Financial Sector Assessment Program
A joint initiative of the World Bank and the IMF

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CHINA

FSA | Financial Sector Assessment

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Glossary

AMC	Asset Management Company
AML	Anti-Money Laundering
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
CAS	Chinese Accounting Standards
CBRC	China Banking Regulatory Commission
CCDC	China Central Depositary Trust & Clearing Co., Ltd.
CCP	Central counterparty
CFETS	China Foreign Exchange Trade System
CIRC	China Insurance Regulatory Commission
CNPS	China National Payments System
CSRC	China Securities Regulatory Commission
DC	Domestically Consolidated
EA	Enterprise Annuity
FATF	Financial Action Task Force
FHCs	Financial Holding Companies
FI	Financial Intermediation
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
GEB	Growth Enterprise Board
HVPS	High Value Payments System
IASB	International Accounting Standards Board
IBBM	Interbank Bond Market
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
JSCBs	Joint-Stock Commercial Banks
IPOs	Initial Public Offerings
LCBs	Large Commercial Banks
LGFP	Local Government Financing Platform
MCCs	Micro Credit Companies
MMMFs	Money Market Mutual Funds
MOC	Ministry of Commerce
MOF	Ministry of Finance
MSEs	Micro and Small Enterprises
MTPL	Motor Third Party Bodily Injury Insurance
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NBFIs	Nonbank Financial Institutions
NPLs	Nonperforming Loans
NSSF	National Social Security Fund
OFIs	Other Financial Institutions
PBC	People's Bank of China
PE	Private Equity
PSBC	Postal Savings Bank of China
QFIIs	Qualified Foreign Institutional Investors
RBC	Risk-Based Capital
RCCs	Rural Credit Cooperatives
RMB	Renminbi (yuan)
SD&C	China Securities Depository and Clearing Corporation Limited
SHFE	Shanghai Futures Exchange
SIFIs	Systemically Important Financial Institutions
SIPS	Systemically Important Payment System
SIVs	Structured Investment Vehicle
SSE	Shanghai Stock Exchange
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
SZSE	Shenzhen Stock Exchange
WMC	Wealth Management Companies
WMP	Wealth Management Products
WTO	World Trade Organization
VAT	Value-Added Tax
VTB	Village and Township Bank
ZCE	Zhengzhou Commodities Exchange

PREFACE

This report summarizes the findings of the Financial Sector Assessment Program (FSAP) exercise for China undertaken in 2010 by a joint IMF/World Bank team.[1] The first mission (June) assessed the observance of selected international standards and codes, and initiated discussions on a broad range of financial sector issues. The second mission (December) completed its review and presented a draft Aide-Memoire along with draft technical and background notes covering a range of topics relevant to China's financial sector.

China's financial system reform efforts have had positive results. Reforms accelerated since 2003, with the Chinese government adopting a series of policies to enhance financial sector's resilience and, on the structural side, strengthening a large part of domestic financial institutions and improving market confidence. However, risks, challenges and development opportunities remain.

This report points out near-term risks, reform challenges and development opportunities China confronts as it continues to modernize its financial sector. China faces potential vulnerabilities, near-term risks and policy-induced distortions common to an evolving financial system. The challenges and opportunities are not unique, and can be addressed. We propose that the authorities could consider carefully sequencing the following reforms and development options: (i) further deepening the commercial orientation of the financial system; (ii) moving to more market-based means of controlling monetary and financial conditions; (iii) further strengthening regulation and supervision; (iv) upgrading the framework for financial stability and crisis management; (v) revising the strategy for financial inclusion to achieve improved access to financial services ; (vi) continuing steps to support a broad based capital market; and (vii) continue to strengthen and deepen the insurance and pension sectors and (viii)continue enhancement of the financial market infrastructure.

Addressing the opportunities and challenges will require creative thinking and a willingness to change. A gradualist and piece-meal approach to financial sector reforms likely will fall short in meeting the increasing depth and complexity of China's financial market. Going forward it will be important to have a holistic approach and to look beyond current laws and regulations for potential means to address market changes as well as to find solutions to current inhibiting factors preventing the attainment of Government goals.

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The mission met senior officials from the China FSAP Taskforce comprised of the Ministry of Foreign Affairs, National Development and Reform Commission (NDRC), the Ministry of Finance (MOF), the Ministry of Human Resources and Social Security, the Ministry of Commerce, People's Bank of China (PBC), National Bureau of Statistics (NBS), Legislative Affairs Office of the State Council, China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC), State Administration of Foreign Exchange (SAFE), and other ministries and agencies including the Ministry of Industry and Information Technology, the Ministry of Housing and Urban-Rural Development, the Ministry of Agriculture, National Audit Office, State-Owned Assets Supervision and Administration Commission of the State Council, State Administration of Taxation and National Council for Social Security Fund, and staff from these agencies, as well as representatives from financial institutions, industry organizations, and private sector representatives in Beijing, Chongqing, Guangzhou, Nanchang, Ningbo, Shanghai, and Shenzhen.

The team would like to convey its deep appreciation to the Chinese authorities and other counterparts for their hospitality, technical engagement, and generous support in facilitating its work.

OVERALL ASSESSMENT AND RECOMMENDATIONS

1. **China's financial system reforms are progressing well.** The authorities are seeking to shift the financial sector from a centrally directed system to one that is commercially-based and financially sound. Improvements are seen in the structure, performance, and oversight of the financial sector. The system is becoming more transparent as it opens up.

2. **China is confronted by a build-up of potential sources of vulnerabilities, including greater exposure to external shocks.** The inter-linkages across markets and institutions are growing, and de-facto banks and informal credit markets, conglomerate structures, and off-balance sheet activities are on the rise. The reform of small-and medium-sized rural financial institutions continues. There is a need for close monitoring, better data collection, intensive information exchange and a stronger framework for identifying and addressing problem institutions and market practices that could impair the on-going reform process.

3. **The near term domestic risks are four-fold:** (i) the impact of the recent sharp credit expansion on banks' asset quality; (ii) the rise of off-balance sheet exposures and lending outside the formal banking sector; (iii) the relatively high level of real estate and commodity prices; and (iv) the increase of imbalances due to the current economic growth pattern. Stress tests of 17 commercial banks suggest that most major banks are resilient to risk in isolation, but gaps and weaknesses in the informational infrastructure make it difficult to assess the possible transmission effect through the economic and financial system. There is potential for damage to financial stability and continued reform should the risks arise simultaneously.

4. **Macroeconomic and financial policies need to be better aligned to create incentives for a durable transformation to a more commercially oriented and effective financial system**. Emphasis should be on credit allocation processes, financial markets and services that reduce the need for high levels of precautionary savings, and more resilient and transparent institutional structures. To facilitate this process, the government should continue to reorient its role and responsibilities. The state's involvement in financial markets and institutions—through ownership of banks and state owned enterprises, management of interest rates, setting of priorities for the financial system, and as an implicit guarantor—is resulting in moral hazard, weak risk management in banks, and a buildup of contingent risk and liabilities.

5. **The commercialization of the financial system needs deepening.** Credit risk strategies are dominated by loan growth targets. The use of commercial bank credit for policy goals should be replaced by other mechanisms such as direct fiscal expenditures, government credit programs and rationalization of policy banks. Bank risk management and supervisory assessments focus too much on backward-looking variables and not enough on forward-looking assessments of credit risk. The concentration of bank exposures to state owned enterprises, the guaranteed margins, the limited ability and willingness to differentiate loan rates, as well as the implicit guidance on credit flows, undermine the development of effective credit risk management capabilities at banks. In this context, a move to more market-based means of controlling monetary and financial conditions would greatly improve

credit allocation. Market interest rates should become the primary instrument for managing credit expansion.

6. **Continued advances in the regulatory and supervisory regime are required.** Efforts are needed to implement consolidated supervision and ensure timely sharing of essential information among all relevant government bodies. The PBC and the primary supervisory commissions must be empowered and have resources commensurate with their expanding responsibilities. The mandates of the supervisory commissions should focus on ensuring safety and soundness of regulated institutions and proper market conduct. Approaches to supervision should be more forward looking in lieu of issuing large quantities of regulations and using very detailed approval processes for governing the day-to-day activities of financial institutions. In addition, customers of financial products and services must be made aware of the underlying risks and obligations through improved market disclosure and enhanced financial literacy. To support this, improvements in accounting requirements, data standards, reporting requirements, and meaningful disclosure are necessary.

7. **A formalized stability framework to monitor and respond to macro-financial vulnerabilities would benefit China.** Building on the experience from the ad-hoc committee in place since June 2008, a permanent Financial Stability Committee should be established having access to relevant supervisory and other financial information.

8. **A framework to resolve weak financial institutions on a timely basis is needed.** The framework should assist in resolving distressed financial institutions at least cost to the public, and facilitate the wind up of institutions in an orderly manner. To facilitate this and to protect the PBC's balance sheet, a deposit insurance fund could be established to finance the orderly resolution of failed institutions and to protect insured depositors. A government entity should be vested with authority to monitor the health of the financial system and have resolution powers for dealing with institutions declared nonviable by their supervisors.

9. **Broader and more diversified financial products and services would deepen and strengthen China's financial system.** Interdependencies between the government and the corporate fixed income markets and policies relating to the interest rate regime should be considered. This should include: (i) a more proactive government debt issuance strategy to support the risk-free yield curve; (ii) expanding access to new non-government issuers; and (iii) increasing the supply of different types of instruments to address the diverse needs of issuers and investors. This should be accompanied by improvements to the repo markets; developing risk pooling and hedging products; prudently promoting the development of securitization, and measures to ensure regulatory consistency across all types of fixed income products.

10. **Financial infrastructure and relevant legal systems need to be further upgraded.** Progress has been seen, but more is needed to: a) enhance the legal framework and oversight function of the payments and securities settlement system, b) improve the coverage and quality of the Credit Reference Center, c) improve the oversight and quality of credit rating agencies, d) upgrade and strengthen consumer protection, e) enhance the insolvency regime and creditors rights; f) define a clear process for dealing with troubled financial institutions

and depositors and g) establish a framework and tools for effective macro prudential and financial stability.

11. **Financial Inclusion could be enhanced through a revised strategy.** This should include reforms to provide the right incentives for: provision of financial services to under-served sectors; market competition and contestability (by adjusting entry and exit criteria); improving the legal framework for financial inclusion; and removing policies not properly aligned with the overall objective of improving access.

