

Case Analysis of Bankruptcy of Baoshang Bank

Wantong Pei^a

College of Law, Australian National University, Canberra, 2600, Australia
^awantongpei@Gmail.com

Keywords: Baoshang Bank; Bankruptcy System; Corporate Governance

Abstract: This article analyzes the bankruptcy case of Baoshang Bank and draws the following conclusion: Firstly, the root cause of Baoshang Bank's bankruptcy is the hollowing out of major shareholders. Under the continuous occupation of Tomorrow Group, the three meetings and one layer of Baoshang Bank had not played a good role. Secondly, Baoshang Bank also faced problems such as non-standard information disclosure, chaotic salary system, and abuse of power by management, which have led to serious problems in corporate governance. In addition, the external regulatory authorities did not take timely measures to address the internal issues of Baoshang Bank, which is also one of the important reasons why Baoshang Bank ultimately went bankrupt.

1. Introduction

After the reform and opening up, the Chinese economy has developed rapidly, and the scale of small and medium-sized commercial banks has also grown rapidly. In recent years, events such as the closure of Hainan Development Bank due to inability to repay debts have all reflected the risk exposure of commercial banks in China. Due to the unique asset liability structure of small and medium-sized commercial banks, their healthy development cannot be achieved without a sound corporate governance system. Based on this background, this article takes the bankruptcy of Baoshang Bank as a case study, analyzes and summarizes it from the perspective of corporate governance, and puts forward some relevant suggestions for the governance system of small and medium-sized commercial banks.

The first part of this article is an introduction. In the second part, this article starts from the background overview of Baoshang Bank, introduces its corporate governance before bankruptcy, and analyzes and summarizes its process of takeover and bankruptcy. The third part of this article summarizes the fundamental reasons, internal reasons, and external reasons for the bankruptcy of Baoshang Bank. In the fourth section, it concludes.

2. Introduction to the Bankruptcy Case of Baoshang Bank

2.1 Overview of the background of BaoShang Bank

The predecessor of Baoshang Bank was Baotou Commercial Bank, established on December 28, 1998, with its headquarters located in Baotou City. It was the earliest regional joint-stock commercial bank established in Inner Mongolia Autonomous Region. After Chairman Zhenxi Li

took office, he expanded the business scope of Baoshang Bank to developed cities such as Beijing and Shenzhen, and also established Baoshang Consumer Finance Company, Small Enterprise Financial Service Center, and 29 rural banks. At the same time, Baoshang Bank was one of the first seven city commercial banks with the lowest risk rated by the China Banking Regulatory Commission, and its regulatory risk rating had remained at level two in recent years[1].

However, in recent years, the risks of Baoshang Bank have begun to be exposed. While Baoshang Bank's loan disbursement growth rate continued to accelerate, its deposit absorption growth rate was slowing down, leading to a continuous increase in its asset liability ratio. Secondly, the non-performing loan ratio of Baoshang Bank had continued to rise in recent years, which also indicated that Baoshang Bank had encountered operational problems. In addition, in terms of regulatory indicators for commercial banks, the core Tier 1 capital adequacy ratio and capital adequacy ratio of Baoshang Bank were able to meet the regulatory requirements of non systemically important banks before and in 2016. Starting from 2017 when the financial reports were self disclosed, Baoshang Bank's core Tier 1 capital adequacy ratio and capital adequacy ratio began to fall below regulatory requirements, reflecting the weakening of Baoshang Bank's debt repayment ability. On May 24, 2019, Baoshang Bank was officially taken over by the People's Bank of China and the China Banking Regulatory Commission. In 2020, Weishang Bank and the newly established Mengshang Bank respectively acquired and undertook the relevant business, assets, and liabilities of Baoshang Bank's headquarters and various branches. On November 23, 2020, the China Banking Regulatory Commission approved Baoshang Bank to enter bankruptcy proceedings[2].

