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Executive Summary

In 2011, economic growth moderated globally against the backdrop of spiraling fiscal and financial risks in major developed economies, turmoil in the international financial markets, and increased uncertainties. The Chinese economy continued to move in the direction as intended by macro-economic management policies, as reflected in deepening financial sector reform, stronger resilience of the sector against shocks, stable financial markets performance, better financial conditions of the government, corporate and household sectors, progress in financial infrastructure construction, and the overall soundness of the financial system. In 2012, the outlook for the world economy remains severe and complicated. We expect more instability and uncertainties in global recovery as the sovereign debt crisis in Europe is unlikely to be resolved any time soon, recovery in major developed economies remains slow and emerging market economies face greater difficulty in macro-economic management. In China, the imbalances and unsustainable problems in economic growth remains pronounced; with downward pressure in economic growth, upward pressure in price movement, and potential risks in the financial sector, there are new challenges in the maintenance of financial stability.

Macroeconomic performance was sound. In 2011, a proactive fiscal policy and prudent monetary policy was adopted, the economy continued fairly stable and rapid growth and economic restructuring progressed in an orderly manner. The domestic demand expanded and external demand was relatively stable. Fiscal revenue increased rapidly and a larger share of the expenditure was used to improve people's welfare and support agricultural and rural development and the farmers. The growth of price indices accelerated in the first half but declined in the second half of the year. With austerity measures becoming stronger, the prices gradually declined on the real estate market. The growth of money and credit normalized and the RMB exchange rate appreciated but remained stable. Going forward, the proactive fiscal policy and prudent monetary policy will continue; the policy measures will be more forward looking, targeted, and more effective to keep the all-system financing aggregate at a reasonable volume and increase financial support to the real sector. Furthermore, key reforms including market-based interest rate reform and exchange rate regime reform will be deepened and a counter-cyclical macro-prudential regulatory framework improved to create a favorable financial environment for the long-term, stable and fairly rapid growth of the economy.

The banking sector implemented the macro-economic management policies earnestly, kept loan disbursement at reasonable sizes, and operated in a sound manner. The various reforms were advanced, assets and liabilities continued to expand, financial support to rural area, agricultural sector and farmers and to micro and small enterprises was enhanced, and asset quality, soundness standard and supervision further improved. At the next stage, the banking sector is expected to support the implementation of a prudent monetary policy, play the essential role of serving the real sector, continue to deepen reform and promote innovation. The banking supervisory framework will be improved with a focus on mitigating and dissolving potential risks in key areas and the risks in the non-financial institutions that have a financial function, with a view to making the banking sector stronger and more resilient.

The securities and futures sector continued to expand as both the number of securities and future companies and their assets grew. Business innovation made further progress with increasing volume of securities margin trading and the launch of investment consulting services by futures companies. Compliance supervision was enhanced on futures and securities sector and increased their resilience against shocks. However, due attention should be given to the simple business structure of securities companies and the lack of comprehensive strength on the part of the futures companies. Going forward, measures will be taken to encourage the securities and futures companies to develop their core competitiveness, cultivate a culture that value integrity and reputation, continue to reform and open up, and to improve financial services to the real economy sector.

The development of **the insurance sector** was in general stable as evidenced in asset and premium income growth, improvement in the organization system of the sector, a broader range of services, progress in reform and innovation, improvement in supervisory system and further opening-up. Still, with relatively low yield of insurance fund investment and reduced solvency, some insurance companies faced stronger pressure in capital replenishment. At the next stage, efforts shall be made to transform the growth model of the sector, optimize business structure, encourage innovation, improve supervision, and better protect the rights and interests of consumers. At the same time, it is necessary to create a favorable external condition to facilitate sound development of the insurance sector so that it can provide better services to consumers and the real sector.

In general, **the financial markets** developed steadily in the process of reform and innovation, and played its role in optimizing resource allocation and support real sector growth. Trading on the money market was brisk, and interest rate fluctuation was fairly big. The trading volume in the bond market remained stable as bond indices moved up and investors base expanded. The valuation of securities market was at a low level compared with historical records. Trading volume on the commodities futures market decreased by a large margin but the growth of financial derivative market was stable. Bill market performance was basically sound, trading on the foreign exchange market was brisk and trading on the gold market boomed. Going forward, measures will be adopted to support healthy development of the bond market, deepen the reform of new stock issuing mechanism, promote market exit reform, continue to develop OTC markets, and improve market mechanism for resource allocation to provide better services to the real sector and promote economic restructuring and transformation of growth model.