12. **Sequencing reforms at the appropriate pace will be a challenge, but essential to China's sustained growth.** This will be crucial to maintaining a balance between development and financial stability while minimizing risks. To facilitate the process, a prioritized list of key recommendations needing consideration was provided (Table 1).

I. Structure and Functioning of the Financial System

A. Context

1. **China's progress in reforming and developing its financial system has been considerable** (Table 2). This development has been supported by key banking sector reforms, creation of capital markets, introduction of a prudential regulatory regime, bank recapitalizations, and a broad-based opening of the financial system following accession to the WTO and reforms since 2003. Joint-stock reforms—including initial government capital injections, and subsequent strategic investor participation and initial public offerings (IPOs) have boosted large banks' commercial orientation. Banks have diversified their equity structures; enhanced corporate governance; introduced internal controls and risk management; and increasingly adopted profit-maximizing strategies. Key securities companies were restructured, and a securities companies' resolution mechanism and an investor protection scheme set up. Insurance sector reform also progressed.

2. **The reform of financial policy is underway but distortions remain.** These are linked to remaining interest rate policies, quantitative credit guidance, limited investment channels, and moral hazard related to the perception of implicit state guarantees**.** As a result, China's system is characterized by: (i) a low cost of capital that does not remunerate adequately domestic households; (ii) a propensity for prices to deviate from market clearing levels; (iii) inadequate incentives to price risk in view of the implicit guarantees on large state-owned enterprise (SOEs)' debt;[2] (iv) emphasis on minimizing NPLs on balance sheets; (v) high levels of structural liquidity; (vi) incentives to push credit off-balance sheet; and (vii) still limited non-state ownership— including foreign shareholder participation—in the financial system. Direct allocation and credit pricing facilitated China's strong growth, when sectors with high-growth potential were easily identified, but they also contributed to overcapacity, potential asset bubbles, and the need for public-funded bank recapitalizations.

3. **Credit is primarily channeled via the banking system, with a limited role for domestic capital markets (Figure 1)**. At end-2009, commercial bank loans accounted for a larger share of total financial system assets compared to others. Nonbank financial institutions (NBFIs)—including trust investment companies, financial leasing companies, and finance companies—have been growing (Table 4).

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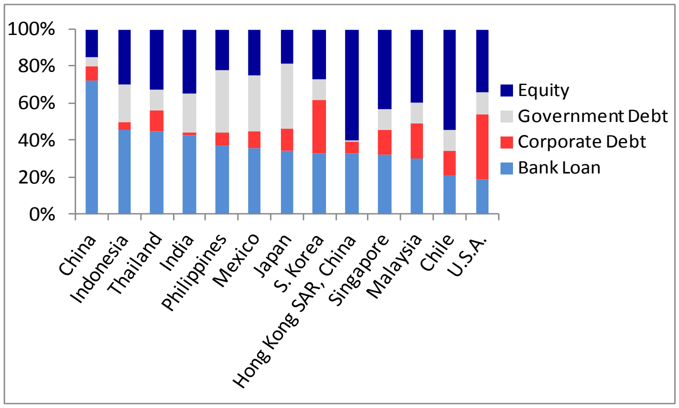
[2] Lending ceilings have been removed, but banks do not let lending rates float up from benchmarks, reflecting incentives to lend to safer borrowers (supported by implicit guarantees), and an insufficient ability to price risks.

Figure 1. China: Size of Selected Countries' Financial Systems, 2009

(In percent of total)

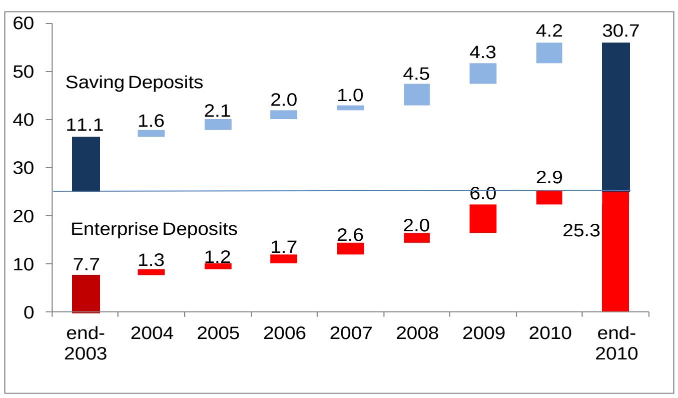


Source: KPMG.

4. **The state of development of the financial sector can be seen in the high degree of bank savings deposits given limited alternative investment options** (Figure 2). Deposits account for over 80 percent of banking system liabilities and have grown by an average of 19 percent. Recently, corporate deposits have become a principal driver of bank funding growth due to strong corporate profitability and household deposits have shifted reflecting an increased risk appetite and low deposit rates.

Figure 2. China: Levels and Incremental Growth of Bank Deposits

(In trillions of RMB)



Sources: CBRC; IMF computations.

B. Macro-Financial Environment

5. **China has maintained high growth rates over the past three decades, on the back of high investment and rapid credit growth (Table 3).** Growth has averaged double-digits since the start of reforms in 1978, and inflation has remained relatively subdued reflecting rapid productivity growth and additions to capacity from high levels of investment. Public debt remains low, although there are contingent liabilities. The economy is prone to asset bubbles, notably in the stock and real estate market, given high levels of structural liquidity, low interest rates, and lack of alternative investment vehicles.

6. **The financial system plays a direct and critical role in the transmission of macroeconomic policies.** In China there are five key macro-financial linkages: i) *The banking system directly facilitates quasi-fiscal policy* through its use as a credit channel; ii) *Banking system directly facilitates monetary policy,* but the credit growth targets undermine the efficiency of credit allocation; iii) *Low cost of capital distorts the saving-investment balance of the economy*; iv) *Capital markets' underdevelopment limits alternatives for corporate funding and household investments,* and represents an impediment to solving structural problems in the financial sector: low rates of return on savings; high precautionary savings through banks; high savings by private enterprises without access to capital markets; continued bank-dominance of the financial system; and potential asset bubbles; v) *Lack of contestability of markets or ownership for large firms limits competition*..

C. The Regulatory and Supervisory Framework

7. **Progress has been made to improve financial regulation and supervision, but the challenge is to increase its efficacy, quality, and responsiveness.** The FSAP revealed a high degree of adherence to international standards. However, going forward, the right balance must be struck between the degree of regulatory control and the need to enable useful innovation and development of the financial system. Suggestions arising out of the assessment were to improve: i) the operational autonomy of supervisory commissions, ii) skills, iii) risk monitoring capabilities, iv) resources and v) interagency coordination.

8. **Commercial Bank Regulation and Supervision**

   a. **CBRC has made strides in improving its framework for supervising commercial banks.** It has a clear safety and soundness mandate but its operational autonomy is challenged by the continued use of the state dominated banking system to pursue development goals and rapid credit growth. Going forward, it will be important to ensure its ability to act fully in pursuit of its mandate. This should include adequate budget and supervisory resources so it can respond to the increasing scale and complexity of the Chinese banking sector.

   b. **Banking legal and regulatory framework has been brought in line with international standards, but gaps remain**. Identified gaps: a) absence of a requirement to be informed of changes in indirect control and the identification of banks beneficial owners and clients; b) inadequate rules on related parties and c) lack of a legal framework underpinning bank resolution.

9. **Securities Intermediaries and Securities Market Regulation**

a. **The CSRC has overseen regulatory reforms to support a more market-based financial system**. A credible program of inspection and surveillance is in place but a stronger emphasis is needed on illegal investment activities and monitoring of hedge funds and private equity (PE) funds. Steps have been taken for detecting and deterring insider trades and market manipulation, but more is needed. CSRC should introduce a formal on-site inspection program of the exchanges to bolster oversight and it should implement and strengthen monitoring of risk-based net capital rules and "Know your client" rules.

b. **The legal and regulatory framework for the regulation of securities markets needs to be further improved to keep pace with market developments**. Areas for improvement include the commercial court, enforcement with respect to illegal investment activities and detection and deterrence of unfair trading practices. CSRC needs greater operational autonomy to enable it to more effectively carry out its mandate without the potential for interference. Budget flexibility is needed so it can respond to the rapid growth of markets and the limited role played by market discipline. The accounting and auditing profession has made strides, but there is a need to continue to develop its size and expertise to meet the increasing size and growing complexity of the market.

10. **Insurance Regulations and Supervision**

a. **CIRC has a comprehensive supervisory framework, with emphasis on corporate governance rules , consumer protection efforts and risk management systems, though improvements are needed in:** i) off-site monitoring through reinstatement of early warning ratios; ii) the non-life liability and solvency regimes; iii) the life minimum solvency margin to make it more risk based as investment options are expanded; iv) ensuring explicit and clear regulation for facilitating the exit of insurance companies from the market via run off or portfolio transfers and v) the coordination and exchange of information between PBC and CIRC in the area of AML. In addition, strict measures should be taken to prevent insurance companies operating below the 100 percent solvency level from issuing new business.

b. **The CIRC's mandate and operational autonomy need to be addressed**. The developmental mandate for CIRC should be reviewed to ensure it can focus on its real mandate. Its budget should ensure adequate organizational and industry capacity. The current prescriptive, rules-based system should be reconsidered as the market and the risk-based supervisory regime mature.

11. **Regulation of Other Financial Institutions**

a. **Regulation of other financial institutions (OFIs) aims to ensure their link with the formal banking sector remains limited.** In addition to commercial and policy banks, there are a host of other NBFIs which are part of the credit delivery system. Some trust companies, finance companies of enterprise groups, and leasing companies, etc., are regulated by the CBRC. In addition, there are entities in the informal financial sector (pawn shops, financing guarantee institutions, micro-finance companies, etc.) which are licensed by local governments and unregulated entities (informal banks) which are surveyed or investigated by the PBC occasionally.