2.2 Corporate Governance of Baoshang Bank

2.2.1 Equity structure

The equity structure of Baoshang Bank was changing every year. Baoshang Bank conducted two shareholder dividends to increase its share capital in 2002 and 2005, respectively. Through further investigation, it can be found that 7 of Baoshang Bank's shareholders in 2005 were related to Tomorrow Group, such as Grassland Sugar Industry and Tomorrow Technology. Since 2011, Baoshang Bank's annual report had only disclosed the top ten shareholders. According to the 2016 annual report of Baoshang Bank, Baotou Taiping Trading Group Co., Ltd. held the most shares, with a shareholding ratio of 9.07%, followed by Da'an Investment, which holds 5.51% equity, and Jinggong Technology, which held 5.32% equity. Except for the top three shareholders, all other shareholders held less than 5% of the shares. However, further investigation of the top ten shareholders revealed that they all had a certain relationship with New Era Trust, which was a financial company controlled by Tomorrow Group. Therefore, both the 2005 and 2016 annual reports have showed abnormal shareholder situations in Baoshang Bank.

2.2.2 Market exit process for Baoshang Bank

After two consecutive years of undisclosed annual reports, on May 24, 2019, the China Banking Regulatory Commission announced the takeover of Baoshang Bank, stating that the reason was that Baoshang Bank had serious credit risks and entrusted its business to China Construction Bank. The Deposit Insurance Fund Management Company was officially established on the same day. After being taken over, the asset inventory and reform and restructuring of Baoshang Bank had steadily progressed.

On June 7, 2019, the Deposit Insurance Fund Management Company completed the acquisition and transfer of Baoshang Bank's large debt. On November 16th of the same year, the asset and

capital verification work of Baoshang Bank was basically completed[3].

On April 30, 2020, the Mongolian Commercial Bank, initiated by institutions such as Huishang Bank, Deposit Insurance Fund Management Company, and China Construction Bank, was established and would undertake the relevant assets, liabilities, and business of the head office and branch offices that were not guaranteed by the Deposit Insurance Fund Management Company.

On November 11, 2020, Baoshang Bank was deemed to have experienced an "inability to survive trigger event". On November 13, it fully reduced the principal of the "2015 Baoshang Bank Secondary Bond" by 6.5 billion yuan and would no longer pay any accumulated payable interest that has not been paid.

On November 23, 2020, the China Banking Regulatory Commission agreed to allow Baoshang Bank to enter bankruptcy proceedings, and the application for bankruptcy liquidation of Baoshang Bank will be accepted by the Beijing First Intermediate People's Court.

China tends to actively assist and rescue banks in dealing with problems, which was also reflected in the takeover of Baoshang Bank by the central bank. In the selection of exit methods for problematic banking markets, administrative mergers and administrative revocations are often used. In the disposal of Baoshang Bank, Baoshang Bank was officially filed for bankruptcy and was officially ruled bankrupt by judicial authorities[4].

3. Analysis of Corporate Governance in Baoshang Bank

3.1 Problems in Corporate Governance

3.1.1 Imbalance of equity structure

When Baoshang Bank was established in 1998, its registered capital was 143.801 million yuan. After experiencing two shareholder dividends to increase share capital, its registered capital increased to 179.6739 million yuan. Tomorrow Group controlled Baoshang Bank through its shadow company and became the controlling shareholder of Baoshang Bank. At the end of 2005, among the top eight shareholders of Baoshang Bank, only Baosteel Comprehensive had no association with Tomorrow Group, while the other seven companies were shadow companies of Tomorrow Group. Therefore, Tomorrow Group controls 65.58% of the shares of Baoshang Bank.

Therefore, from the perspective of equity structure, the shareholders of Baoshang Bank were relatively single and highly concentrated, completely controlled by Tomorrow Group. On the surface, the shareholding ratio of all shareholders of Baoshang Bank met the standards set by the China Banking Regulatory Commission for the shareholding ratio of major shareholders, but in reality, the equity of Tomorrow Group had actually reached 89.27%. However, the cumulative shareholding ratio of other shareholders was only about 10%, which made it difficult to form an effective balance for the major shareholders of Baoshang Bank.

3.1.2 Unreasonable management structure

Baoshang Bank also faced issues in internal management such as the failure of the board of directors and supervisory board to play a role, management neglecting the company's system, and a lack of compliance management departments.

Zhenxi Li, the Chairman of Baoshang Bank, had been serving as the President since 2002, and six years later, he had been serving as the Party Secretary and Chairman of Baoshang Bank. He was responsible for operating and managing banks and other institutions under Tomorrow Group, and had also served as the Vice President of Tomorrow Holdings, a listed company under Tomorrow Group. On the premise that Tomorrow Group fully controlled Baoshang Bank, coupled with Zhenxi

Li's dual roles as chairman and party secretary in the early stage, the overall operation of Baoshang Bank was only carried out under the command of Zhenxi Li.

