of uncertainty in the legal regime on foreign investors is more obvious. Foreign investors are very sensitive to change of policy or legal environment in a targeted investment area that may affect their investment in a given asset class. Any changes of law or market conditions may influence their participation in China.

For example, in 2009, many foreign investors left China’s NPL market, possibly due to a ruling of the PRC Supreme Court against United Bank of Switzerland (UBS).<sup>231</sup> In that case, UBS acquired NPLs that was guaranteed by a SOE from an AMC, but it did not obtain consent from the SOE guarantor before the transfer.<sup>232</sup> UBS tried to enforce its rights against the guarantor in the court.<sup>233</sup> According to 2009 PRC Supreme Court Guidance, when the AMCs transferred NPLs to investors, the guarantee remained valid and its validity was not subject to the

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<sup>228</sup> *Id.* art. 6; PwC no. 11, *supra* note 74, at 4.

<sup>229</sup> 2011 ORIENT REPORT, *supra* note 140, at 14.

<sup>230</sup> *Id.*

<sup>231</sup> *See* PwC no. 11, *supra* note 73, at 4.

<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

consent of guarantors.<sup>234</sup>

However, in its decision issued in July 2009, Supreme Court disregarded this 2009 PRC Supreme Court Guidance.<sup>235</sup> Instead, it relied upon two earlier guidelines<sup>236</sup> to rule that the guarantee was invalid because it did not obtain the prior consent from the guarantor.<sup>237</sup> This case had cast doubt on the foreign investors' confidence in the predictability of the legal framework of China's NPL market. Since then, the involvement of foreign investors has become less and less.

Although PRC Supreme Court issued another guideline in 2010 to re-clarify that as long as the guarantor has been informed and the transfer of guarantee rights has been duly registered with SAFE, the guarantee will be deemed as effective.<sup>238</sup> However, the repetitive change of PRC Supreme Courts' guidance on the same issue makes the investors reasonably worry about the legal risks. In particular, considering the importance of realization of guarantee for investors to recover the value from NPLs in which they invested, it is not surprising to see that investors chose to leave China's NPL market. Until May 2011, there were still no signs of recovery of foreign investors' return or intention to return

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<sup>234</sup> PwC no. 11, *supra* note 74, at 3–4. See 2009 PRC Supreme Court Guidance, *supra* note 227, art. 3.

<sup>235</sup> Victor C. Shih, *Why China Isn't Ready to Lead*, WALL ST. J. (Oct. 22, 2009), <http://online.wsj.com/article/SB10001424052748704500604574484532133485624.html>

<sup>236</sup> 最高人民法院关于适用《中华人民共和国担保法》若干问题的解释 [Judicial Interpretation of the Supreme People's Court on Some Issues Regarding the Application of "Law of Guarantees"] (promulgated by Sup. People's Ct., Dec. 08, effective Dec. 13, 2000), CLI.3.34740, art. 6. See generally 国家外汇管理局关于转发和执行《最高人民法院关于适用〈中华人民共和国担保法〉若干问题的解释的通知》 [Notice of SAFE on Transmitting and Executing "Judicial Interpretation of the Supreme People's Court on Some Issues Regarding the Application of "Law of Guarantees"] (promulgated by SAFE, effective Jan. 18, 2001), CLI.4.36719.

<sup>237</sup> PwC no. 11, *supra* note 74, at 4.

<sup>238</sup> 最高人民法院关于审理金融资产管理公司利用外资处置不良债权案件涉及对外担保合同效力问题的通知 [Notice of the Supreme People's Court on the Trial of Cases Involving the Validity of External Guarantee Contract in which Financial AMCs Dispose of NPLs by Using Foreign Funds] (promulgated by Sup. People's Ct., effective July 1, 2010), CLI.4.135907, art. 1.