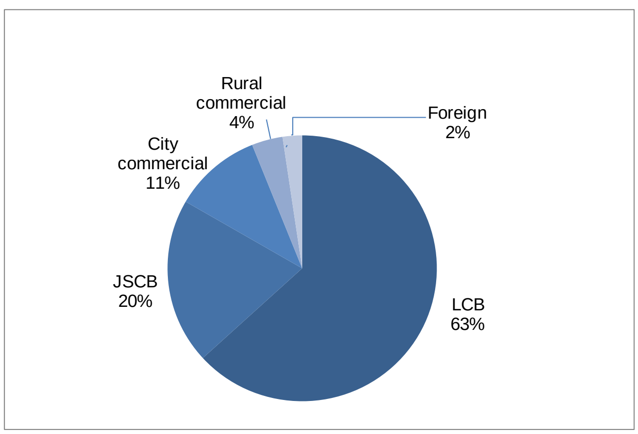
b. **Regulatory policies applied to shadow banks and their responsibilities need to be clarified.** CBRC and NDRC view the universe of shadow banks as comprising mainly PE (the majority of which have not been regulated) and informal lenders and deposit takers (monitored by the PBC and CBRC). The regulatory policies applying to shadow banks and their responsibilities need to be clarified. Interagency coordination backed by memoranda of understanding for information sharing, needs to be strengthened to prevent episodes of build-up of systemic risk via cross-market financial products or activities.

II. THE BANKING SECTOR

12. **The banking system is dominated by large commercial banks (LCBs) and joint-stock commercial banks (JSCBs)**. Collectively, the five LCBs and the twelve JSCBs accounted for 83 percent of total commercial bank assets at end-2010 (Figure 3). All LCBs and most JSCBs are owned or partially owned by the government and thus, most are substantially controlled by the government. Deepening the commercial orientation of the banking sector will serve to foster a general deepening of the entire financial sector.

13. **The banking sector balance sheets have expanded rapidly in part due to the macroeconomic stimulus policies**. As a result credit demand for infrastructure and transportation increased. A large proportion of such demand came through local government financing platforms (LGFPs) that have increased considerably as a result of the 2009 economic stimulus. The fiscal revenue and expenditure mismatches coupled with the inability of local governments to borrow directly have made it difficult to achieve appropriate balance between rapid economic growth and avoiding undue financial risks.

Figure 3. China: Size of the Commercial Banking System, End-2010



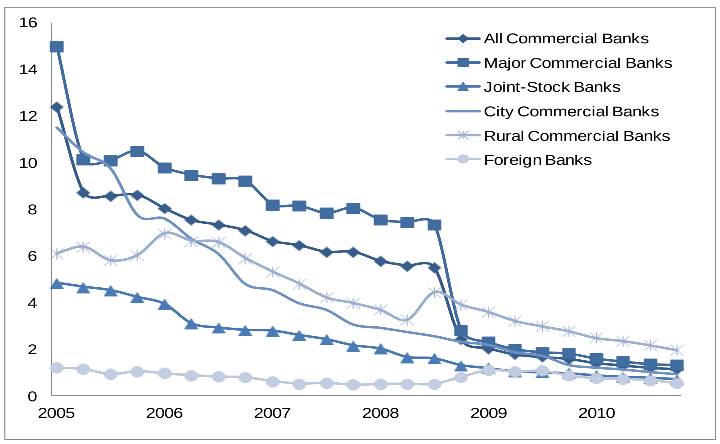
Sources: CBRC; and IMF staff calculations.

14. **Banking sector profits remained high as a result of large expansion of credit and balance sheets, in part due to the macroeconomic stimulus policies.** A large portion of the demand came from local governments. This, together with the credit demand for property purchases and credit creation associated with large FX inflows, led to a surge of new RMB loans. In addition, off-balance sheet exposures have expanded rapidly since the Q2 of 2009, mostly as a result of banks' promoting wealth-management products.

15. **Banks' NPL ratios reflect a downward trend, reaching 1.1 percent at end-2010** (Figure 4). This decline was driven by rapid expansion of credit and the significant decline in NPLs. The contraction of NPLs to RMB 434 billion at end-2010 from RMB 1.3 trillion at end-2005 substantially reflects the carve-out and resolution of RMB 816 billion (NPLs) from one large bank in 2008. The migration of some loans to performing status and some improvements in risk management in banks also has prevented NPL levels from rising

Figure 4. China: Nonperforming Loans to Total Loans

(In Percent)



Source: CEIC China Database.

16. **Banks' funding appears stable, but a rise in longer-term loans adds to challenges for banks' maturity mismatches**. The sizable and low-cost deposit base contributed to stable bank funding. The growth in domestic corporate deposits since 2008 has become a driver of total deposits. Maturity mismatches are rising. Increasing reliance on medium- and long-term loans for investment project financing has lengthened asset maturities. Interest rate mismatch is balanced by the regular repricing of loans, but the maturity mismatches pose challenges for liquidity management.

17. **A stress test covering 5 LCBs and 12 JSCB banks was jointly conducted by the FSAP team and the authorities**. These banks have better information disclosure and more sophisticated risk management systems than other banks. The exercise was done in close cooperation with the PBC and CBRC. It involved single-factor shocks and macroeconomic scenario analysis, but was limited by the lack of consistent data. The shock sizes took into account past experience in China and other countries, as well as past FSAP practice. The single-factor sensitivity calculations suggest that the system would be able to withstand a range of sector-specific shocks occurring in isolation. The analysis suggests that the system could be severely impacted if several major shocks materialized concurrently.

III. STRENGTHENING BOND AND EQUITY MARKETS

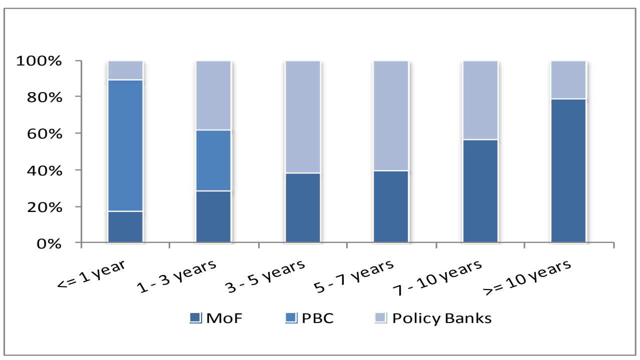
18. **The capital market as an alternative funding channel to banks has grown over the last five years (Table 6), but an enourmous potential for growth remains untapped**. Although progress has been seen in establishing a multilayer capital market addresing finanical needs of both large or state-owned enterprises with high credit ratings and SMEs. However, there is still room for a more relevant

role of capital markets as a funding source for large enterprises with lower credit ratings (even above investment grade) and SMEs. Bank dominance in the financial sector presents challenges in developing the capital markets as an effective capital raising mechanism.

19. **Despite prospects of banking disintermediation deepening, the banking sector is expected to continue playing a prominent role in capital market development.** As issuers, underwriters, distributors, investors and liquidity providers, banks would influence the speed and quality of growth of fixed income markets. The speed of development of the market also will be influenced by Government's plans for further interest rate reform.

20. **A full-fledged Government bond market is needed for the growth of diversified and sophisticated fixed income markets.** Currently the risk-free yield curve is unevenly developed as the Government shares it with PBC bills in the short term and the more liquid Policy Bank bonds in the medium term (Figure 5). While the active use of PBC bills has thus far played an important role in setting up the basis and infrastructure for further development of a fully fledged bond market, going forward the continued issuance in sizeable volumes of these bills may require further institutional coordination with the MOF on its issuance policy of instruments of similar maturities. This is a common evolution observed in many advanced emerging market economies that are confronted to large sterilization needs related to capital inflows as they pursue development of a liquid risk free yield curve. It is expected that as China's economy continues to progress such disparities will be mitigated as large sterilization needs diminish with reduced capital inflows.

Figure 5 China: Each Public Sector Debt Issuer Dominates in a Different Maturity Segment



Source: Chinabond.

21. **A more proactive and sustained benchmark building strategy is required**. This should include strengthening of coordination between the MOF and the PBC in common maturities and active liability management to support benchmark building. This would help to provide clarity to market participants, support secondary market liquidity and the development of interest rate hedging instruments while increasing bond market development.

22. **Currently, regulatory oversight of China's fixed income markets involves three agencies** (PBC, NDRC, and CSRC). Their respective roles should be further clarified to ensure regulations are consistent and equivalent regulations apply to similar types of participants even if regulators are different. A possible option would be to delineate regulatory responsibilities between the wholesale and retail markets which would be supportive of existing market practices, but regulatory consistency should

be strengthened and connectivity improved (between the Interbank and the Exchange fixed income markets). Alternatively, other models may be followed which could accomplish this desired result.

23. **In promoting the development of sub-national debt markets, it will be important to carefully account for associated risks and to ensure timely public disclosure of data**. This is key to ensuring risks do not get transferred as contingent liability to the government and do not negatively impact the development of the fixed income market. It will be important that provincial issuers have technical capacity to issue and manage debt and periodically undertake debt sustainability analysis. Also, it will be vital to ensure that investors are diversified and that the commercial banking system is not a captive investor.

24. **More is needed for the development of a segment of the fixed income market that accommodates lower, yet credible, credit rating standards.** This will allow SMEs and other private enterprises to access these markets. Innovations in relation to SMEs launched over the past year appear to be supportive of market development. Concern of the authorities in managing risks associated with the entry of enterprises with lower credit standings is legitimate, but a more flexible approach would enable the creation of a segment of eligible investment grade companies. Action would be required on the supply and demand side, to enable appropriate institutional investors to invest in these instruments. In addition, easing the 40 percent of net assets limit applicable to corporation's market based debt issuance should have a positive impact in expanding direct funding capacity instead of bank funding.

25. **Opportunities to further improve the Inter-Bank Bond Market exist.** Enhancements to the market making scheme, such as those contemplated by MOF and PBC are a critical building block in the process of price formation and the development of a risk-free yield curve. Additionally, market liquidity can be expected to improve by further leveling the playing field for nonbank participants.

26. **The repo market has grown substantially, but its economic impact is limited by legal and operational constraints**. The dominance of pledged repos and the limited use of documented outright repos enabling collateral re-hypothecation, limits liquidity and necessary linkages between money markets and Government bond markets. In a market as large as China's, the volume of documented outright repos is unusually small which has led to the development of an informal repo market. Formalizing and standardizing the former is critical to the efficiency and integrity of fixed income markets.

27. **The underdevelopment of effective hedging instruments, such as interest rate derivatives, is an additional obstacle to the further development of the capital market**. The low liquidity of government debt limits its development. Upgrades in the government issuance policy, secondary market organization and repos would provide a sound framework to build derivatives markets.

28. **China's equity markets have evolved, but challenges remain**. One challenge involves reinforcing the role of the Shanghai Stock Exchange (SSE) as a relevant source of funding for large enterprises other than SOEs. Technological and regulatory initiatives and investments have been made, however, other challenges remain such as increasing the current low percentage of free float among public companies and SOEs. A second challenge involves better serving the financing needs of SMEs. The implementation of a multitier market system in the Shenzhen Stock Exchange comprising the Main Board, the SME Board (2004) and the Growth Enterprise Board (GEB) (2009) seems to be a step in the right direction and going forward should contribute to the further expansion of cost effective funding for a broad spectrum of enterprises.