The analysis of the financial statements of the government, corporate and household sectors show that the government's financial condition was good with controllable and safe debt level but potential risks in the indebtedness of some local governments should be watched. The profits of the corporate sector increased further but their solvency was slightly eroded and liquidity was tight. The enterprises faced eased pressure in raw material prices and orders from home and abroad both declined. The financial assets of the household sector expanded but remained to be further diversified. Their overall level of indebtedness was relatively low and supported strong solvency.

The building of **financial infrastructure** made progress. The payment, clearing and settlement system operated in a steady and safe way and supervisory system was improved. The use of non-cash payment instruments became more popular. The business of centralized bond clearing and settlement grew rapidly. Laws and regulations were adopted for the financial sector, strengthening the basis of financial legislation. The formulation and implementation of accounting standard was advanced and the system of accounting standard improved. The building of a social credit system moved ahead with the credit information system playing an increasingly important role and credit environment being improved. The work in anti-money laundering (AML) continued to advance with supervision and investigation effectiveness improved, and international cooperation deepened. In the next stage, measures will be taken to enhance supervision of payment, clearing and settlement system, improve financial legislation, promote convergence with international accounting standard, improve social credit environment and optimize AML supervision.

Macro-prudential regulation was further enhanced. International organizations increased input in the research and formulation of international standard and code on macro-prudential regulation. Financial regulatory reform in major economies was advanced and macro-prudential mandate strengthened. In 2011, China made useful exploration in enhancing macro-prudential regulation. The financial statistics system and risk monitoring and analysis were improved and the counter-cyclical macro-adjustment mechanism focusing on the dynamic adjustment of differentiated reserve requirement was improved. Research was made on improving regulation of systemically important financial institutions (SIFIs) and on building a framework for crisis management and risk resolution. Looking ahead, based on a study of the lessons of the global financial crisis and international practice and in view of the Chinese situation, more efforts will be made to improve macro-prudential policy framework, establish a system for macro-prudential regulation and micro-prudential supervision to supplement and work together with one another, improve risk prevention capability of the financial system and the sustainability of financial support to real sector.

Abbreviations and Acronyms

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
AMC	Asset Management Company
AML	Anti-money Laundering
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BOC	Bank of China
BOCOM	Bank of Communications
BOJ	Bank of Japan
BOK	Bank of Korea
CABD	County Area Banking Division
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCP	Central Counterparty
CDB	China Development Bank
CEB	China Everbright Bank
CEPA	Closer Economic Partnership Arrangement
CEXIM	The Export and Import Bank of China
CGB	China Guangfa Bank
CGFS	Committee of Global Financial System
CIRC	China Insurance Regulatory Commission
CMGs	Crisis Management Groups
CPI	Consumer Price Index
CPSS	Committee on Payment and Settlement System
CRB	Commodity Research Bureau
CSI	China Securities Index Co. Ltd
CSRC	China Securities Regulatory Commission

CTF	Counter Terrorist Financing
DARs	Detailed Assessments Reports on Observance of Financial Standards and Codes
DVP	Delivery Versus Payment
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ERM	Enterprise Risk Management
ESMA	European Securities Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchanges Traded Fund
EU	European Union
EUR	Euro
FASB	Financial Accounting Standards Board
FATF	Financial Action Task Force on Money Laundering
FCA	Financial Conduct Authority
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FPC	Financial Policy Committee
FSA	Financial Service Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Committee
FSSA	Financial System Stability Assessment
G20	Group of Twenty
GDP	Gross Domestic Product
GEM	Growth Enterprise Market
G-SIBs	Global Systemically Important Banks
G-SIFIs	Global Systemically Important Financial Institution
HICP	Harmonized Index of Consumer Prices
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICB	Independent Commission on Banking
ICBC	Industrial and Commercial Bank of China
ICPs	Insurance Core Principles

IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
JPY	Japanese Yen
LGFP	Local Government Financial Platform
LME	Large and Medium Enterprise
MFA	Ministry of Foreign Affairs
MHRSS	Ministry of Human Resources and Social Security
MOC	Ministry of Commerce
MOF	Ministry of Finance
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NPL	Non-Performing Loan
ODI	Outward Direct Investment
OECD	Organizations for Economic Co-operation and Development
OTC	Over the Counter
PBC	People's Bank of China
P/E	Price-earnings
PICC Asset	PICC Asset Management Company Limited
PICC Group Limited	People's Insurance Company (Group) of China Limited
PICC P&C	PICC Property and Casualty Company Limited
PPNs	Private Placement Notes
PPI	Producer Price Index
PRA	Prudential Regulation Authority
PSBC	Postal Savings Bank of China
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
REITs	Real Estate Investment Trusts
RMB	Renminbi
ROI	Return on Investment
ROSC	Reports on Observance of Standards and Codes
RQFII	RMB Qualified Foreign Institutional Investors
SAFE	State Administration of Foreign Exchange
SIFI	Systemically Important Financial Institution
Sinosure	China Export & Credit Insurance Corporation

