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Inquiry: Design of a Sustainable Financial System

ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 13: Establish the Legal Liability of Financial Institutions

This is a background paper to the report: *Establishing China's Green Financial System* published by the Research Bureau of the People's Bank of China and the UNEP Inquiry into the Design of a Sustainable Financial System.

Detailed recommendations 13:

Establish the Legal Liability of Financial Institutions

The Fourth Plenum of the 18th CPC Congress has called for "protection of eco-environment with a strict legal system, development of a legal system of ecological civilization that effectively restrains development activities and promotes green, circular and low carbon development, enhances the legal responsibilities of environmental protection on the part of producers, and significantly increases the costs of violations". We believe that the identification of environmental legal responsibilities of commercial banks should be an important component of a 'green legal system'.

By their corporate nature, commercial banks are profit-seeking and conscious of risk mitigation with the abilities to steer resources towards companies or projects with limited or controllable environmental risks and superior environmental performance. By regulating commercial banks and incorporating environmental impacts into their financial decision-making, it is possible to channel financial resources to those companies or projects that meet sustainability principles. In this sense, commercial banks are a key factor in the realization of sustainable development. Nevertheless, due to the absence of environmental legal responsibilities of commercial banks in China's current environmental and financial legislations, some commercial banks have invested in highly polluting sectors and projects such as iron and steel, cement and chemical industries due to high investment return or local government pressures. These banks have inescapable responsibilities for the environmental consequences of their investment decisions. In promoting green finance in China, it is natural to stipulate the environmental responsibilities of commercial banks for the environmental impacts of their investment projects. This report defines such legal responsibilities as the environmental legal responsibilities of commercial banks.

(I) Definition of environmental responsibilities of commercial banks

'Environmental legal responsibilities of commercial banks' refers to the legal liabilities to be assumed by commercial banks for environmental pollution caused by their mistakes committed in the process of loan issuance, which mainly includes the following two circumstances: first, commercial banks provide borrowers with credit extension and loans despite the knowledge that the borrowers are financing for polluting projects. Second, commercial banks are involved in the operation of the investment projects and wield a dominant influence over these projects. Of course, the environmental liabilities of commercial banks have another dimension of meaning, i.e. the environmental responsibilities that should be fulfilled by commercial banks in the process of their operation such as the use of environmentally friendly products, employment of electronic bills and classified waste management, but this dimension of meaning does not fall into the scope of environmental legal responsibilities of commercial banks to be discussed in this paper.

It is generally believed that the system of environmental legal responsibilities of commercial banks originates from the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) instituted by the US in 1980 to provide effective solutions for the clean up of hazardous matters left over from the development of petroleum and chemical industries in the 1960s and 1970s. In addition to the thorough, timely and effective clean up of hazardous wastes, the CERCLA also needs to ensure that the tremendous clean-up costs would be borne by responsible actors rather than taxpayers. For this purpose, the CERCLA put into place a system where all the costs must be borne by potential responsible actors including lenders that took part in the operation and management of borrowers. The liabilities assumed by potential responsible actors are referred to as the CERCLA liabilities and later extended to the environmental liabilities of lenders.

(II) Feasibility study for the establishment of environmental liabilities for commercial banks

1. Theoretical basis

Commercial banks have been called on to assume legal responsibilities for environmental impacts of their investment projects for the following two theoretical justifications: first, the 'polluter pays principle'; second, the theory of environmental public trust. The former refers to the responsibilities of organizations and individuals who cause pollution to clean up their pollution sources and polluted environment. From a legal perspective, this principle requires people to be responsible for their own actions. From an economic perspective, environmental management costs are imposed upon polluters to internalize environmental costs into product prices and reduce the 'tragedy of the commons'. After first proposed by the OECD in 1972, the 'polluter pays principle' has become a basic principle for environmental protection legislation of various countries. Generally speaking, polluter refers to industrial enterprises that emit pollutants but under the CERCLA, the concept of 'polluter' is extended to include lenders, operators, waste transporters and waste processors in order to follow this principle.