29. **It is critical for China's capital markets that regulators of the different types of institutional investors (mutual funds, pension funds, insurance companies) have a concerted strategy to develop a diversified institutional investor base.** A stronger presence of institutions would increase efficiency in the allocation of capital, support the expansion of listings and listed shares, and reduce volatility. In fixed income markets, a more flexible approach to investments, within prudent limits, would enhance access to a large segment of private companies that would still be within investment grade credit ratings.

30. **Developing a sound investor base is challenging and requires, among others**: a more active role of banks in the growth of institutional investors as owners of AMCs and distributors; ensuring that regulations of collective investment pools are consistent with the expansion of capital markets to private enterprises; and monitoring regulatory arbitrage opportunities emerging in the context of the fast growing WMCs.

IV. DEVELOPING A SOUND INSURANCE SECTOR

31. **The insurance sector has grown rapidly, but has scope for further deepening.** Its assets under management corresponded to less than 11 percent of China's domestic personal bank deposits at end-2009. The sector is already the six largest in the world, reflecting China's enormous population and the fact that its life (personal lines) sector is sizeable. But there is further scope for deepening. In particular, penetration in the non life (property & casualty) sector is lower than expected given income levels and structural metrics.

32. **The rapid growth has been associated with important risks**. Insurance companies have seen growth rates of real premiums above 15 percent per annum, and these are expected to be sustained in the near future. At the same time, returns to equity in the non life sector have not been sufficient on average to sustain capital growth adequate to fund the commensurate rates of increase in the basic risk elements.

33. **Most of the 87 insurers licensed in the current decade continue to lose money under the current accounting methodology.** In many cases this reflects establishment costs and rapid growth, with economic values (based on future cash flows) actually increasing. However a number of insurers have fallen below, or close to, the 100 percent solvency level and CIRC will need to monitor these closely in case their business models prove to be defective. Rapid expansion (typically through highly competitive commissions and pricing) is also placing profit pressures on larger established insurers. While the great majority of insurers meet current minimum solvency requirements the aggregate solvency position could be strengthened. The current distribution of solvency ratios adds considerably to CIRC's supervisory load, and potentially also has negative development implications.

34. **Recent steps by CIRC appear to have been effective in stabilizing the technical results of the non life sector.** Actions taken to deal with capital requirements include raising capital by listing the major insurers (most of which are state and provincially controlled), allowing generous levels of proportional reinsurance, allowing approved insurers to issue subordinated debt and include this for statutory solvency determination, and adopting forbearance in certain cases. Solvency standards have been the subject of research and review within CIRC and it is desirable that strengthened prudential standards are expedited, particularly in the life sector as investment options are expanded.

35. **A rationalization strategy is needed and could be fostered by introducing more comprehensive Risk Based Capital (RBC) requirements and requiring shareholders to achieve**

these over a suitable period. Strengthening the actuarial oversight of non life claims provisioning and clarifying the voluntary wind up and exit rules and processes are also desirable steps. In addition, other strategies could involve taking action to enable insurers to generate more stable and higher returns to equity**.** This could include placing motor third party bodily injury insurance (MTPL) in a central mutual pool(s) to be managed separately by approved insurers, introducing pricing that is more reflective of underlying risks and similarly developing properly priced (possibly subsidized) catastrophe insurance pools.

36. **A further desirable prudential step is to require assets matching life insurance mathematical reserves and minimum capital requirements to be explicitly earmarked and not available as collateral for borrowing** (although approved repos could be allowed to enhance yields as long as possession of the underlying asset is retained). The fact that staff salaries and benefits and secured borrowers rank ahead of life policyholders in the event of a wind up is contrary to international best practice.

37. **A number of governance items with prudential implications should be reviewed.** Related party transactions are permitted and while these are subject to governance regulations, the rules are not sufficiently precise to prevent malfeasance. As insurance groups and financial conglomerates become more common, all related party transactions above a certain size plus loans to management/staff should require CIRC clearance and then be reported in the annual accounts.

V. Addressing Challenges in the Pension Sector

38. **China is gradually consolidated its multi-pillar pension system, but it is facing sizable challenges.** The Old Age Insurance System (first pillar) includes an unfunded and a partially funded component. The second pillar, or enterprise annuity (EA) system, is a voluntary occupational supplementary pension system. The third pillar includes personal and occupational pension plans that offer greater flexibility than the EA system, but have been largely unexploited. Each of the pillars faces challenges that require the attention of the authorities.

39. **Pension reserves of the first pillar are invested in inefficient portfolios**. Tier 1 of the first pillar is a traditional unfunded pay-as-you-go system. Tier 2 of the first pillar is a partially funded system with individual accounts, managed by the government. Due to a lack of sufficient funds to finance the transition to a fully funded system, many local governments financed the shortage of Tier 1 with resources of the individual accounts. Among the provinces with Tier 2 backed by real assets, most of the pension resources are invested in low earning bank deposits and short-term bills. Nine provinces have part of their Tier 2 pension assets (central government subsidies on personal accounts) managed by the National Social Security Fund (NSSF), which is a model that can be replicated across the country.

40. **Better pension funds investment strategies are essential for fostering the development of the capital market**. Capital protections investment strategies, which are common across pension funds, will not be sufficient for obtaining reasonable pensions in the future. Longer-term horizon strategies involving equity and long term bonds will be necessary. Investment regulation should discourage short term evaluation of performance and focus on aligning the investment strategies with the long term objectives of the contributors.

41. **The EA covers mostly workers of state owned companies**. Limited tax benefits, a complex design of the EA governance framework, and an incomplete regulatory structure have been impediments

to the development of the EA system. Since the regulatory framework of EA system is not compatible with the structure of labor agreements of SMEs and the weak enforcement of the labor contracts, it is unlikely the EA system will grow at the necessary speed to cope with the growth of employment in urban areas.

42. **An option for consideration given China's savings culture is to foster the development of personal pension plans**. This idea would channel part of precautionary savings into retirement savings. There is room for designing personal income tax incentives[3] for the contributions and matching fund contributions (for lower income individuals) to incentive retirement savings individual accounts. These initiatives could provide coverage to a large segment of the population that currently does not have formal retirement savings plans. Personal pension plans could offer standardized pension products consistent with the long term objectives of contributors**.** Although different institutions would be allowed to offer different products, the investment strategy of the plans should be aligned with a portfolio benchmark designed by independent experts following the life cycle approach.

VI. Policy and Strategic Issues in Promoting Inclusive Finance

43. **Progress has been made in financial services that depend on extensive networks and technical advancements, but access remains limited for rural and urban households, micro and small businesses.** Demand for credit by rural households is, to some extent, met by informal providers. Alternative financial services such as non-life insurance, factoring and leasing are still at their nascent stages.

44. **China has a huge potential to develop greater financial inclusion.** To meet this potential, the following should be considered: i) further reform of financial institutions to bring out their potential in delivering financial services and products to the most productive users, ii) reform of the roles and functions of government in the provision of finance, and iii) further improvements to the financial infrastructure and regulatory oversight.

45. **To build an integrated and coherent rural and MSE finance strategy, further improvements are needed.** As a result of rapid urbanization and industrialization and demographic movements, commercial sustainability in rural and micro finance has shifted and the need for policy-oriented financial services has reduced. A policy, based upon the objective of promoting convenient, speedy and long-lasting access to financial services and products based on commercial principles is needed. The primary role of government should be to provide an environment and infrastructure in which well-governed and supervised financial institutions compete with each other in serving rural and MSE clients. There is a need to clarify the roles and functions of government agencies and. more could be done in promoting regulatory effectiveness in the area of inclusive finance.[4] The remaining

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[3] The current structure of the personal income tax system which separates sources of income, rather than treating income as a whole, makes crafting the incentive more challenging. Care should be taken to ensure the targeted group will be the ones best positioned to take advantage of the incentive. Since they are not covered today by any formal pension system, perhaps the incentive could be structured to apply to only those with no formal coverage today.

[4] All told there are over a dozen types of financial institutions that are registered locally, subject to minimum or no regulation and supervision.

restrictions and obstacles in rural and MSE finance (in the areas of market entry, funding, geographic expansion and mobile banking) should be carefully reviewed.

46. **The potential role of financial institutions in broadening access should be further explored**. Many banks have embarked on the path of commercially oriented lending to rural households and MSEs. The emerging rural financial institutions—Village and Township Bank (VTB), lending companies and rural mutual cooperatives — and Micro Credit Companies (MCCs) have exerted some competitive pressure but their role will take time to develop. To further broaden outreach there is a need to further strengthen some state-owned financial institutions—especially the Agricultural Development Bank of China (ADBC) and PSBC—and the RCCs, to enable them to further improve their corporate governance and risk management.

47. **To create a framework for inclusive finance, the authorities should consider legislative and other changes.** This should focus on: (1) expanded consumer credit information coverage; (2) a national secured transaction framework and out of court settlements; (3) developing factoring and leasing as alternative means of finance for the MSEs; (4) rules for the existence and business conduct of informal lenders; (5) careful performance evaluation of policy lending programs and (6) designing a statistical system to place emphasis on true outreach (measured by the number of micro loans and clients), efficiency, and financial sustainability.

48. **Continued liberalization of lending interest rates is essential to commercially sustainable rural and MSE lending**. Financial intermediaries incur high operating costs as they move down-market. The lending interest rate cap imposed may contribute to unfair competition against RCCs and may prevent them from serving otherwise bankable micro and small borrowers. The effect of Supreme Court rulings concerning usury has discouraged the formal sector from lending to this group and forced the group to accept higher rates from the black market. Resolving the conflict is necessary to increasing access.

49. **The government should improve measurement of financial inclusion to allow meaningful performance monitoring and evaluation and to guide public policies.** Using lending by county-level FIs as the criteria for agriculture related loan statistics is misleading and likewise, the definition of SMEs in China includes bigger companies than the intended small clients. Consideration should be given to designing a statistical system in keeping with international practice to lay emphasis on true outreach (measured by the number of micro loans and clients), efficiency, and financial sustainability.

