Supervision over and Regulation of Operating Leasing: Principles and Directions

Luo Ping，Senior Research Fellow at NIFD

Highlights

- On January 8, the China Banking and Insurance Regulatory Commission released the *Interim Supervisory and Regulatory Rules on Operating Leasing Companies (Draft for Comments)* to solicit public opinions. This document contains 55 clauses in six chapters, including general provisions, operation rules, regulatory indicators, supervision and regulation, legal liabilities and supplemental provisions. This article offers a detailed interpretation on the clauses of the document, focusing on the business scope and prudential regulatory indicators.

- The document says little about the industry's development and largely references the regulatory approach for commercial banks without accommodating the industry's uniqueness. The draft should be continuously improved by including regulatory requirements that reflect the industry's characteristics.

- Under the current central-local two-tier regulatory framework, local financial regulators must be equipped with adequate regulatory muscle to perform day-to-day supervision, especially classified supervision.

Participants in China's financial leasing industry include operating leasing companies and financial leasing companies, which used to be subject to the regulation of the Ministry of Commerce and the then China Banking Regulatory Commission (CBRC), respectively. On April 20, 2018, the newly formed China Banking and Insurance Regulatory Commission (CBIRC) took over regulatory responsibilities for operating leasing companies, commercial factoring companies and pawn-broking business from the Ministry of Commerce.

The CBIRC is vested with powers to draft regulatory rules on operating leasing business, and local financial regulators are responsible for implementation. Such division of responsibility can be seen as a form of separate regulation and supervision, which makes sense in light of the numerous operating leasing firms in China with uneven levels of development. Over the years, Chinese financial regulators have followed the principle of equal powers and responsibilities, highlighting regulatory duties at the local level.

Recently, the CBIRC released the *Interim Supervisory and Regulatory Rules on Operating Leasing Companies (Draft for Comments)* as the first step for effectively regulating the financial leasing industry.

Specifically designed for the operating leasing industry, the document aims to enhance

functional regulation as the National Financial Work Conference emphasized in 2017, i.e. the regulatory policy orientation, business rules and standards should be consistent for the same type of business to avoid uneven regulatory criteria for different market entities that beget regulatory arbitrage.

Compared with the *Supervisory and Regulatory Rules on Operating Leasing Enterprises* released by the Ministry of Commerce in 2013, the *Draft for Comments* has expanded the regulatory chapter. In terms of business scope, rules on business operation and supervision and regulation, the *Draft for Comments* is generally consistent with the *Rules on Financial Leasing Companies* released by CBIRC in 2014. As CBIRC-licensed non-banking financial institutions, financial leasing companies are subject to a high industry access threshold and stringent business regulation, higher than those for *operating* leasing companies. There are only 70 financial leasing companies in China, most of which are sponsored by commercial banks.

Judging by the content of this *Draft for Comments*, there are differences between *financial* leasing companies and *operating* leasing companies in terms of business scope, regulatory indicators, classified regulation and legal responsibilities. Such differences will continue to exist for a long time since many of the nearly 10,000 operating leasing companies in China are "empty-shell companies," which must be cleared out if the industry is to develop healthily. Market clearing also creates a condition for unifying regulatory rules on the two types of leasing companies. The newly released *Draft for Comments* is succinct and involves numerous issues, but may require implementing rules in some respects to make it more operational. Here, I would like to share some of my opinions on the specific clauses of the *Draft for Comments*.

1. Scope of Operating Leasing Business

The *Draft for Comments* reflects China's banking regulatory approach, i.e. commercial banks with the same license may vary in their actual business scope, and some services require regulatory approval; no bank may offer unlicensed services.

Specifically, the *Draft for Comments* stipulates that operating leasing companies may run five items of business, including operating leasing and fixed-income securities investment, which allows them to diversify business portfolio and improve profit mix. It is also conducive to their capital management efficiency and liquidity management.

The *Draft for Comments* also creates a negative list prohibiting operating leasing companies from engaging in certain businesses or activities such as fundraising, acceptance of public deposits in explicit or disguised forms, issuance or entrusted issuance of loans; lending or borrowing with other operating leasing companies; raising funds or transferring assets through online lending intermediaries, private equity investment funds, among other channels.

In my opinion, the negative list may not apply to the financial sector. Since the permitted types of services are specified already, the case for a negative list appears weak.

Take the banking sector for instance, a bank must apply to the regulator for approval if it wishes to engage in anything beyond the 14 basic businesses. For instance, it needs to apply for a special license for any of the following services: forex business or additional types of forex business, debt raising and issuance, capital supplement instruments, derivatives trading, and offshore banking business.