China's NPL market.<sup>239</sup>

## 5. Proposals for Reform

After analyzing the current NPL situation of China and discussing the legal and regulatory regime for the primary NPL market and the secondary NPL market, it can be summarized that: the legal and regulatory framework impedes banks' ability to avoid generating new NPLs in the primary market and negatively influence AMCs' NPL resolution in the secondary market. Although for the present situation, AMCs are still playing the key role in NPL resolution, it is very doubtful whether the current condition of AMCs will be able to shoulder the responsibility of resolving the anticipated NPLs, in a way not relying on the prior practice of imposing the loss on the state. Therefore, it is necessary to consider the need for reforming of the existing system. This paper proposes that the reform should take two dimensions: one is the short-term reform of improving the functioning/operation of the existing AMCs; the other is the long-term reform of creating new framework for NPL resolution.

### 5.1 Short-term Reform: Improving AMCs

From the discussion of the impediments to AMCs' performance, it can be seen that there are both internal and external problems existing in the current system. Internal problems mean the problems that result from the practices of AMCs themselves; while external problems mean the problems that result from the social, legal or political influences. Therefore, to improve the current situation of AMCs, both internal and external efforts should be made.

#### 5.1.1 Internal Efforts: from AMCs' Perspective

AMCs should focus on improving the internal management and cooperation with banks and other agencies. First of all, in order to

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<sup>239</sup> PwC no. 12, *supra* note 124, at 26.



maintain efficient and effective management of practices, AMCs should make efforts to hire more professionals and experts and give them large discretion to make technical decisions. The difficulty of incentivizing employees or hiring employees could be solved by setting up a more attractive and clear-cut awards-punishment mechanism.

Second, in order to reduce the operational cost, the responsibilities between the headquarters and the local branches should be clarified so as to reduce the transaction cost. The local branches should enhance cooperation with each other so as to share the professional resources and technical skills. But the clear responsibility of different branches and the standard of sharing resources should be set forth very clearly beforehand, so as to avoid the problem of shifting responsibility to each other.

Third, AMCs need to cooperate more with banks to solve the transparency problem of obtaining the debtors' information. AMCs can require reducing the price of NPLs if the banks refuse to facilitate the debtors' non-confidential information.

Fourth, AMCs should cooperate more extensively with international rating agencies or accounting agencies so as to achieve realistic pricing of NPLs. It is impractical for AMCs to only focus on the acquiring price of NPLs in the market. Instead, AMCs need to study how other markets operate in similar conditions, so as to maintain a competitive position.

### **5.1.2 External Efforts: from the Regulatory Perspective**

AMCs could only improve the technical and management aspects of the current system, but the reform of the regulatory framework can essentially improve the current AMCs by removing the legal and regulatory obstacles.

First of all, the Chinese authority should unify the rules concerning AMCs. As introduced in Section 2, the current legal structure is at a very low hierarchy, which poses risk of changing from time to time as well as

internal conflict among different legal instruments. Therefore, a separate law, maybe named as “the Law of Chinese Financial Asset Management Companies,” should be enacted by Standing Committee of the National People’s Congress. This new law should comprise the scattered rules or notices issued by different authorities together and clarify the independent legal status of AMCs from governments so as to avoid the political influence from local governments. In order to resolve the contradictory problem of different legal instruments, this new law should be set forth as a special law which only applies to the special circumstances of AMCs’ practice.

Second, in order to reduce the redundancy of People’s Courts to receive AMCs’ cases, to delay hearings concerning AMCs’ cases or to charge unreasonable fees, special panels should be established in each level of People’s Courts to hear AMC-related cases, with a special set of procedural rules to be followed by courts. The special procedural rules should reduce litigation fees, prepayment legal fees or fees for enforcement of judgments so as to reduce the burden of high cost for AMCs.

Third, in order to reduce AMCs’ pressure of being accused of selling NPLs too cheaply, the Chinese authority should clarify the conditions when the disposal of NPLs should be regarded as unfair disposal of state-assets, and avoid imposing mandatory recovering rate on AMCs. These standards should be published through media so as to make the public be aware of them.

In conclusion, the short-term reform mainly aims to create a sound legal environment for AMCs’ operation.

## **5.2 Long-term Reform: Avoiding NPLs and Finding New Ways of Resolution**

In the long run, the focus should be on how to avoid the new NPLs and how to normalize the NPL resolution process, without relying on special treatment of AMCs, because the cost of special treatment of

AMCs, such as the tax exemption, will eventually be shouldered by the state, namely, by the society as a whole.