VII. Financial Markets and Market Infrastructure

A. Financial Stability and Crisis Management

50. **A review of the regulatory architecture is needed to ensure it is suited to the challenges posed by a rapidly evolving financial sector.** China has adopted an institutional approach to financial regulation, with three separate commissions and the PBC sharing responsibilities (Table 7). The State Council has the overarching responsibility for the financial system. It exercised this responsibility by establishing and chairing a high-level ad-hoc committee of the key financial agencies in June 2008. The mission recommended that a permanent Financial Stability Committee be established, building on the experience from the ad-hoc committee.

51. **China's crisis management arrangements fall under the purview of the State Council.** The preference for responding to episodes of financial distress thus far has been with "open resolution" outcomes. This could have been influenced by Government's dual role in crisis management and ownership of institutions. As a result, injections of equity to undercapitalized banks and the de-risking of balance sheets through transfers of poorly performing assets to AMCs[5] took place in 1999.

52. **Consideration should be given to establishing institutional arrangements and expanding the resolution toolkit so that closed resolution is a viable option for dealing with all banks.** This should include providing supervisors with legal authority to intervene promptly in nonviable financial institutions; and providing a separate entity with the resources to close, recapitalize or sell such an institution and capacity to manage the intervened institution, including its assets. The authorities have given considerable thought to the introduction of a deposit insurance scheme and should accelerate this work, consistent with the large number of depository institutions and the need to reduce the financial exposure.

B. Money, Foreign Exchange, and Interbank Markets

53. **The managed interest rate regime and exchange rate system has inhibited financial development and innovation. Continued advances in market based interest rate reform and improvements to the RMB exchange rate regime will improve financial development and innovation**. Wholesale interest rates and derivative prices are unregulated. Although progress has been made in improving exchange rate flexibility since 2005, intraday movements of the exchange rate of RMB against the U.S. dollar in the inter-bank spot market are limited to ±0.5 percent, and inter-day movements in the central parity rate have, in effect, not moved more than this, while retail interest rates remain regulated. Both limit the exchange rate and interest rate risk exposure of financials and corporates, thereby reducing the demand for hedging products and the incentive for financial market and product innovation. The PBC is actively researching and guiding innovation of financial institutions on tools to hedge FX risks.

54. **Bond market efficiency would be enhanced by pursuing more active Government's issuance strategy, continuing to reform the interest rate regime, and addressing other price distortions**. The issuance strategy could also be used as an instrument to foster secondary market liquidity. Arbitrage opportunities remain along different segments of the yield curve.

C. Systemic Liquidity

55. **Abundant liquidity limits the risk of a systemic liquidity crisis in the near term, but complicates aggregate liquidity management**. PBC's aggregate liquidity management would benefit from a move towards more indirect instruments. The PBC's control of base money is becoming difficult as capital controls become more challenging, financial markets develop, and China's integration in the global financial system proceeds. This argues for moving towards greater use of indirect instruments which could be tested in a pilot program to target a short-term money market interest rate.

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[5] A strategy for AMCs established to help restructure banks needs to be developed. Transforming AMCs into commercial entities is recommended to eliminate moral hazard and to encourage banks to undertake quality risk analysis. In the interim, AMCs should be required to make periodic financial statements and management reports public.

56. **Lowering reserve requirements and introducing reserve averaging would facilitate institutional level liquidity management and enhance stability**. Consideration should be given to piloting reserve averaging at institutions with a structural surplus of funds, as well as several of those with a persistent deficit. To limit the impact of the PBC's liquidity management activities on the yields of MOF's issuances, both institutions should strengthen coordination when issuing in the same maturity segments. Different models could be assessed (e.g. Mexico, Brazil) to develop a framework suitable for China. The challenge is to preserve PBC's autonomy to guide short-term interest rates in line with its monetary policy goals and to conduct sterilization operations when needed, while supporting the MOF's ongoing development of a sustainable liquid risk-free yield-curve. Also, access to the PBC's standing facilities should be made more automatic and transparent with moral hazard concerns dealt with through pricing.

D. Payment and Securities Settlements Systems

57. **The PBC has carried out a comprehensive reform of the China National Payments System (CNPS)**. The backbone is the High Value Payment System (HVPS), which is a systemically important payment system (SIPS). The assessment of the HVPS concludes that it broadly observes the Core Principles for SIPS. However, there is room for improvement, in particular with regard to the legal framework and oversight arrangements. The authorities should ensure the legal framework gives full protection to payments, derivatives and securities settlement finality. Regarding oversight, the PBC should clarify its policy stance in payment system oversight and determine the scope, major policies and instruments of the function. A more proactive oversight by the PBC of the China Foreign Exchange Trade System (CFETS) is advisable.

58. **The FSAP team's assessment of securities and derivatives settlements systems suggest broad compliance with international standards.** Improvements however could be made in the following areas:

- *Bond market CCDC system*: legal foundation, pre-settlement and settlement risk, governance, transparency, regulation and oversight:

- *Stock exchanges SD&C systems:* ensuring further robustness of the CCP and transparency;

- *Commodities futures markets-SHFE system*: legal foundation, margin requirements, and transparency.

E. Legal and Regulatory Structure

59. **The structure of the legal framework for the financial sector has developed largely on a piecemeal basis.** The framework could benefit from a routine review for effectively identifying and changing rules. While much has been done to ensure effective rule making in the form of public exposure and broad based consultation and interventions by the NPC Standing Committee and the State Council in ensuring timely reforms, more can be done to ensure effective implementation by having feedback mechanisms. In this regard, a "stock-take" of the gaps, overlaps and lack of clarity in the laws governing the financial sector is necessary.

60. **China could benefit from applying a more principle-based approach in the formulation and implementation of laws**. The regulatory system is rule-based, and there is a lack of flexibility for financial intermediaries to apply the rules and still have confidence that they have fully complied with

them. The result is a high cost of compliance. The rule-base approach to regulation may have been appropriate, but going forward, consideration should be given to making it more principle-based.

61. **The legal framework for insolvency proceedings and creditors' rights should be reviewed to provide for efficient and effective exit mechanisms**. Detailed laws concerning the insolvency of financial institutions have not been developed for some sectors. The legal framework for insolvencies can be improved in areas relating to threshold tests, treatment of future claims and rules for dealing with cross border insolvencies. In addition, Consumer protection should be strengthened by building capacity in the courts to enforce contracts, empowering consumer organizations to play an effective role, enhancing personal data and privacy protection and by requiring market practices and codes of conduct to be in place.

F. Accounting and Auditing[6]

62. **Chinese commercial banks have adopted the new *Chinese Accounting Standards (CAS)*, which have achieved substantial convergence with the International Financial Reporting Standards (IFRS).** First introduced in 2007 by the MOF, CAS include a basic standard and 38 specific Accounting Standards for Business Enterprises. The capacity of the auditing profession is uneven and attention will need to be given to ensuring the quality of financial statements of small financial institutions matches that of large ones. The standard auditor independence regulation and oversight of the profession need to be improved.

G. Market Integrity

63. **China has made significant progress in implementing its anti-money laundering and combating the financing of terrorism (AML/CFT) system.** In 2007 the Financial Action Task Force (FATF) mutual evaluation report found the system in China to be acceptable, but lacking in some areas. The AML/CFT legal regime has since been strengthened and China has submitted a number of follow up reports to FATF reporting progress in addressing identified deficiencies. Based upon the submissions, the FATF plenary has concluded that China's level of compliance with its standards is now essentially largely compliant. However, two shortcomings remain. First, Chinese law and practice provides limited ability for authorities or financial institutions to have access to the identity of beneficial owners of legal persons. Second, preventive measures have not been sufficiently extended to non-financial businesses and professions.

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[6] See also the 2009 World Bank *Report on the Observance of Standards and Codes–Accounting and Auditing*.