SME	Small and Medium-sized Enterprise
USD	US Dollar
XBRL	Extensible Business Reporting Language
y-o-y	Year-on-year

CONTENTS

Chapter I

Macroeconomic Performance

In 2011, against the backdrop of slower global growth, decelerated growth of international trade and significant fluctuations on the international financial markets, the world economy faced heightened risks. Major developed economies suffered the spiral of fiscal and financial risks and insufficient driving force for growth. The European sovereign debt crisis deteriorated markedly. Emerging market economies encountered compromised growth momentum, and some of them went through severe inflation and big swings of short-term capital inflow and outflow. Continuing to develop in the direction as intended by macroeconomic management, the Chinese economy performed soundly in general, with lessened inflationary pressure at the end of the year.

In 2012, world economic environment will remain grave and complicated with heightened instability and uncertainty. The European sovereign debt crisis has become the major drag to global recovery. Growth of emerging markets will slow down further. Under the joint influence of external demand and domestic economic cycle, China's growth will moderate. It is imperative to speed up transforming the growth pattern and adjusting economic structure to achieve stable and relatively rapid economic development.

I. Global Economy and Financial Markets in 2011

Global recovery slowed down in 2011, with an annual growth rate of 3.9%. Economic performances varied across economies. Growth rates of the developed and the emerging economies stood at 1.6% and 6.2% respectively. International financial markets continued to swing within a wide range. Global stock market went downward in general and commodity prices fell down from their peaks.

1. Performance of the Major Economies

Though employment and inflation turned for the better, the U.S. still ran a huge deficit. The U.S. GDP grew by 1.7% in 2011, which was 1.3 percentage points slower y-o-y. The unemployment rate at the end of 2011 was 8.5%, the lowest level since 2009. Inflationary pressure moderated. The CPI in December grew 3.0% y-o-y, slowing down for the third consecutive month. Trade deficit posted USD 558 billion in 2011, up 11.6% y-o-y. Federal deficit registered USD 1.3 trillion in fiscal year 2011, as much as 8.7% of GDP. Though slightly smaller than 9.0% of 2010, it was still the third highest reading of fiscal deficit as a percentage of GDP since 1945.

Driving forces for recovery of the Euro Zone were weakened, and the pace of growth further diverged across countries. The GDP growth in the Euro Zone was 1.4% in 2011. The slower growth was accompanied by elevated unemployment, which stood at 10.4% in December. The inflation was beyond the 2% target for a 13th consecutive month, with HICP going up by 2.7% y-o-y in December. Broken down by countries, German GDP growth was 3.1%, 0.5 percentage point lower compared with 2010, but still remarkably stronger than the other Euro Zone countries. French GDP grew by 1.7%, 0.3 percentage point faster than that of 2010. Troubled economies such as Greece and Portugal suffered further deterioration, and their GDP contracted by 6.9% and 1.5% respectively.

Japanese economy rebounded more vigorously than expected, but faced weaker trade and heavier debt burden. The package of policy measures in response to the earthquake and tsunami taken in Japan effectively curbed the momentum of rapid economic decline. The Japanese economy rallied after a contraction, and the annual GDP growth rate was -0.7% in 2011. The unemployment rate was 4.5% at the end of 2011, 0.4 percentage point lower y-o-y. Consumer price remained subdued, and the core CPI declined by 0.2% y-o-y in December. Affected by yen depreciation, the earthquake and weaker external demand, export deteriorated. Japan registered a deficit of JPY 2.5 trillion , the first trade deficit in 31 years. The earthquake led to a surge of fiscal expenditure, adding up to heavier debt burden. At the end of Q3 2011, outstanding government debt reached the record high of JPY 954 trillion, as much as 199% of the GDP.

Emerging economies went through much slower growth, and faced more challenging policy making. Jointly affected by tightening domestic policy, downward movement of economic cycle and weaker external demand, major emerging economies suffered slower growth in 2011. The GDP growth of India was 7.2% in 2011, 3.4 percentage points slower than that of 2010. The CPI of 7.5% in December touched the lowest level in the recent two years, alleviating inflationary pressure. Brazilian GDP growth posted 2.7%, 4.9 percentage points slower y-o-y. Besides, the emerging economies including South Africa, Turkey, Indonesia and Vietnam encountered significantly slower growth in general. Dimmed prospect undermined investors' confidence in assets of emerging markets. Moreover, some Euro Zone banks sold their assets in emerging economies to fill their funding gaps, leading to capital outflow and depreciation of local currencies, and complicating decision making of macroeconomic policies.