### 5.2.1 To Enhance Reforms of the Banking System

The banks should try to avoid generating large amount of new NPLs. According to a survey conducted by PBoC in 2003, political influence accounted for the major cause of NPLs (for NPLs generated between 2001-2002, 30% was resulted from various kinds of government intervention, 30% was resulted from policy loans to SOEs, 10% was resulted from changes of the overall economic policies, and 20% was resulted from banks' bad operation.)<sup>240</sup> Therefore, in order to help banks avoid generating new NPLs, banks and the government shall make joint efforts to reduce political influence in banks' operations, to improve the quality of loans to SOEs and to enhance the internal control of banks.

First, in order to facilitate the banks to keep sound performance, the state should no longer frequently require the banks to issue policy loans or to dominate the banks' business decisions. The starting point is that the banks should strictly follow the requirements set forth in relevant laws, such as PRC Commercial Banks Law, to make business judgments in a commercial manner. Banks should adopt the market disciplines, which require, for example, the banks should duly follow-up with the borrowers' outstanding liabilities and the banks should not rely on the bail-out by the government for the failure of banks' performance."<sup>241</sup>

Second, since the large proportion of NPLs can be attributed to SOEs, it is important for banks to improve the quality of loans to SOEs on one hand, and for the government to help restructure SOEs on the other hand. Although debt-for-equity had already been taken to restructure SOEs, it is just the first step. Within insolvent SOEs, some

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<sup>240</sup> 张慧 (Zhang Hui) & 唐淑文 (Tang Shuwen), 我国商业银行不良资产的形成原因及处理对策分析 [*Analysis of the Reasons for the NPLs of China's Commercial Banks and the Solutions*], 企业家天地 [WORLD OF ENTREPRENEURS], no. 8 at 64, 64 (2008).

<sup>241</sup> Lou, *supra* note 59, at 1156.

parts of the SOE assets are problematic, while other parts are working very profitably. As a result, the two parts shall be divided into separate groups in asset disposition according to the level of generating further values, so as to ensure that the good parts can still work to recover some loss incurred by other bad parts.

Third, banks should enhance their internal control. Internal controls can provide reasonable assurance of effective and efficient operation, reliable financial information and reporting, and compliance with laws and regulations. To improve internal control of the banking system, Chinese government needs to help create a sound environment, with the following work needing to be done:

First of all, China needs to establish high-standard credit rating agencies in China to provide credit information of borrowers. Currently in China, although China has established few domestic rating agencies (such as Dagong Global Credit Ratings, China Chengxin International and China Lianhe Credit Rating), these agencies have been criticized for “being too close to the borrowers its rates” (such as giving top ratings to the UDIVs of China’s local governments).<sup>242</sup> Therefore, most Chinese financial institutions have to resort to international rating agencies. However, considering the importance of keeping sensitive information concerning national securities, Chinese banks may be reluctant to provide the full package of information to foreign credit rating agencies. As a result, it is important to establish domestic rating agencies, which can act independently to make ratings for the financial market.

Moreover, China needs to establish a comprehensive social credit system of individuals and corporations, which shall be strictly consulted when the banks make decisions. China does not have a comprehensive social credit system; therefore, the banks cannot fully track the credit record of the borrowers. Consequently, the banks are unable to dully

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<sup>242</sup> 周小川 (Zhou Xiaochuan), 国内金融机构要降低对外部评级的依赖 [Chinese Financial Institutions Should Reduce Reliance on Foreign Ratings], CCSTOCK. CN (Dec. 26, 2011, 22:48), <http://www.ccstock.cn/finance/hongguanjingji/2011-12-26/A665288.html>.

differentiate good borrowers from bad borrowers, which results in loans made to borrowers which have a lot of behaviors lacking of credibility, such as business fraud, selling or manufacturing pirate products and so on. China had realized the importance of establishing the social credit system even at the beginning of the 21st century,<sup>243</sup> but it still hasn't put its plan of establishing the social credit system into real practice.<sup>244</sup> Therefore, China needs to push its effort in this regard.