Table 1. Key Recommendations

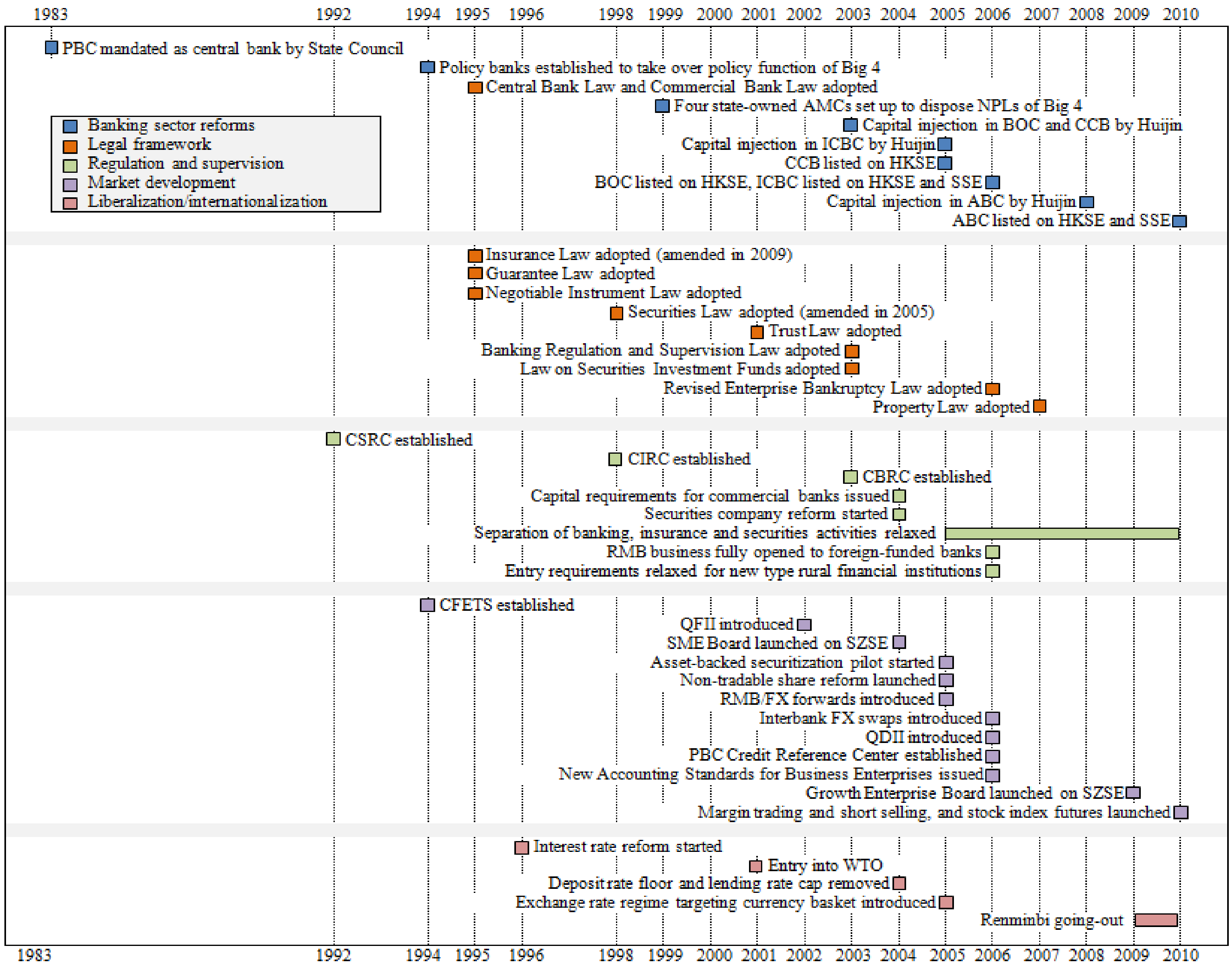
Recommendations	Priority	Time-Frame
Improving commercialization		
1. Continue to advance the process of interest rate and exchange rate reform while ensuring that appropriate credit risk management practices in financial institutions are in place.	High	MT
2. Clearly delineate the roles and functioning of policy financial institutions from commercial financial institutions.	Medium	MT
3. Transform the four Asset Management Companies (AMCs) into commercial entities, and, as a first step, require them to make public periodic financial statements and management reports.	Medium	MT
Increasing efficiency of the institutional, regulatory, and supervisory framework		
4. Empower the PBC and three supervisory commissions with focused mandates, operational autonomy and flexibility, increased resources and skilled personnel, and strengthen interagency coordination to meet the challenges of a rapidly evolving financial sector.	High	MT
5. Develop a framework for regulation and supervision of financial holding companies (FHCs), financial conglomerates, and informal financial firms. In the interim, acquisition of a regulated institution should be approved by the regulatory commissions that are responsible for the underlying financial institutions.	Medium	NT
6. Introduce a more forward-looking assessment of credit risk in the CBRC risk rating system and eliminate deviations from the capital framework for credit and market risk.	Medium	NT
7. Introduce a formal program whereby the CSRC conducts regular comprehensive on-site inspections of the exchanges to improve oversight.	Medium	NT
8. Introduce a risk-based capital (RBC) solvency regime for insurance firms with suitable transition period and restrict new businesses by insurance companies operating below the 100 percent solvency level.	Medium	MT
9. Develop explicit and clear regulation for facilitating the exit of insurance companies from the market via run off or portfolio transfers.	Medium	NT
10. Enact a payment system law to give full protection to payments, derivatives and securities settlement finality.	Medium	MT
11. Ensure that beneficial ownership and control information of legal persons is adequate, accurate, and readily accessible to competent authorities.	High	MT
12. Improve information sharing and coordination arrangements among the PBC and other agencies on anti-money laundering (AML) and other supervisory issues.	High	MT
Upgrading the framework for financial stability, systemic risk monitoring, systemic liquidity, and crisis management		
13. Establish a permanent committee of financial stability, with the PBC as its secretariat.	High	MT
14. Upgrade data collection on financial institutions including their leverage, contingent liabilities, off-balance-sheet positions, unregulated products, and cross-border and sectoral exposures.	Medium	NT
15. Build a macro prudential framework for measurement and management of systemic risks; this should include increasing the resources and capacity of the PBC and regulatory agencies to monitor financial stability and to carry out regular stress tests.	High	NT

Recommendations	Priority	Time-Frame
16. Enhance the sterilization of structural liquidity through market-based instruments and manage systemic liquidity spillovers via indirect monetary policy instruments.	High	NT
17. Introduce reserve averaging to facilitate liquidity management and enhance stability and efficiency.	High	NT
18. Start targeting a short-term repo rate on a pilot basis, as a trial of indirect liquidity management, and commence daily open market operations.	High	NT
19. Ensure that PBC's standing facilities operate immediately and automatically, with specified collateral requirement identical across all domestically incorporated institutions.	Medium	NT
20. Introduce a deposit insurance scheme to assist in the orderly wind-down of financial institutions and to help clarify the contingent liability.	Medium	NT
Developing securities markets and redirecting savings to contractual and collective investment sectors		
21. Ensure regulations are consistent and clarify regulatory responsibilities to support fixed income market development.	Medium	MT
22. Continue to improve bond issuance strategies between MOF and the PBC to help improve the existing market-making across all maturities of the yield curve.	High	MT
23. Upgrade regulatory and operational repo market framework to increase market liquidity, enhance risk management and reinforce the money and bond market interest rate nexus.	Medium	NT
24. Ease the 40 percent of net assets limit applicable to corporation's market based debt issuance to expand direct funding capacity.	Medium	MT
25. Upgrade links between China Central Depository Trust & Clearing Co., Ltd (CCDC) and Securities Depository and Clearing Corporation Limited (SD&C) to enhance connectivity among Interbank Bond Market (IBBM), Shanghai Stock Exchange (SSE), and Shenzhen Stock Exchange (SZSE), support further development, and contribute to efficiency in all three markets.	Medium	MT
26. Consolidate the multi-pillar pension system, with emphasis on the funded component.	Medium	MT
Improving alternative financing channels and access		
27. Review existing government programs to determine their effectiveness in promoting rural and micro and small enterprise (MSE) finance and formulate an integrated and coherent rural and MSE finance strategy.	High	MT
28. Further reform the rural credit cooperatives (RCCs) to enhance their efficiency and sustainability as commercial providers of financial products and services.	Medium	MT
29. Complete the reform of the Postal Savings Bank of China (PSBC) by optimizing equity ownership, overhauling the bank to become a corporation, and building effective corporate governance.	Medium	MT

Notes: 1. NT (Near Term) means implementation completed within 3 years; MT (Medium Term) means implementation completed in 3–5 years.

2. The table has been revised since the delivery of the Aide Mémoire.

Table 2. China: Financial Sector Reforms



Note: The Big 4 banks are ICBC, CCB, ABC and BOC, which have been commercialized in recent years. The Big 4 and BOCOM together are referred to as large commercial banks.

Table 3. China: Selected Economic Indicators[1]

	2005	2006	2007	2008	2009	2010
	(Annual percentage change, unless otherwise specified)					
National accounts and employment						
Real GDP	11.3	12.7	14.2	9.6	9.2	10.3
Consumption	8.1	9.8	11.1	8.6	8.4	8.1
Investment	10.6	13.6	14.7	11.0	20.8	12.0
Net exports[1]	2.6	2.0	2.5	0.8	-3.7	0.9
Consumer prices						
Average	1.8	1.5	4.8	5.9	-0.7	3.3
Unemployment rate (annual average)	4.2	4.1	4.0	4.2	4.3	4.1
	(In percent of GDP)					
External debt and balance of payments						
Current account	5.9	8.6	10.1	9.1	5.2	5.2
Trade balance	5.5	7.7	8.8	7.7	4.4	3.9
Capital and financial account	4.5	1.9	2.7	1.0	3.6	3.8
Gross external debt	13.1	12.5	11.1	8.6	8.6	9.3
Gross reserves	36.6	39.8	44.3	43.5	49.2	49.6
Saving and investment						
Gross domestic investment	42.1	43.0	41.7	44.0	48.2	48.8
National saving	49.2	51.6	51.9	53.2	53.5	54.0
Public sector finance						
General government gross debt	17.8	16.2	19.6	17.0	17.7	17.0
General government balance	-1.4	-0.7	0.9	-0.4	-3.1	-2.2
	(Annual percentage change)					
Real effective exchange rate	-0.5	1.6	4.0	9.2	3.3	-0.5

Sources: Data on net exports, external debt and balance of payments are provided by the Chinese authorities; the rest is based on historical data and staff estimates and projections.

[1] Contribution to annual growth in percent.