The theory of environmental public trust underscores that the environment is shared resources and public assets for all the people and cannot be wilfully occupied, dominated or damaged by anyone. In order to properly allocate and protect these 'common assets', the state should manage these assets on behalf of common owners. This theory transcends the framework of conventional legal theory and particularly property law and provides legitimacy for proactive state intervention of environmental protection. In this manner, empowerment of state intervention has effectively resolved the dilemma of whether the state has the power to intervene when land owners have polluted their own lands without infringing upon the rights and interests of others. Under the CERCLA framework, 'public trustees of natural resources' must be appointed, i.e. 'authorized representatives of the president or individual states shall claim compensation from polluters on behalf of the public trustees of natural resources'. That is to say, as the trustees of the environment, the president and executive officers of individual states have the rights to claim compensation and require environmental restoration and clean up and such rights represent a higher level of authority above conventional property rights. Establishment of environmental

public trusteeship and public trustees has led to a very different situation of environmental protection in the US: as the administrative department responsible for environmental protection, the Environmental Protection Agency (EPA) claims compensation from potential responsible actors including owners by filing tort litigations to the court rather than taking administrative actions. Based on this system, the US has developed a relatively complete environmental responsibility system for the borrowers. With a view to protecting the harmonious relationship between man and nature and different generations of people for public interest, this system enables measures to be taken upon the occurrence of environmental hazards in order to prevent further deterioration of environmental pollution (such as the launch of the litigation procedures). In practice, the environmental liabilities of borrowers and conventional civil liabilities can be effectuated at the same time.

We may thus conclude that the investigation and punishment of environmental legal liabilities of commercial banks remains an administrative act but are different from usual administrative law enforcement for the reason that judicial means can play a supportive role in this matter and the form of administrative law enforcement is finally embodied in the judicial rulings. Such a composite approach of administrative and judicial proceedings can substantially increase public confidence and justice, ensure timely treatment and effective prevention of regulatory capture or excessive regulation and help achieve the objective of deterrence.

2. Legal support

Financial laws. As a matter of fact, environmental issues are not neglected in China's financial policies and regulations. In 1995, the PBoC promulgated the *Notice on Relevant Matters of Implementing Credit Policy and Enhancing Environmental Protection*, which requires financial authorities at all levels to integrate the needs of supporting national economic development and environmental protection and improvement in credit-related matters and identify environmental protection and pollution treatment and prevention as a factor of consideration in the lending of commercial banks. Paragraph 2 of Article 24 of the Lending General Provisions of the PBoC promulgated in 1996 stipulates that "no loans shall be granted to any borrower that … has not obtained the permission of environmental protection department for a production, business or investment project". In 1997, the Agricultural Bank of China (ABC) and the State Environmental Protection Administration promulgated the *Notice on Enhancing the Prevention and Treatment of Pollution from Township Enterprises and Safeguarding Loan Security*. Most of these provisions are declarative policies for the guidance of commercial bank lending without punitive provisions. Nevertheless, these financial policies and regulations have paved the way for further enhancing the environmental legal responsibilities of commercial banks.

Company law. An important theoretical foundation for the assumption of environmental legal responsibilities by commercial banks is the theory of corporate social responsibilities. Under traditional corporate theory, there is only one purpose for the founding of companies: to maximize shareholder interests. In the early stages of companies, a golden rule was that any public interest activities of companies cannot contradict with the corporate objective of 'seeking

maximal interests' in order to avoid the breach of law. Under this sole objective, it is unlikely that companies will take their environmental protection responsibilities seriously. With the progress of social development and diversification of corporate objectives, however, the assumption of social responsibilities became a corporate objective as well. This is not only a legal requirement but is increasingly becoming a conscious act of companies. Paragraph 1 of Article 5 of China's Company Law stipulates that "When engaging in business activities, a company shall abide by laws and administrative regulations, observe social morality and business ethics, act in good faith, accept supervision by the government and the public, and bear social responsibilities." Revision of China's Company Law reflects the philosophy to enhance social responsibilities and also requires commercial banks as corporate legal persons to assume more social responsibilities include environmental responsibilities.