Box 1 Global Economic and Financial Policy under the G20 Framework

After the outburst of the global financial crisis, the G20 Finance Ministers' and Central Governors' Meeting was upgraded into the G20 Summit. Under the framework of the G20 Summit, the developing countries had a stronger say. The G20 Summit has become the most important global economic and financial governance platform, playing a major role in the promotion of employment, economic growth, handling with the global financial crisis, reforming the international monetary system, promoting financial regulatory reform and reinforcing the multilateral trade system.

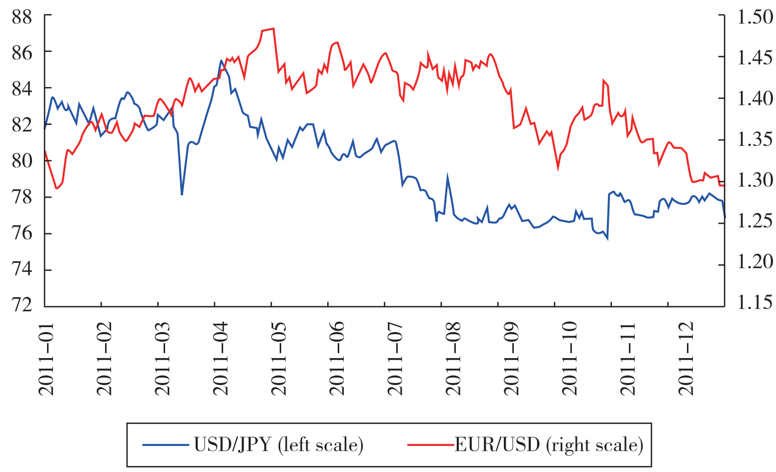
The G20 Cannes Summit in November 2011 proposed the following key economic and financial policies: First, promoting employment and growth. The G20 leaders pledged to promote strong, sustainable and balanced growth of global economy. They also encouraged member countries to implement structural reforms to stabilize growth, address short-term economic fragilities and consolidate the foundation for medium-term growth. Second, preventing and responding to international financial crisis. The leaders agreed to support the IMF to further strengthen global safety nets, and urged concerned countries in the euro area to implement reform plans, so as to restore market confidence and maintain financial stability. Third, reforming the international monetary system. They declared to implement the quota reform of the IMF, improve member countries' representation at the IMF and provide it with additional resources, and also clarify the criteria of SDR composition. Forth, pressing ahead with financial regulatory reform. The leaders committed to addressing major problems that came to the front due to the outburst of the global financial crisis through leveraging on the FSB. Specifically, they pledged to strengthen the regulation and reform of systemically important financial institutions, shadow banking, OTC derivatives, and compensation. Fifth, strengthening multilateral trade system. The G20 leaders declared to take concrete actions to avoid trade protectionism, and support the WTO to play a more active role in improving transparency on trade relations and policies and enhancing the functioning of the dispute settlement mechanism.

As a result of the joint efforts of G20 members, global economy has been gradually walking out of the shadow of the financial crisis. Threatened by multiple risks including the European sovereign debt crisis, global economy is still facing significant uncertainties. Amidst complicated and changeable international economic and financial situation, the G20 members should strengthen dialogue and cooperation with relevant international organizations and non-member countries based on an equal footing and mutual trust, so as to coordinate international economic policies, promote international financial reform and maintain global stability.

2. International Financial Market

The exchange rates of the major currencies fluctuated with large swings. During the year of 2011, the US dollar gathered after a decline. Though its exchange rate at the end of the year didn't change much from that at the beginning of 2011, significant ups and downs were seen along the year. At the end of 2011, the exchange rate of the US dollar against the euro was 1.2945 dollar per euro, a depreciation of the US dollar by 3.23 percent compared with last year. January through April 2011, euro continued to appreciate against the US dollar due to strong market expectation of interest rate hike against the background of generally stable performance of the European economies. However, the euro reversed course against the US dollar among fluctuations as a result of the deterioration and spread of the European sovereign debt crisis. Due to risk aversion, the yen/dollar rate remained at an elevated level, and the yen appreciated 5.22% against the US dollar among fluctuations. Currencies of the most emerging economies depreciated against the US dollar after an appreciation.