2. Prudential Regulatory Indicators for Operating Leasing Companies

Compared with the regulatory regime for commercial banks, the *Draft for Comments* prescribes uneven regulatory indicators for operating leasing companies. Overall, these indicators are relatively appropriate, highlighting a problem-oriented approach for the leasing sector. Based on the comments and suggestions received from the industry, the CBIRC may modify some indicators. Here, I would like to focus on the following indicators:

(1) The ratio of leasing assets: Operating leasing and other leasing assets must account for no less than 60% of the total assets of an operating leasing company. The background for this requirement is that some big firms have set up captive leasing companies that behave more like commercial factoring companies: commercial factoring accounts for a similar or higher share as leasing service in their business portfolio. Thus, it is necessary to regulate the ratio of leasing assets. Fixed-income securities investment should not exceed 20% of an operating leasing company's net assets. In accordance with the principles set forth at the Central Financial Work Conference, these two requirements are intended to ensure that financial leasing companies focus on their main business, serve the real economy with better quality and efficiency, and reduce business concentration by diversifying business portfolio or offering subleasing service, and to prevent big firms from engaging in capital operations by setting up captive leasing companies.

(2) Leverage multiple: The risky assets of an operating leasing company should not exceed eight times of its net assets. Total risky assets are a company's total assets minus cash reserves, bank deposits and Treasury bond holdings. This rule reflects the guiding opinions the State Council General Office released in 2015 on expediting the operating leasing industry's development and improving the risk-based regulatory system underpinned by capital regulation.

Ostensibly, this indicator is below the capital regulation standard for financial leasing companies, but on a closer look, the two are different by nature. **While the former is a leverage ratio, the latter is risk-linked capital adequacy ratio.** According to the regulation, the ratio of a financial leasing company's net capital to risk-weighted assets must stay above the CBIRC's minimum regulatory requirement. In fact, the 10.5% risk-weighted capital adequacy ratio requirement applies to financial leasing companies as they do to commercial banks (for details, please refer to the *Measures for the Capital Management of Commercial Banks* of 2012: "these *Measures* shall apply mutatis mutandis to policy banks, financial asset management companies, rural cooperative banks, rural credit unions, village and township banks, corporate financial companies, financial leasing companies, auto-finance companies and consumer finance companies").

Leverage ratio is a simple regulatory indicator for capital adequacy. The *Draft for Comments* prescribes a simple leverage multiple while avoiding the 10.5% minimum capital adequacy ratio requirement - an indicator reflecting the capital, credit, market and operational risks of commercial banks. The minimum leverage ratio requirement for commercial banks is 4%, which is equivalent to a leverage multiple of 25 times. At the end of 2018, the 33 listed commercial banks in China recorded an average leverage ratio slightly above 6%, and the highest was 8.7%. Yet regulators still highlight the importance for small and medium-sized banks to further replenish capital adequacy ratio via various avenues. To what extent a leverage ratio is prudent depends on how it is calculated. As the numerator, the net capital of a leasing company is akin to Tier 1 capital for a commercial bank. On the denominator side, a leasing company's risky assets are smaller in scope than those for a commercial bank, and after some deductions, do not take into account the balances of derivative assets and securities financing assets. As such, operating leasing companies tend to have higher leverage multiples. The regulatory requirement that risky assets should not exceed eight times of net assets is not demanding and still has room to be more stringent. The current practice of international banking regulation is to follow a simple approach for capital regulation, such as using leverage ratio rather than risk-linked capital adequacy ratio, to raise the ratio of minimum capital requirement to ensure prudent and reasonable capital regulation.

(3) Asset classification and reserve fund. The *Draft for Comments* provides that an operating leasing company shall create an asset quality classification system and a reserve fund system and, on the basis of accurate classification, make timely and full provisions for losses on asset depreciation to boost risk resilience. Notably, the CBIRC follows the same regulatory requirement for financial leasing companies, i.e. "A financial leasing company shall comply with the five-category risk assets classification system. A financial leasing company shall put in place the bad debt provisioning system and promptly set aside adequate provisions for bad debts. It shall not make profit distribution before the provisions are adequately set aside." Although the loan classification guidelines for commercial banks released in 2007 are not applicable to non-banking financial institutions, the *Interim Measures for the Financial Asset Classification of Commercial Banks (Draft for Comments)* released in 2019 is applicable mutatis mutandis to other financial institutions regulated by the CBIRC.