Environmental law. Principles reflected by China's environmental law also provide relevant theoretical support to the assumption of environmental legal responsibilities by commercial banks: first, the assumption of environmental legal responsibilities by commercial banks is consistent with the principle of liability assumption of damages. Under this principle, those who have caused pollution or damages of the environment and resources shall be subject to legal obligations and liabilities. The principle of liability assumption of damages makes clear that polluters shall be responsible for the environmental losses and pollution treatment costs, which cannot be transferred to the state and the public. The implication is that polluters shall be responsible to participate in pollution control and pay relevant costs. Investigation and prosecution of environmental pollution liabilities of commercial banks are also the requirements of the principle of liability assumption of damages. The reason is that lending by commercial banks to polluting enterprises has to some extent led to the consequence of environmental pollution. Second, the assumption of environmental pollution responsibilities by commercial banks is also consistent with the principle of prevention in the environmental law. According to the principle of prevention, environmental policies on environmental law shall not only passively respond to specific environmental damages but also take proactive measures to prevent the occurrence of such damages. By providing loans or participating in the business activities of borrowers, commercial banks are likely to assume joint and several liabilities for environmental pollution caused by borrowers and will therefore be brought under pressure to take the environmental performance of borrowers into their lending decisions and overseeing the fulfilment of environmental obligations by borrowers after lending. In this manner, commercial banks become partners with the government in environmental supervision and play an important role in preventing the occurrence of pollution.

3. Practical effect

Establishment of the environmental liabilities system for borrowers has exerted a major influence on the US and the European Union. As a result, the capacity of the US government for environmental management has been significantly enhanced. In more than a decade after the launch of the CERCLA, the EPA has cleaned up great volumes of hazardous wastes, which led to significant improvements in people's health and environmental quality. More importantly,

environmental factor has become a key factor affecting the profitability of financial institutions including banks and environmental management has become an indispensable element in the business activities of financial institutions, whose environmental protection awareness has been significantly increased. On the other hand, the prudent attitude of financial institutions has largely influenced corporate financing activities, making it necessary to conduct environmental evaluation or environmental auditing prior to the conduct of any business dealings. In this sense, the CERCLA not only effectively improved the performance of eco-environment in the US but embedded national environmental protection strategies into relevant industries and industrial enterprises in a rapid, complete and effective manner through credit leverage and profoundly transformed their ways of thinking and business models. Despite certain differences regarding the environmental liabilities systems between the US and European Union, both have adhered to a basic spirit, i.e. under the principle of the assumption of liabilities by actual polluters, environmental cost is converted into financing cost through investment and financing decision-making process of financial institutions in order to influence the business operations of producers. The environmental liabilities system for US borrowers and environmental laws of advanced economies represented by the UK have set immediate examples for the broad communication of the concept of environmental management by borrowers and operators (rather than polluters alone).

(III) Creation of environmental responsibilities for Chinese commercial banks

1. Establish the principle of civil responsibilities as main responsibilities supplemented by administrative and criminal responsibilities

It should be noted that the environmental responsibilities of borrowers first advocated by the US and then successively applied in different advanced economies are mainly civil tort responsibilities. In order to implement the legal environmental responsibilities of commercial banks in an all-round manner, we believe that the environmental legal responsibilities assumed by Chinese commercial banks should go beyond the limit of tort responsibilities and be incorporated into existing administrative and criminal responsibilities to develop a system of dominant civil responsibilities supplemented by criminal and administrative responsibilities.

China currently practices a set of strict financial regulatory measures. Legal responsibilities prescribed in the Law of the People's Bank of China are reflected in the accountability of direct responsible persons and the administrative penalties imposed by the PBoC and mainly refer to the administrative and criminal liabilities imposed on individuals under the bank governor responsibility system. The liabilities stipulated under the other two laws regulating commercial banks, the Commercial Banking Law and the Law on the Regulation of and Supervision over the Banking Industry, also mostly concern administrative and criminal liabilities. Through the above analysis, we can clearly see that the current financial legal liabilities defined in China are primarily administrative and criminal liabilities, with civil liabilities playing a supporting role. We believe that the viable environmental legal structure for China's commercial banks should feature civil liabilities as the primary component, and complemented by administrative and criminal liabilities. After the corporatization reform, Chinese commercial banks have already been transformed into market-

oriented financial institutions. In addition, the emergence of many private banks and foreign banks in China requires the government to abandon the obsolete mindset of the planned economy and moderately relax its restrictions on financial sector and particularly the banking sector, so that commercial banks will become real civil subjects rather than affiliates of administrative institutions. In the final analysis, commercial banks have to return to the market and the nature of civil subjects has decided that their legal liabilities should mainly comprise civil liabilities supported by administrative and criminal liabilities. This report will focus on the discussion of the civil liabilities of commercial banks.