Table 4. China: Structure of the Financial Sector, 2007–10

	2007					2008				2009				2010			
	Number of Institutions	Total Assets (in bln RMB)	Share of Total Assets	Share of GDP		Number of Institutions	Total Assets (in bln RMB)	Share of Total Assets	Share of GDP	Number of Institutions	Total Assets (in bln RMB)	Share of Total Assets	Share of GDP	Number of Institutions	Total Assets (in bln RMB)	Share of Total Assets	Share of GDP
Banking Institutions	**8,721**	**51,627**	**84.1**	**194.2**	**-**	**5,578**	**61,982**	**87.8**	**197.4**	**3,767**	**77,978**	**87.0**	**229.0**	**3,639**	**93,215**	**87.6**	**234.2**
Commercial banks	187	40,459	65.9	152.2	-	323	47,819	67.8	152.3	336	61,513	68.6	180.7	379	74,160	69.7	186.3
Large commercial banks	5	28,007	45.6	105.4		5	32,575	46.2	103.7	5	40,800	45.5	119.8	5	46,894	44.1	117.8
Joint-stock commercial banks	12	7,249	11.8	27.3		12	8,834	12.5	28.1	12	11,818	13.2	34.7	12	14,904	14.0	37.4
City commercial banks	124	3,340	5.4	12.6		136	4,136	5.9	13.2	143	5,680	6.3	16.7	147	7,853	7.4	19.7
Rural commercial banks	17	610	1.0	2.3		22	929	1.3	3.0	43	1,866	2.1	5.5	85	2,767	2.6	7.0
Foreign banks	29	1,252	2.0	4.7		148	1,345	1.9	4.3	133	1,349	1.5	4.0	130	1,742	1.6	4.4
Locally incorporated foreign subsidiaries	…	…	…	…		32	996	1.4	3.2	38	1,132	1.3	3.3	40	1,522	1.4	3.8
Branches of foreign banks	…	…	…	…		116	349	0.5	1.1	95	217	0.2	0.6	90	220	0.2	0.6
Policy banks and China Development Bank	3	4,278	7.0	16.1		3	5,645	8.0	18.0	3	6,946	7.7	20.4	3	7,652	7.2	19.2
China Postal Savings Bank	1	1,769	2.9	6.7		1	2,216	3.1	7.1	1	2,705	3.0	7.9	1	3,397	3.2	8.5
Cooperative financial institutions	8,503	5,121	8.3	19.3		5,150	6,295	8.9	20.0	3,263	6,789	7.6	19.9	2,870	7,893	7.4	19.8
Rural cooperative banks	113	646	1.1	2.4		163	1,003	1.4	3.2	196	1,270	1.4	3.7	223	1,500	1.4	3.8
Urban credit cooperatives 1/	42	131	0.2	0.5		22	80	0.1	0.3	11	27	0.0	0.1	1	2	0.0	0.0
Rural credit cooperatives1/	8,348	4,343	7.1	16.3		4,965	5,211	7.4	16.6	3,056	5,493	6.1	16.1	2,646	6,391	6.0	16.1
New-type rural financial institutions	27	0	0	0		101	6	0	0	164	25	0	0.1	386	113	0	0.3
Village or township banks	19	0	0	0		91	6	0	0	148	25	0	0.1	349	113	0	0.3
Rural mutual credit cooperatives	8	0	0	0		10	0	0	0	16	0	0	0	37	0	0	0
Non-Bank Financial Institutions	**690**	**9,744**	**15.9**	**36.7**	**-**	**738**	**8,582**	**12.2**	**27.3**	**772**	**11,666**	**13.0**	**34.3**	**782**	**13,168**	**12.4**	**33.1**
Insurance companies	102	2,831	4.6	10.6		112	3,280	4.6	10.4	120	3,971	4.4	11.7	125	4,965	4.7	12.5
Life	54	2,351	3.8	8.8		56	2,713	3.8	8.6	59	3,366	3.8	9.9	61	4,267	4.0	10.7
Re-insurance [1/]	6	89	0.1	0.3		9	101	0.1	0.3	9	116	0.1	0.3	9	115	0.1	0.3
Non-life	42	391	0.6	1.5		47	466	0.7	1.5	52	489	0.5	1.4	55	584	0.5	1.5
Pension funds	39	592	1.0	2.2		39	754	1.1	2.4	39	1,030	1.1	3.0	1	1,138	1.1	2.9
National Social Security Fund	1	440	0.7	1.7		1	562	0.8	1.8	1	777	0.9	2.3	1	857	0.8	2.2
Enterprise annuities	38	152	0.2	0.6		38	191	0.3	0.6	38	253	0.3	0.7	…	281	0.3	0.7
Fund management companies	59	3,280	5.3	12.3		61	1,939	2.7	6.2	60	2,677	3.0	7.9	63	2,520	2.4	6.3
Securities investment funds [2/]	346	3,280	5.3	12.3		439	1,939	2.7	6.2	577	2,677	3.0	7.9	704	2,520	2.4	6.3
Securities firms	106	1,734	2.8	6.5		107	1,191	1.7	3.8	106	2,027	2.3	6.0	106	1,967	1.8	4.9
Futures companies	177	50	0.1	0.2		171	59	0.1	0.2	167	121	0.1	0.4	164	192	0.2	0.5
Qualified Foreign Institutional Investors	51	286	0.5	1.1		76	179	0.3	0.6	94	290	0.3	0.9	106	297	0.3	0.7
Other non-bank financial institutions	152	972	1.6	3.7		168	1,181	1.7	3.8	182	1,550	1.7	4.6	213	2,089	2.0	5.2
Finance companies of enterprise groups	73	…	…	…		84	975	1.4	3.1	91	1,229	1.4	3.6	107	1,541	1.4	3.9
Trust companies	54	…	…	…		54	87	0.1	0.3	58	113	0.1	0.3	63	148	0.1	0.4
Finance leasing companies	10	…	…	…		12	80	0.1	0.3	12	160	0.2	0.5	17	316	0.3	0.8
Money brokerage firms	2	…	…	…		3	0.1	0.0	0.0	3	0.2	0.0	0.0	4	0.3	0.0	0.0
Finance companies	13	…	…	…		15	38	0.1	0.1	18	48	0.1	0.1	22	84	0.1	0.2
Lending companies	4	…	…	…		6	0	0	0	8	0	0	0	9	0.1	0.0	0
Auto financing companies	9	…	…	…		9	38	0.1	0.1	10	48	0.1	0.1	13	84	0.1	0.2
Banking asset management companies [3/]	4	…	…	…		4	…	…	…	4	…	…	…	4			
Total Financial System [4/]	**9,411**	**61,370**	**100.0**	**230.9**		**6,316**	**70,564**	**100.0**	**224.7**	**4,539**	**89,644**	**100.0**	**263.3**	**4,421**	**106,383**	**100.0**	**267.3**

Sources: PBC, CBRC, CIRC, CSRC, NBS of China, and Ministry of Human Resource and Social Security.

[1] As there is no insurance company engaged in both life and non-life business, data of reinsurance companies are provided instead. In 2007 the insurance sector adopted new accounting principles which are applied to the data starting from 2007.

[2] Proceeds raised by securities investment funds are managed by fund management companies on behalf of fund unit holders.

[3] The table excludes assets of the four AMCs. According to the FSAP team's calculations, the book value of the non-performing assets transferred to the AMCs amounted to about RMB2.6 trillion as of end 2006 (about 6 percent of total financial system assets or 12 percent of GDP). Comparable data for 2007–10 are not available, as the AMCs have not released financial statements since 2006.

[4] This table does not include informal finance, the estimates of which vary.

Notes: Data for 2008-10 were provided by the Chinese authorities in the context of the FSAP. Data for 2007 were collected from publically available sources, particularly the annual reports of the three financial regulatory agencies and the financial statements of the NSSF. Data on rural and urban credit cooperatives were collected from the CBRC's annual reports.

Table 5. China: Selected Indicators of Financial Health, 2005–10[1]

	2005	2006	2007	2008	2009	2010
Major Commercial Banks	*(In percent, unless otherwise indicated)*					
Capital Adequacy						
Regulatory capital to risk-weighted assets[2/]	2.5	4.9	8.1	12.0	11.0	12.0
Regulatory Tier I capital to risk-weighted assets	…	…	6.0	9.6	8.5	9.6
Nonperforming loans net of provisions to capital	…	…	55.9	4.2	1.4	-2.2
Capital to assets[3/]	4.3	5.2	5.4	5.9	5.3	6.0
Asset Quality						
Nonperforming loans to total gross loans	8.9	7.5	6.4	2.4	1.6	1.1
Loan loss provisions to non-performing loans[3/]	24.8	34.3	39.2	117.9	155.4	217.7
Sectoral distribution of loans to total loans[4/]						
Residents	…	…	97.8	97.9	99.3	…
Deposit takers	…	…	5.1	5.7	5.7	…
Central bank	…	…	3.0	2.1	4.2	…
Other financial corporations	…	…	1.0	1.7	1.1	…
General government	…	…	0.0	0.0	0.0	…
Non-financial corporations	…	…	70.5	69.8	68.3	…
Other domestic sectors	…	…	18.3	18.5	20.1	…
Non-residents	…	…	2.2	2.1	0.7	
Earnings and Profitability						
Return on assets[2/]	0.6	0.9	1.4	1.4	1.4	1.5
Return on equity[2/]	15.1	14.9	25.6	24.8	24.7	26.3
Interest margin to gross income[5/]	…	…	83.6	81.1	78.0	79.1
Noninterest expenses to gross income[5/]	…	…	41.2	37.0	38.4	35.5
Net interest margin[5/]	2.5	2.4	2.8	2.9	2.3	2.5
Noninterest expenses to average assets[5/]	1.7	1.7	1.6	1.8	1.4	1.4
Cost to income ratio[5/]	46.3	51.7	39.2	38.1	41.7	36.8
Interest income to operating income[5/]	87.4	90.2	87.7	87.1	84.8	84.2
Spread between reference lending and deposit rates[3/]	333.0	360.0	333.0	306.0	306.0	306.0
Liquidity						
Liquid assets to total assets	…	…	22.1	23.5	22.8	22.6
Liquid assets to short-term liabilities	…	…	37.6	44.7	41.6	41.2
Exposure to foreign exchange risk						
Net open position in foreign exchange to capital	…	…	22.7	12.8	7.4	7.4
Non-Bank Sectors						
Insurance sector						
Coverage ratio[6/]	…	…	444.0	210.0	223.0	206.0
Return on average equity (Life)	…	…	28.7	5.7	17.1	21.1
Return on average equity (Non-life)	…	…	-7.0	-26.2	2.9	21.5
State-owned enterprise corporate sector						
Number of SOEs[7/]	127,067	119,254	115,087	113,731	115115.0	…
Total debt to equity ratio	1.7	1.7	1.4	1.4	1.6	…
Central government	1.4	1.4	1.2	1.3	1.4	…
Local government	2.4	2.3	1.9	1.8	1.9	…
Return on equity	5.6	6.2	7.2	8.7	5.7	…
Central government	8.3	8.6	10.4	6.8	7.0	…
Local government	2.2	3.2	6.4	4.4	4.3	…
Return on assets	2.0	2.1	3.0	3.6	2.2	…
Central government	3.2	3.2	4.8	3.0	3.0	…
Local government	0.6	0.9	2.2	1.5	1.5	…
Debt service coverage ratio[8/]	4.12	4.43	7.25	3.72	4.3	…
Central government	6.55	6.96	7.41	4.36	5.0	…
Local government	2.83	3.33	4.30	2.94	3.4	…
Small- and medium-sized enterprises						
Number of SMEs[9/]	242,061	269,031	300,262	385,721	393,074	…
Total debt to equity ratio	1.45	1.42	1.38	1.31	1.26	…
Return on assets	5.75	6.52	7.84	8.44	8.6	…
Return on equity	14.06	15.82	18.70	19.51	19.5	…
Debt service coverage ratio[8/]	6.47	7.09	7.33	7.43	8.64	…
Real estate sector						
Commercial property inflation[10/]	5.6	4.0	5.8	4.6	…	…
House price inflation[10/]	8.4	6.4	8.2	7.1	…	…
Domestic residential house purchasing loans as percent of total loans[11/]	…	…	…	12.5	14.0	14.5

Sources: PBC, MOF, CBRC, CIRC, State -Owned Asset Administration Commission, NBS of China, IMF *Global Financial Stability Report*, Bankscope, and IMF staff calculations.

[1] All data for this table were provided by the Chinese financial regulatory and supervisory commissions in the context of the FSAP. The following footnotes describe some cases in which the figures were obtained from other publically available sources or calculated by the FSAP team.

[2] Comparability across years is limited due to differences in data coverage. Data for 2005 and 2006 refer to the total banking industry as reported in the IMF Global Financial Stability Report, whereas data from 2008 to 2010 refer to the 17 major commercial banks as reported by the national authorities to the FSAP team.