There are two options for an operating leasing company to make provisions. The first option is to follow both the *Regulatory Measures for the Loan Loss Reserves of Commercial Banks* promulgated by the then China Banking Regulatory Commission (CBRC) in 2011, which is applicable mutatis mutandis to banking financial institutions other than commercial banks, and accounting standards at the same time. Specifically, an operating leasing company shall follow the accounting standards of 2007 and implement the accounting standards revised in 2017 effective starting from 2021. The other option is to follow the new accounting standards only, which require companies to divide financial assets into three categories instead of five as is the case for banks. Financial assets overdue for 90 days are deemed as Class III non-operating assets or bad assets, and reserves for Class III financial assets should be made following the expected loss method. **Please be reminded that** overseas listed Chinese banks already started to implement the new accounting standards since last year and have set aside additional reserves worth a total of about 300 billion yuan. The message is that

the new accounting standards are more stringent than the 2.5% loan loss reserves to gross loss ratio (LLRGL) and the 150% provisioning coverage ratio stipulated by the then CBRC in 2011. Practicality aside, those requirements would put a heavy financial strain to many operating leasing firms. Regulators must consider and prescribe how commercial banks and other financial institutions including leasing companies may choose between the two sets of reserve systems.

(4) Concentration and related transactions: The *Draft for Comments* also stipulates the financing concentration for a single lessee and its related parties to effectively prevent and scatter operational risks. For instance, an operating leasing company's balance of operating leasing business for a single lessee shall not exceed 30% of its net assets. The same ratio also applies to related parties. Compared with loan concentration and related lending requirements for commercial banks, the 30% ratio for leasing companies is much more relaxed considering their characteristics and risk profiles.

(5) Classified regulation at the implementation level: The *Draft for Comments* does not specify any explicit criteria for classifying leasing companies. Instead, it requires local financial regulators to implement classified regulation based on the business size, risk profile and internal management of operating leasing companies. Without specifying any classification criteria, **it only requires classified regulation at the implementation level, putting a premium on risk profile.** Classified regulation, though easier to perform at the implementation level, requires regulators to exercise sound discretion. Inspections should be more extensive and frequent for riskier institutions and less so for those that appear less risky. Such is the "risk-based regulation" that is distinguished from traditional compliance-based regulation.

3. Regulatory Challenges

The *Draft for Comments* is not without flaws. **First, it offers little incentives for industry development other than holding the government at all levels responsible for drafting supporting policies.** The 19th CPC National Congress has identified "three tough battles", i.e. preventing major risks, reducing poverty and fighting pollution, in the three-year run-up to achieving the goal of moderate prosperity in all respects. Given the foremost priority of risk prevention, recent regulatory systems tend to be more stringent than before. Yet there should be a policy directive on encouraging the industry's development. **Second, the regulatory approach for leasing companies is largely modelled after that for commercial banks in spite of their fundamental differences.** There is great room for improving the regulatory system by accommodating the leasing industry's uniqueness.

Let us review the history of banking regulation in China. When the then CBRC was unveiled in 2003, there was little coordination in the nation's banking regulatory systems for state-owned banks, joint-stock banks, rural banking financial institutions and foreign banks. After more than a decade of legislative efforts, the CBIRC published the *Compendium of China Banking Regulations and the Supervisory Rules*, a 2,240-page tome. in 2019, which contains a total of 713 legislative and regulatory documents. Among them, there are about

2,000 pages on regulations of commercial banks, 200 pages on regulations of rural small and medium-sized financial institutions, and 110 pages on regulations of six categories of nonbanking financial institutions, including financial leasing companies (five documents, six pages in total). Obviously, the complete range of banking regulations may provide reference for regulating non-banking institutions. Specific rules for non-banking institutions take time to draft and require a high degree of industry sophistication. The leasing industry may work with regulators to enhance regulatory compatibility and effectiveness, recognizing the industry's differences from banks. Fortunately, the CBIRC's recent regulatory systems have put a premium on the principle of compatibility, particularly with respect to the regulation of capital and liquidity risks.

As such, we should place more realistic expectations about regulatory sophistication for the operating leasing business. While rules for commercial banks may be referenced initially, regulators should come up with more industry-specific requirements in the long run. Under the current central-local two-tier regulatory framework, it is important that local financial regulators are equipped with adequate regulatory resources to enforce day-to-day industry supervision, particularly classified supervision. In the spirit of perseverance and professionalism, we should keep improving financial regulatory systems and enhance regulatory effectiveness without letup.