Third, Chinese government needs to help banks to establish a sound performance assessment mechanism to evaluate the performance of the officials within state-owned commercial banks. As previously introduced, a large percentage of NPLs were generated because of the improper management of the officials of the banks. Therefore, in order to change this situation, the banks should establish a clear punishment-incentive mechanism for officials to follow so as to clarify the accountability and responsibility in lending practices.

In addition, the appointment mechanism of management members of banks shall also be changed in accordance with commercial standards. Currently, the management members of bank's headquarters as well as branches are all appointed by Chinese government. Therefore, in order to keep the current management position or to seek new appointment, the officials within the banks have to try their best to satisfy the government's various kinds of requirements, including making unreasonable loans to government projects.<sup>245</sup> Considering this situation, China needs to gradually relax appointment power of human resource of banks in the way that banks can operate independently from the government entities as a commercial entity in the market.

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<sup>243</sup> *China Plans to Establish Social Credit System Within Five Years*, PEOPLE'S DAILY (Sept. 20, 2003), [http://english.peopledaily.com.cn/200309/20/eng20030920\\_124585.shtml](http://english.peopledaily.com.cn/200309/20/eng20030920_124585.shtml).

<sup>244</sup> *China to Set Up Social Credit System*, XINHUA NEWS (Oct. 20, 2011), [http://www.china.org.cn/china/2011-10/20/content\\_23674263.htm](http://www.china.org.cn/china/2011-10/20/content_23674263.htm).

<sup>245</sup> 杨盛昌 (Yang Shengchang), 国有商业银行不良资产体制性成因探究 [*The Systematic Reasons for Chinese Commercial Banks' NPL Problem*], J. YUNNAN NATIONALITIES U. (Social Sciences), no. 1 at 101, 103 (2011).

With the joint efforts of banks and the Chinese government, banks should be in a better position to avoid generating large amount of new NPLs.

### 5.2.2 Allowing Banks to Establish Financial AMCs

In the near future, the Chinese authorities may consider allowing the banks to get involved in the process of resolving NPLs. Even the four AMCs have more than twelve years' experience of NPL resolution; more than 60% percent of the banks still believe that the banks have the better or similar capacity in NPL resolution.<sup>246</sup> This suggests that banks have the confidence of resolving NPLs by themselves.

Generally speaking, financial AMCs could be established by the government, the banks or the individual investors.<sup>247</sup> In some countries, such as Korea and Japan, financial asset management companies (FAMCs) were solely established by the government.<sup>248</sup> However, in other countries, besides the government, they also allow the banks or individual investors to establish financial AMCs. For example, the banks in Sweden and the individual investors in Thailand are allowed to establish financial AMCs. In both countries, the governments established separate financial AMCs as well.<sup>249</sup>

#### 5.2.2.1 Sweden's Experience

Sweden adopted a flexible approach in its resolution of non-performing assets (NPA).<sup>250</sup> The government established state-owned asset management company-SECURUM in 1992, and at the same time, it allowed the banks to establish their own FAMCs.<sup>251</sup> For example, its banks like SEB established DILIGENTIA, SHB established

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<sup>246</sup> 2009 ORIENT REPORT, *supra* note 69, at 42.

<sup>247</sup> LI JIANNAN, *supra* note 111, at 30.

<sup>248</sup> *Id.*

<sup>249</sup> *Id.*

<sup>250</sup> *Id.* at 35.

<sup>251</sup> *Id.*

NACKEBRO, SWEDBANK established TORNET.<sup>252</sup>

Sweden's two state-owned asset management companies performed very well, SECURUM took only four years to resolve the NPLs which were supposed to be resolved within ten years.<sup>253</sup> This good result largely contributes to the banks' active involvement in the NPL resolution process through their respective FAMCs.<sup>254</sup> Sweden's experience demonstrates that it is feasible to use FAMCs established by banks.