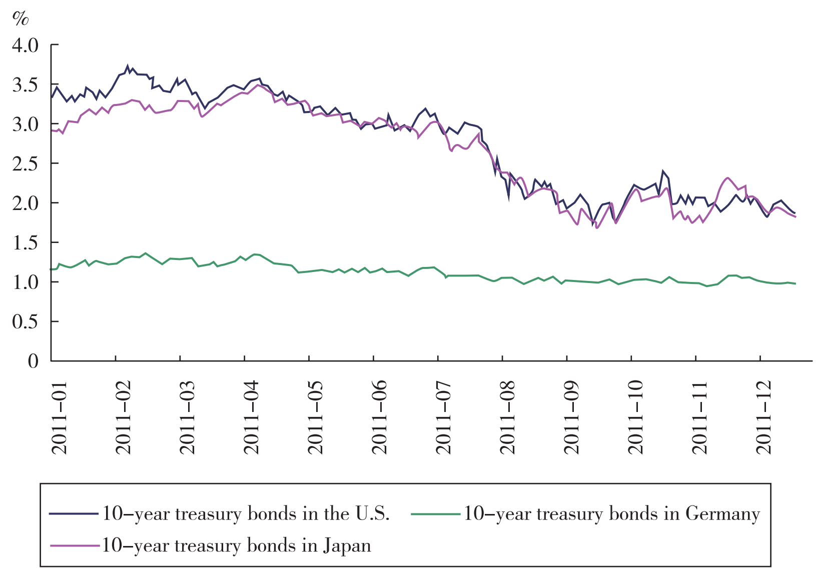
Figure 1.1 Exchange Rate Movements of Major Currencies in 2011



Source: Reuters.

The yields of government bonds in the major countries declined. In 2011, as the international credit rating agencies downgraded sovereign rating of Greece, Ireland and Italy, hedging demand of international capital was pushed up. Though S&P and the Moody's downgraded the sovereign rating of the U.S. and Japan, the yields of treasury bonds in the two countries went down. The yield of German bonds also decreased among fluctuations. By the end of 2011, yields of 10-year treasury bonds in the U.S., Germany and Japan closed at 1.88%, 1.83% and 0.99% respectively, down 1.48, 1.14 and 0.13 percentage point from the end of last year.

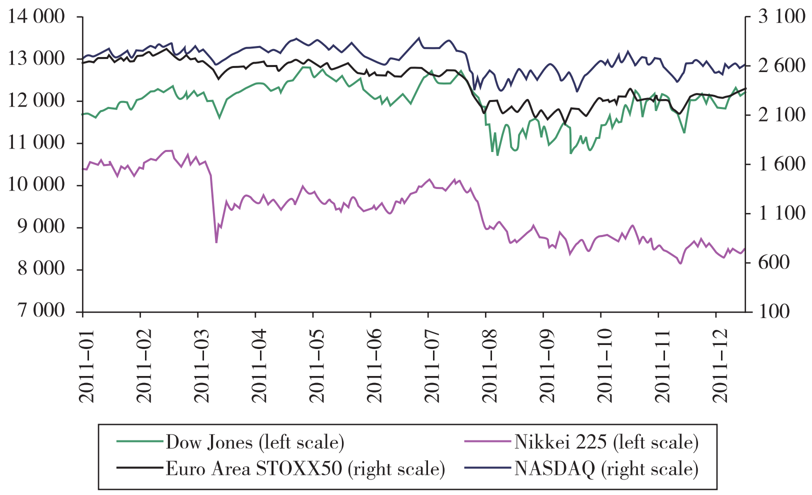
Figure1.2 Yields of T-bonds in Major Economies in 2011



Source: Reuters.

Global stock indices fluctuated within a large range. In the first half of 2011, global stock markets remained generally stable with temporary dip in the middle of March due to the earthquake hit Japan. In Q3, stock indices of major economies swung up and down substantially at a low level due to greater market panic brought by dispute over the U.S. debt ceiling, deterioration of the European sovereign debt crisis, and moderated pace of global recovery. In Q4, boosted by changes in expectations about the debt crisis and the pickup of the economic performance in the U.S. and the EU in Q3, the stock markets in these countries squeezed up. On December 31, the Dow Jones Industrial Average, the NASDAQ, and the STOXX50 closed at 12 217.56, 2 605, and 2 369.52 respectively, up 5.5 percent, up 1.8 percent, and down 8.9 percent respectively from the end of last year. Influenced by the a sluggish recovery and the devastating earthquake and tsunami, the Japanese stock market continuously moved downward in 2011, with the Nikkei 225 closing the year at 8 455, down 17.3 percent y-o-y. Stock markets of the major emerging economies plunged. Declining margin of RTS, Sensex, IBOVESPA, KOSPI and Shanghai Stock Composite Index posted 21.94%, 24.64%, 18.11%, 10.98% and 21.68% respectively.