[3] Capital adequacy and asset quality indicators were calculated with data from CBRC's 2010 annual report. Capital to assets ratio is defined as equity to assets. Interest rate spreads were calculated with data from PBC's Monetary Policy Reports.

[4] Ratios where the numerator and denominator were compiled on a domestically consolidated basis (DC).

[5] Simple averages of 17 major commercial banks. FSAP team's calculations based on the banks' financial statements and Bankscope.

[6] Available solvency margin over required solvency margin.

[7] Number of non-financial SOEs above Grade Three. The State-Owned Assets Supervision and Administration Commission directly held SOEs are Grade One. Grade One SOEs directly held subsidiaries companies are Grade Two. Grade Two enterprises directly held subsidiaries are Grade Three.

[8] Earnings before interest and tax as a percentage of interest and principal expenses.

[9] Number of SMEs in the industrial sector.

[10] Percent change in commercial real estate and house price indices.

[11] CBRC's statistics based on credit data based on institution (legal person).

Table 6. China: Financial Development Indicators, 2005–10

	2005	2006	2007	2008	2009	2010
Banking						
Total number of banking institutions	-	19,667	8,721	5,578	3,767	3,639
Number of branches/million population	-	140	144	146	145	146
Bank deposits/GDP (%)	147.2	153.3	143.5	147.5	169.6	171.3
Private credit[1]/GDP (%)	114.3	113.0	111.0	108.3	129.3	131.1
Bank assets/total financial system assets (%)	-	-	84.1	87.8	87.0	87.6
Bank assets/GDP (%)	197.1	198.3	194.2	197.4	229.0	234.2
Insurance						
Number of life insurers	42	48	54	56	59	61
Number of non-life insurers	35	38	42	47	52	55
Insurance Penetration (premiums in % of GDP)						
Life	1.8	1.7	1.8	2.2	2.3	-
Non-life	0.9	1.0	1.1	1.0	1.1	-
Insurance Density (premiums per capita, RMB)						
Life	250	272	336	498	554	-
Non-life	129	155	194	234	273	-
Pension						
Percentage of labor force covered by pensions	30.1	31.5	32.8	35.4	41.2	45.7[2]
Pension fund assets/GDP (%)	1.5	1.7	2.2	2.4	3.0	2.9
Pension fund assets/total financial system assets (%)	-	-	-	1.1	1.1	1.1
Mortgage						
Mortgage assets/total financial system assets (%)	-	-	-	4.2	5.0	5.2
Mortgage debt stock/GDP (%)	-	-	-	9.4	13.1	14.0
Money markets						
Interbank lending (RMB billion)	1,278	2,150	10,647	15,049	19,350	27,868
Pledged repo value of transactions (RMB billion)	15,678	26,302	44,067	56,383	67,701	84,653
Outright repo value of transactions (RMB billion)	219	292	726	1,758	2,602	2,940
Central bank bill value traded (RMB billion)	2,893	4,240	8,704	22,827	14,213	17,465
Foreign exchange markets						
Foreign exchange reserves in months of imports	13.3	14.4	16.8	18.1	24.6	-
Foreign exchange reserves/short-term debt	4.8	5.4	6.5	8.6	9.3	7.6
Value of transactions in FX swap (USD billion)	0	51	315	441	806	1,296
Value of transactions in FX forward (USD billion)	2.7	14.1	22.6	17.9	11.7	36.4
Capital Markets						
Equity market						
Number of listed companies	1,387	1,440	1,550	1,625	1,700	2,063
Market capitalization of listed companies[3]/GDP (%)	17.5	41.3	123.1	38.6	71.6	66.7
Stock market value traded/market capitalization[3] (%)	96.4	100.4	140.8	220.1	219.7	205.6
Number of new offers	15	66	124	76	99	347
Value of new offers (RMB billion)	5.8	134.2	481.0	103.4	187.9	488.3
Bond market						
Government bonds outstanding[4]/GDP (%)	27.3	28.9	32.4	31.3	29.3	28.1
Financial bonds outstanding/GDP (%)	10.8	12.1	12.7	13.4	15.1	15.0
Corporate bonds outstanding/GDP (%)	1.7	2.6	3.0	4.1	7.1	8.6
Derivatives market						
Total market value of warrants traded on SSE and SZSE (RMB billion)	-	-	54.0	17.5	20.9	1.5
Annual turnover of warrants on SSE and SZSE (RMB billion)	-	-	7,783	6,969	5,365	1,499
Annual turnover of commodity futures (RMB trillion)	-	-	20.5	36.0	65.3	113.5
Total notional outstanding of RMB interest rate derivatives[5] (RMB	5.0	33.3	217	529	662	1,486
Average daily trading volume of RMB interest rate derivatives (RMB	0.0	0.1	0.9	2.1	1.9	6.0
Collective investment funds						
Number of licensed investment funds	-	-	346	439	557	704
Number of fund management companies	-	-	59	61	60	63
Total assets under management by investment funds/GDP (%)	-	-	12.3	6.2	7.9	6.3
Share of retail investors in investment funds (%)	-	-	89	81	82	82
Memo:						
Nominal GDP (RMB billion）	18,494	21,631	26,581	31,405	34,051	39,798
Population (million)	1,304	1,311	1,318	1,325	1,331	1,338

Source: PBC, CBRC, CIRC, CSRC, MOHRSS, CFETS, BIS, IFS, WDI, and Swiss Re Sigma and ChinaBond.com.cn.

Notes: 1. Including credit to public enterprises.

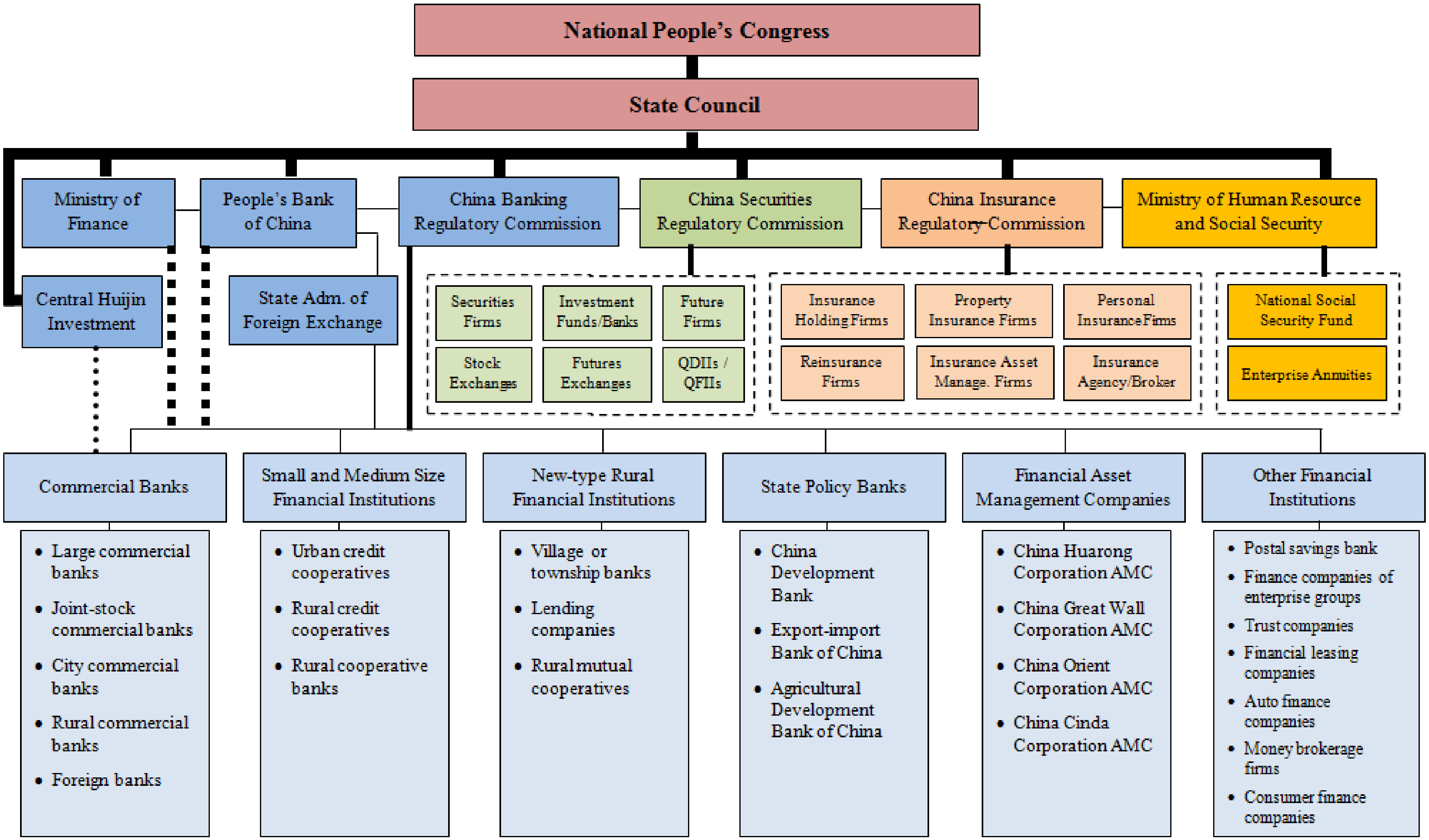
2. Labor force data for 2010 is an estimate.

3. Including all the A and B shares of companies listed on SSE and SZSE.

4. Data for government bonds are from the BIS and include both treasury securities and central bank bills/notes.

5. Estimates by CFETS.

Table 7. China: Financial System Architecture



Notes: The thickest connecting lines correspond to the highest levels of authority in financial policy making. The NPC promulgates all financial sector laws and the State Council executes financial regulation and issues mandatory policy directives to all the financial regulatory and supervisory agencies. The dotted connecting lines indicate the three primary functions of PBC—formulating monetary policy, maintaining financial stability, and providing financial services—and the triple role of the MOF as tax administrator, treasurer, and owner of several commercial banks. The thinner connecting lines emerging from CBRC, CSRC, CIRC, and MHRSS reflect that these entities are mostly responsible for regulating and conducting supervision and oversight of their respective financial sectors. **Additional notes:** The SAFE is responsible for foreign exchange operations of securities and insurance companies. The China Development Bank and the Postal Savings Bank are in the process of reforming into commercial banks. Central Huijin exercise rights and obligations as an investor in major state-owned financial enterprises on behalf of the State. The National Social Security Fund has also a dual role as an institutional investor and a stakeholder in some of the largest commercial banks.