### 5.2.2.2 FAMCs Established by the Government vs. FAMCs Established by the Banks

FAMCs established by the banks have their own advantages and disadvantages. Financial AMC established by the government can separate the NPLs from the banks by purchasing the NPLs from the banks. This kind of separation has the following advantages:

First, it can help the banks keep good balance sheets and also ensure the managing teams of the banks to focus on the business development of the banks.<sup>255</sup> Second, it is easier for the market to evaluate the value of banks so as to decide when the banks need to raise new capital.<sup>256</sup> Third, it gives the banks incentive to enhance the borrowers' credit management after the NPLs are written off the banks' books. Financial AMCs are in a better position to collect on "delinquent loans" since they do not need to consider the prior business relationship between the banks and the borrowers.<sup>257</sup> Fourth, it puts together all the NPLs in a large pool, which increases the possibility of resolving similar NPLs in a large scale as well as facilitates the possibility of using the method of asset securitization.<sup>258</sup>

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<sup>252</sup> *Id.*

<sup>253</sup> *Id.*

<sup>254</sup> *Id.*

<sup>255</sup> David Woo, *Two Approaches to Resolving Non-performing Assets During Financial Crisis* 9 (IMF Working Paper, WP/00/33, 2000), <http://www.imf.org/external/pubs/ft/wp/2000/wp0033.pdf>.

<sup>256</sup> *Id.*

<sup>257</sup> *Id.*

<sup>258</sup> *Id.*

Fifth, compared to a single-claim holder, financial AMCs may gain stronger bargaining power by collecting multiples claims against the same debtor together, especially when the “credits are scattered in the system” and “collateral is pledged to multiple creditors,” and “the size and the clout of the debtor are large relative to the banks.”<sup>259</sup>

However, FAMCs established by the governments have the following disadvantages: first, after separating NPLs from the banks, it is hard for the FAMCs to get transparent information regarding the debtors as well as the loans.<sup>260</sup> Second, because the debtors do not rely on the FAMCs for new lending, the debtors lack incentive to cooperate with FAMCs in NPL resolution. By contrast, if the NPLs remain with the banks, the debtors will more likely cooperate with the banks in order to obtain new lending.<sup>261</sup> Third, because of lack of transparent information from borrowers, it is very hard for the FAMCs to set forth a reasonable pricing level for the NPLs when acquiring the NPLs from the banks or when resolving the NPLs—e.g., if the FAMCs seek to sell the NPLs.<sup>262</sup> Fourth, government-established FAMCs normally directly or indirectly receive financing from the government and the managing teams are also designated by the government, therefore, it is inevitable that they will be influenced by the political pressure.<sup>263</sup> Fifth, it will take a long time for the government-established FAMCs to build up professional teams with the financial expertise and the relevant skills in NPL resolutions.<sup>264</sup>

In contrast, FAMCs established by banks could avoid the disadvantages of FAMCs established by the government. Remaining as a subsidiary of the banks, FAMCs established by banks can still enjoy the comprehensive information system of the banks regarding the loans as well as the debtors to set forth a reasonable price of the NPLs.

With the sufficient information about the debtors, banks are in a

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<sup>259</sup> *Id.* at 10.

<sup>260</sup> *Id.* See also Huang Linhuang, *supra* note 194.

<sup>261</sup> Woo, *supra* note 256, at 10.

<sup>262</sup> *Id.*

<sup>263</sup> *Id.*

<sup>264</sup> *Id.*



better position to enforce certain rights under the original loan contracts. For example, banks are in a better position to timely enforce some of their rights under PRC Contract Law, such as the subrogation right (*dai wei quan*) and the cancellation right (*che xiao quan*) of creditors. The subrogation right of creditors enables creditors to enforce the debtor's claiming rights with another third-party, and the cancellation right of creditors enables creditors to petition the courts to cancel the debtors' assignment of assets to another third party with an unreasonable low price, thus harming creditors' right.<sup>265</sup> The enforcement of both rights sets forth the precondition that the creditors need to have sufficient information regarding the debtors' assets. In this regard, banks are in a better position because when the banks issued loans to the debtor, they should have conducted sufficient due diligence, in which they were given the chance to acquire debtor's information. Banks can share this information with FAMCs established by the banks.