The board of directors of Baoshang Bank consists of 14 directors, but a large number of directors did not participate in decision-making on major issues of the company. And due to the excessive power of the chairman, the power of the board of directors was undermined. The board of directors of Baoshang Bank had 8 committees, including risk management and related party transaction control. However, these committees did not play a professional role, and the relevant personnel actually violated professional ethics by assisting Baoshang Bank in related party transactions. This rendered the board of directors nominal and lacked substantive significance[5].

3.1.3 Potential credit risks

By analyzing the main credit risks of Baoshang Bank, it can be found that there was a risk of insolvency. Firstly, banks themselves are a highly indebted industry, but excessive debt also reflects the bank's susceptibility to credit risks. The asset liability ratio of Baoshang Bank showed an overall upward trend from 2013 to 2017, and the growth rate significantly accelerated in 2017. This indicated that Baoshang Bank's operations are increasingly reliant on liabilities.

Secondly, the maturing debt of Baoshang Bank had rapidly increased from 1.7 billion yuan in 2015 to 123.91 billion yuan in 2018. Then, the debt maturity scale of Baoshang Bank further increased, reaching 126.434 billion yuan in 2019. This indicated that the liquidity of Baoshang Bank was increasingly dependent on liabilities, especially short-term liabilities. As of September 2017, Baoshang Bank had only RMB 42.046 billion in cash and funds deposited with the central bank, far less than its liabilities and insufficient to repay its maturing debts.

In addition, since 2014, the net profit growth rate and operating revenue growth rate of Baoshang Bank had shown a significant downward trend. As of September 2017, Baoshang Bank's net profit had begun to show negative growth. This indicated a decline in the operational capacity of Baoshang Bank[6].

3.1.4 Delayed information disclosure

Through the analysis above, it can be found that the top ten shareholders of Baoshang Bank were all related to Tomorrow Group, but the information disclosed in its annual report indicates that there was no association between the top ten shareholders of Baoshang Bank, and the bank had no significant transactions. There was no mention of the important information of Tomorrow Group's shareholding in the annual report. In addition, on April 28, 2018 and June 28, 2018, Baoshang Bank issued announcements to "postpone disclosure" and "temporarily withhold disclosure" of its 2017 annual report on the grounds of possible changes in equity. At the same time, regulatory authorities had not taken measures to address the non-standard disclosure of information by Baoshang Bank, indicating that there was also non-standard practice by regulatory authorities.

3.2 Reasons for Bankruptcy of Baoshang Bank

3.2.1 Root cause

As mentioned earlier, Baoshang Bank had the problem of "one shareholder dominating", and its major shareholder was Tomorrow Holdings Limited (Tomorrow Group). Tomorrow Group continuously established subsidiaries and joint ventures through its subsidiaries, making it difficult for these companies to see any connection with Tomorrow Group. Tomorrow Group regarded Baoshang Bank as a tool in its banking field, continuously exporting Baoshang Bank's funds through seemingly legal means, which had led to Baoshang Bank becoming Tomorrow Group's

fund pool. The funds exported by Tomorrow Group from Baoshang Bank had grown from the initial several billion yuan to the final 156 billion yuan, mainly because the funds lent by Baoshang Bank to Tomorrow Group had not been recovered. Tomorrow Group was not incapable of repayment, but had used Baoshang Bank as a financing tool with no intention of repayment. This had further worsened the financial data of Baoshang Bank, led to an increasing non-performing asset ratio, intensified credit risk, and ultimately led to its bankruptcy[7].