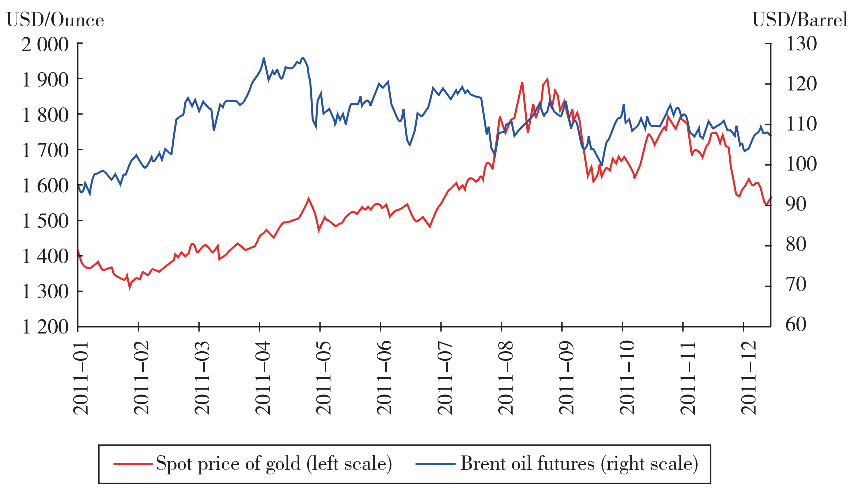
Figure 1.3 Global Stock Indices in 2011



Source: Reuters.

Global commodities price fell back from their peak. London Brent Crude Oil Futures Price touched the peak of USD126.65 on April 8th and fluctuated downward since then, closing at USD107.38 at the end of the year, which was up 13.3 percent y-o-y. Spot gold price at London Metal Exchange hit the record high of USD1 898.99 per ounce on September 5th and dived to USD1 563.8 per ounce at the end of 2011, up 10.2 percent y-o-y. The U.S. Commodity Research Bureau (CRB) index comprised of 19 commodities on global market fell by 8.49 percent cumulatively, among which the futures price of copper, steel and stannum plummeted for more than 20 percent, and that for sugar, wheat and natural gas declined for more than 10 percent.

Figure1.4 Price Indices of Crude Oil and Gold on the International Market



Source: Reuters.

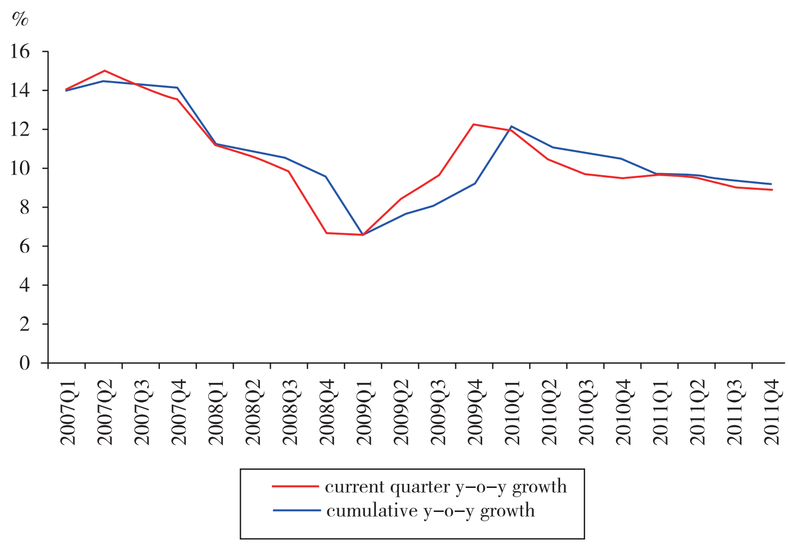
II. Features of China's Economic and Financial Performance in 2011

In 2011, against the backdrop of complicated international political and economic environment and new conditions and changes in domestic economic operation, China continued the implementation of an active fiscal policy and prudent monetary policy. Macroeconomic policy has been better-targeted, more flexible and proactive while remaining consistent and sound at the same time, striking a balance between maintaining stable and relatively rapid economic growth, restructuring and managing inflationary expectation. As a result, China has maintained stable and relatively rapid economic growth with over rapidly rising price momentum curbed and economic structure improved. The national economy developed in the direction intended by macroeconomic policy.

1. The economy grew steadily with good progress of restructuring

The National Bureau of Statistics (NBS) estimated that China's nominal GDP registered RMB 47.16 trillion yuan in 2011, up 9.2 percent in real terms y-o-y, a deceleration of 1.2 percentage points. From Q1 through Q4, GDP growth stood at 9.7 percent, 9.5 percent, 9.1 percent and 8.9 percent respectively, showing slight slowdown (figure 1.5). Broken down by industries, added value for the primary, secondary and tertiary industry registered RMB 4.77 trillion yuan, RMB 22.06 trillion yuan and RMB 20.33 trillion yuan respectively, up 4.5%, 10.6% and 8.9% respectively over the previous year. Added value of the primary, secondary and tertiary sectors accounted for 10.1 percent, 46.8 percent and 43.1 percent respectively as a percentage of GDP, down 0.06 percentage point, 0.08 percentage point and up 0.14 percentage point from the previous year.