Furthermore, FAMCs could use the expertise of the banks' management teams to structure different kinds of NPL resolution methods, such as restructuring or workouts. In the meantime, it can ensure that the debtor will most likely to cooperate since it needs further lending from the banks.

Nevertheless, FAMCs established by the banks lose the advantages enjoyed by the FAMCs established by the government. For example, because banks simply transfer rather than sell NPLs to FAMCs established by themselves, NPLs are still reflected on the banks' balance sheets and the banks are still exposed to the loss from the NPLs.

### 5.2.2.3 How to Use the Two Different Approaches

To some extent, the two approaches of establishing FAMCs complement each other with their different advantages and disadvantages. Considering this particular feature, we should use the two approaches in appropriate situation so as to make use of their benefits and avoid their

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<sup>265</sup> Contract Law, arts. 73 & 74.

disadvantages.

Therefore, when the NPLs are too large to exceed the banks' capacity and there are a lot of very low-quality NPLs which are very hard for the banks to resolve by themselves, it is better to transfer those NPLs to the government-established FAMCs. FAMCs are in a better position to expedite the NPLs and save the banks from bad balance sheets in a short time.

However, when the NPL ratio does not exceed the capacity of the banks and the NPLs are of good quality, such as where there is sufficient collateral backing the loan or the debtors having the potentials to revitalize after restructuring, it is better to leave these NPLs with the FAMCs established by the banks. The banks are in a better position to maximize the value from this type of NPLs. In addition, the banks can flexibly decide whether they need to expedite or slow down the disposition of NPLs.

### **Conclusion**

Based on assessment of the current legal and regulatory regime of China for NPL resolution from the dimensions of the two-level markets, this paper finds that there are different problems imposed by the legal and regulatory regime in the two-level market.

For the primary market, China has made efforts to reform the regulatory structure for banks. For example, China revised Law of the People's Republic of China on Commercial Banks in 2003 to enhance the banks' adoption of market disciplines, and China adopted Law of the People's Republic of China on Enterprise Bankruptcy in 2007, which brought banks within the bankruptcy regime with the supervisory authorities' approval.

However, the legal and regulatory reform does not help the banks reduce generation of large amount of new NPLs, especially following the lending spree during and post the 2008-2009 financial crisis. This reveals

that first, the historical practice of making policy loans continues to play a role in banks' practices; and second, the bankruptcy system is not practical to make banks to bankruptcy.

For the secondary market, the legal and regulatory regime has major three features: first, there is a diversified supervisory structure comprising of many government entities to supervise the banks, which creates problems such as contradictory overlapping supervision; second, there is no unified law for AMCs, and major legal instruments concerning NPLs are not laws but administrative regulations, rules, or notices, guidelines and opinions issued by the supervisory entities, which creates the problems such as changing from time to time and reducing the predictability for the market participants; third, there is an unsatisfactory judicial system in China which impedes AMCs' resolution of NPLs through court proceedings.

Because of the features of legal and regulatory regime for the secondary market, AMCs, as the major participant in the secondary market, have not performed very well since the establishment in 1999. Considering the expected new NPLs in the coming year, it is uncertain whether AMCs can shoulder the responsibility of resolving NPLs and saving state-owned banks from another round of NPL problem.

With this in mind, this paper argues that certain reforms should be made to better handle the NPL problem in China. In the short-term, China should try to improve the function of the existing AMCs, focusing on the internal improvement of AMCs' management and the external improvement of the judicial system and the legal environment for AMCs. In the long-term, China should try to enhance the banking system's adoption of market disciplines so as to reduce new generation of NPLs.

In view of the advantages and disadvantages of the approaches of establishing the FAMCs by the government or by the banks, it is also suggested that the Chinese government should consider using the two approaches to complement each other. China may allow banks to establish their own FAMCs to resolve NPLs with good conditions for

recovery, and then leave FAMCs established by the government to resolve NPLs with bad conditions for recovery. When there are both good NPLs and bad NPLs in banks, the NPLs should be split up according to their quality and then banks can decide whether the given NPLs should be transferred to a FAMC established by the government or a FAMC established by banks.