3.2.2 Internal reasons

Through carefully planned personnel relationships, Baoshang Bank was firmly controlled by Tomorrow Group. The governance phenomenon of both major shareholder control and insider control had emerged within Baoshang Bank. In 2002, Zhenxi Li was appointed as the President of Baoshang Bank. Although his position has changed since then, he had remained the actual internal controller of Baoshang Bank. In addition, Zhenxi Li also served as the Vice President of Tomorrow Holdings in Tomorrow Group, so he was actually the agent of Tomorrow Group. Zhenxi Li, as the agent of Tomorrow Group, provided convenience for Tomorrow Group to empty the contractor bank. Therefore, the collusion between insiders and major shareholders of Baoshang Bank had seriously harmed the interests of small and medium-sized shareholders. Secondly, the organizational structure and functions of Baoshang Bank under his management had completely failed, and the board of directors was virtually non-existent. Moreover, the professional committees and supervisory board under the board of directors did not have the supervisory and management role they should have. Moreover, under the management of Zhenxi Li, the corporate culture of Baoshang Bank was distorted, and grassroots employees ignored compliance and risk control requirements when issuing credit, only focusing on whether performance can be improved, which increased the operational risks faced by Baoshang Bank.

3.2.3 External reasons

At the same time, changes in the external environment were also affecting small and medium-sized commercial banks. In recent years, China has been steadily promoting interest rate marketization. With the continuous deepening of reform, the profit space of small and medium-sized commercial banks was decreasing, and their survival space was constantly being squeezed. In order to improve profitability, many small and medium-sized commercial banks adopted to obtain deposits from peers at lower interest rates and invest them in non-standard assets with higher yields to obtain interest spreads. However, the proportion of deposits on the liability side of Baoshang Bank continued to decrease, while the proportion of deposits from peers and other financial institutions was on the rise. Since 2016, deleveraging had become one of the important goals of supply side structural reform, which requires small and medium-sized commercial banks to compress their liabilities. However, Baoshang Bank, which had a high proportion of liabilities in the same industry, did not shift its business focus as a result. From the 2019 interbank certificate of deposit issuance plan released by Baoshang Bank to the public, it could be found that its liabilities as of the end of the third quarter of 2018 were 503.4 billion yuan, of which interbank liabilities accounted for 43.92%, which was 221.1 billion yuan. This reflected that Baoshang Bank had a strong dependence on interbank funds and lacks market adaptability.

4. Conclusion

Baoshang Bank is the first bank in China to be administratively taken over since the reform and opening up, and also the first commercial bank in China to complete liquidation and exit through judicial bankruptcy procedures. This article analyzes the reasons for the bankruptcy of Baoshang

Bank and its corporate governance, and finds that the hollowing out of Tomorrow Group is the most fundamental cause of Baoshang Bank's bankruptcy. Tomorrow Group had achieved absolute control over Baoshang Bank by establishing a "shadow company" and indirectly holding 89.27% equity in Baoshang Bank. This had also led to many problems in corporate governance of Baoshang Bank, such as the ineffective board of directors. In addition, Baoshang Bank also faced issues such as chaotic salary systems and abuse of power by management in terms of corporate governance, which had led to the failure of Baoshang Bank's corporate governance.

The bankruptcy of Baoshang Bank has brought certain impacts to the banking market, warning small and medium-sized commercial banks to operate prudently and attach importance to the effectiveness of corporate governance. At the same time, this incident also serves as a warning to regulatory authorities to pay attention to the information disclosure of small and medium-sized commercial banks. In addition, the bankruptcy of Baoshang Bank has innovated the exit path of China's problematic banking market and established a deposit insurance fund management company, which has improved the institutional structure of China's deposit insurance system.

References

- [1] Chen Zhaofu, Cui Tengjie. *Research on the legal system of commercial bank bankruptcy in China* [J]. *Enterprise reform and management*, 2021 (15): 125-126
- [2] Demsetz H, Lehn K. *The structure of corporate ownership: causes and consequences* [J]. *Journal of Political Economy*, 1985, 93(6): 1155~1177.
- [3] Hu Yaolong. *Enlightenment to China's banking supervision from the perspective of three bankrupt banks* [J]. *Science and technology economic market*, 2021 (08): 75-77 + 81.
- [4] Liu Bingkun. *Case study on the bankruptcy of Baoshang Bank bank* [D]. *Hebei Institute of finance*, 2021
- [5] Huang can. *Research on the impact of shadow banking on the operational stability of Baoshang Bank banks* [D]. *Southwest Jiaotong University*, 2020
- [6] Ma Yanchao. *Case study on business crisis of Baoshang Bank bank* [D]. *Hebei University*, 2020
- [7] Xiao Yutong, Sun Yingjun. *Problems in the development of small and medium-sized banks in China from the Baoshang Bank bank incident* [J]. *Economic Research Guide*, 2019 (33): 101-102.