Figure1.5 Y-o-y Growth of Cumulative and Current Quarter GDP

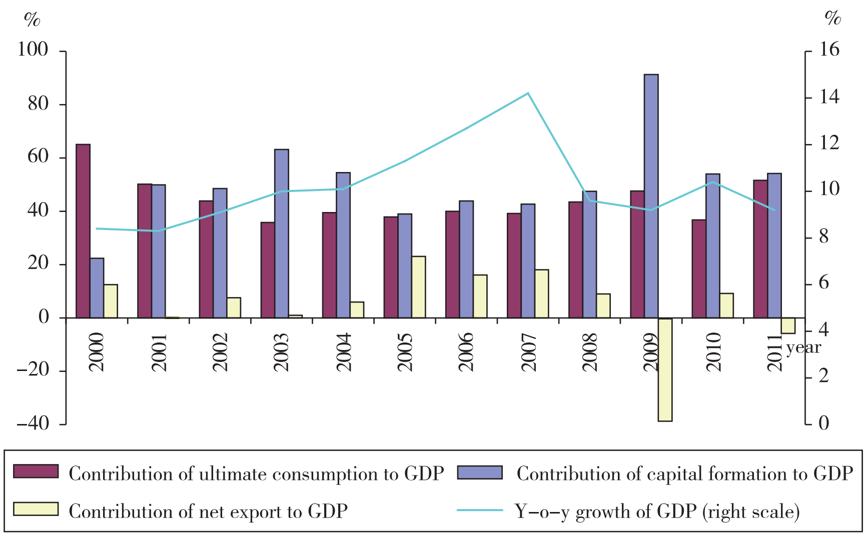


Source: The NBS.

2. Domestic demand rose steadily while external demand remained generally stable

In 2011, investments in fixed asset totaled RMB 31.10 trillion yuan, up 23.6% y-o-y in nominal terms and 15.9% in real terms. Among this total, fixed asset investments in the urban area posted RMB 30.19 trillion yuan, an increase of 23.8% from the previous year. Total retail sales reached RMB 18.12 trillion yuan, up 17.1% y-o-y in nominal terms and 11.6% in real terms. Exports and imports totaled USD 3.64 trillion, up 22.46% from the previous year. Among this total, exports registered USD 1.9 trillion, a rise of 20.34% y-o-y, and imports stood at USD 1.74 trillion, up 24.87% from the previous year. Total trade surplus was USD 155.14 billion a reduction of 14.5% y-o-y. The growth of imports and exports was on a gradual decline month on month despite temporary large swings at the beginning of the year as a result of seasonal factors. It was estimated that capital formation and ultimate consumption contributed 54.2% and 51.6% respectively to GDP growth.

Figure1.6 Contribution of Consumption, Investments and Exports to GDP Growth



Source: The NBS.

Box 2 Cross-border Use and Offshore Market of RMB

The 12th Five-year plan expressly proposed to promote the cross-border use of RMB, gradually make RMB convertible under the capital account, and support Hong Kong to be the center for offshore RMB business and asset management. In 2011, the PBC continued to make joint efforts with relevant agencies in promoting the cross-border use of RMB and the development of RMB offshore market in order to facilitate trade and investment.

Breakthroughs were made in cross-border RMB business. The PBC launched a series of new policies concerning cross-border use of RMB, including expanding the pilot program of RMB settlement of cross-border trade transactions to cover the whole country, allowing domestic institutions' ODI and foreign investors' FDI in RMB, permitting domestic banks to extend RMB loans to Chinese-invested enterprises or programs operating overseas, and allowing HK subsidiaries of qualified domestic fund management companies and securities companies (RQFII) to make portfolio investment domestically with the RMB raised in HK. The launch of these policies has widened the channels for cross-border flows of RMB, making breakthroughs in cross-border RMB business. In 2011, a total of RMB 2.08 trillion yuan worth of RMB settlement of cross-border trade transactions was carried out nationwide, increasing 3.1 times y-o-y. Settlement of ODI in RMB amounted to RMB 20.15 billion yuan and that of FDI reached RMB 90.72 billion yuan. At the end of 2011, there were altogether 181 countries and regions engaged in RMB receipt and payment business with mainland China. Currency cooperation was pushed forward. By the end of 2011, China had signed local currency swap agreements with 14 countries and regions, with a total size of RMB 1.3012 trillion yuan.