2. Civil responsibilities

Civil responsibilities of environmental pollution to be assumed by commercial banks are mainly tort responsibilities. Chapter 8 of China's Tort Liability Law has been dedicated to the discussion of 'environmental pollution liabilities'. However, this chapter only targets the actors of pollution without the inclusion of relevant parties to pollution including commercial banks. Environmental legal liabilities to be assumed by commercial banks can be envisioned in the following aspects:

First, circumstances for the assumption of environmental legal liabilities by commercial banks. Prior to the identification of responsible entities, we first need to define the legal relationship between commercial banks and the polluting companies as an equity relationship and an obligatory relationship. When commercial banks invest in polluting companies and acquire their equity, if polluting companies are legally liable for the consequences of their environmental pollution, commercial banks as their shareholders are free from the assumption of direct liabilities in accordance with the principle of limited liabilities of shareholders. However, if commercial banks abuse their rights as shareholders and use a company to execute acts that pollute the environment, commercial banks can be held liable for the consequences in accordance with the system of disregard of corporate personality prescribed in China's Company Law. Obviously, the environmental legal liabilities of commercial banks are not applicable under the circumstances of an equity relationship between commercial banks and polluting companies. Therefore, this report discusses the legal liabilities between commercial banks and polluting companies under an obligatory relationship. We believe that commercial banks shall assume environmental legal liabilities under the following circumstances:

First, commercial banks provided loans despite their actual knowledge or constructive knowledge that borrowers are financing for polluting projects. 'Actual knowledge' refers to the existence of direct evidence that commercial banks are aware that a specific act pollutes the environment. 'Constructive knowledge' is a presumption that commercial banks should be aware of environmental pollution caused by companies according to the universal cognitive abilities of average people. Here, constructive knowledge can be ascribed to the obligation of commercial banks to review their investment projects. Review obligations of commercial banks are embedded in the entire process of lending. Once commercial banks fail to fulfil their review obligations or take relevant actions, commercial banks shall assume environmental legal liabilities in the event of environmental pollution caused by their investment projects.

The *Notice on Relevant Matters of Implementing Credit Policy and Enhancing Environmental Protection* (PBoC [1995] No.24 Document) promulgated by the PBoC in 1995 stipulates that "in issuing fixed asset loans to the construction, expansion and renovation projects with environmental impacts, financial departments at various levels shall strictly conduct the review, approval, issuance and supervision of loans, require that facilities for the prevention of pollution and other hazards must be designed, constructed and put into operation simultaneously with the main works as a prerequisite for loan application, and coordinate with environmental protection departments in credit issuance and management in accordance with Article 26, Chapter 4 of the Environmental Protection Law of the People's Republic of China and the Regulations on the Administration of Construction Project Environmental Protection enacted by the Environmental Protection Commission of the State Council". It also states that "In providing working capital loans to enterprises, financial department at all levels should adopt a differentiated credit policy according to actual situations and strictly in accordance with the requirements of national environmental protection regulations and industrial policy". In 2007, the State Environmental Protection Administration, the PBoC and the CBRC jointly promulgated the *Opinions on Implementing Environmental Protection Policies and Rules and Preventing Credit Risks* (MEP [2007] No.108 Document), which stipulates that "illegal provision of loans by commercial banks to projects with environmental violations shall be subject to serious investigation and prosecution and in the event of serious losses, relevant institutions and responsible persons shall be liable for the consequences". These normative documents and departmental rules have prescribed the statutory review obligations of commercial banks for the environmental impacts of their investment projects. Further, if commercial banks have provided loans to borrowers despite their actual knowledge that borrowers are or will be executing polluting projects, whether their investments of commercial banks have constituted 'funding support' to the acts of environmental pollution by borrowers and whether joint and several tort has been constituted should be investigated in accordance with Article 9 of the Tort Liability Law of the People's Republic of China, i.e. "a person who aids or abets another person to commit a tortious act shall bear joint and several liability with the actor". If the aforesaid violations have been constituted, the commercial bank should assume the joint and several liabilities of environmental pollution with borrowers and assume the obligations of compensation not higher than the investment value.