The HK RMB market developed fairly rapidly. At the end of 2011, there were more than 130 institutions operating RMB business in Hong Kong. The outstanding value of RMB loans stood at RMB 30.8 billion yuan. The outstanding value of RMB deposits registered RMB 588.5 billion yuan, accounting for 10% of total outstanding value of RMB deposits in Hong Kong. RMB has become the third most used currency in Hong Kong, only after the HK dollar and the US dollar. A total of RMB 110 billion yuan worth of RMB bonds was issued in Hong Kong for the whole year (including the RMB 20 billion yuan worth of bonds issued in Hong Kong by the Ministry of Finance). The RMB bond market in Hong Kong developed in its depth as there were more diversified issuers, brisk transactions and investment, and more market participants.

Cross-border RMB business has provided important support for the development of RMB market in Hong Kong, which in turn facilitates expansion of cross-border use of RMB, opening-up of domestic financial markets and capital account convertibility of RMB. In the next stage, the PBC will further develop the cross-border RMB businesses in a stable and orderly manner, so as to promote liberalization and facilitation of trade and investment, put the advantages of Hong Kong into full play during the development of RMB market and facilitate the cyclical use of RMB overseas.

3. Fiscal revenue grew fast while fiscal expenditure increased fairly rapidly

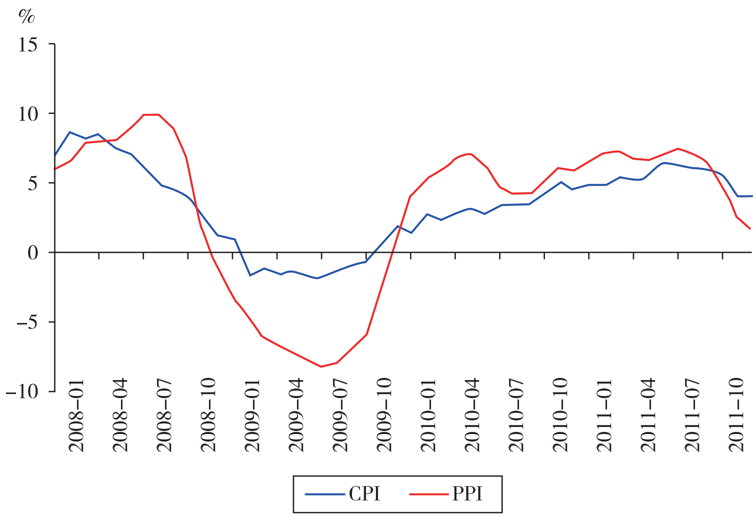
In 2011, China's fiscal revenue registered RMB 10.37 trillion yuan, up RMB 2.06 trillion yuan, or 24.8% y-o-y. Such growth was 3.5 percentage points higher than 2010. Over the year 2011, the growth of fiscal revenue declined after a rally. The slowdown became more visible entering Q4, as a result of slower growth, retreat of price from an elevated level, higher threshold for levying personal income tax, and smaller transaction volume in the real estate and automobile sectors. Fiscal expenditure posted RMB 10.89 trillion yuan, up RMB 1.91 trillion yuan, or 21.2% y-o-y. The growth rate was 3.4 percentage points higher compared with the previous year. Fiscal support extended to enhance people's livelihood was strengthened, going into the agricultural sector, rural areas, farmers, education, medical services, social security, employment, affordable housing and cultural programs. Among this total, fiscal expenditure to sectors directly related to people's livelihood including education, medical services, social security, employment, affordable housing and cultural programs reached RMB 3.81 trillion yuan, a rise of 30.3% y-o-y. The fiscal expenditure extended to support the agricultural sector, rural area and farmers totaled RMB 2.9342 trillion yuan, an increase of 21.2%.

4. Price indices edged down after a rally and inflationary pressures were moderated

In the first half of 2011, higher price of energy, resources and labor, strong inflationary expectation and continuously rapid growth of domestic demand added to higher pressures for price hike. Y-o-y growth of CPI continued to widen, reaching the record high 6.5% in July after the outburst of the global financial crisis. Entering the second half of the year, against the backdrop of slower domestic growth and a fall of international commodities price, and as the prudent monetary policy took effect, the upward pressure of price level was moderated. Major price indices stabilized and went down further, indicating curbed momentum of excessively rapid growth of price level (figure 1.7). From the beginning of August, CPI growth narrowed month on month, to 4.1% in December. Over the whole year, CPI rose by 5.4% y-o-y, 2.1 percentage points higher compared with 2010. Food and non-food prices grew 11.88% and 2.7% respectively, accelerating by 4.6 percentage points and 1.3 percentage points from the previous year. In the first three quarters of 2011, year-on-year increase of PPI remained at an elevated level of around 7%, and PPIRM rose more than 10% y-o-y. From August, y-o-y growth of PPI declined, especially in the fourth quarter. Over the whole year, PPI increased 6% y-o-y. 0.5

percentage point higher compared with the previous year.

Figure1.7 Movements of CPI and PPI

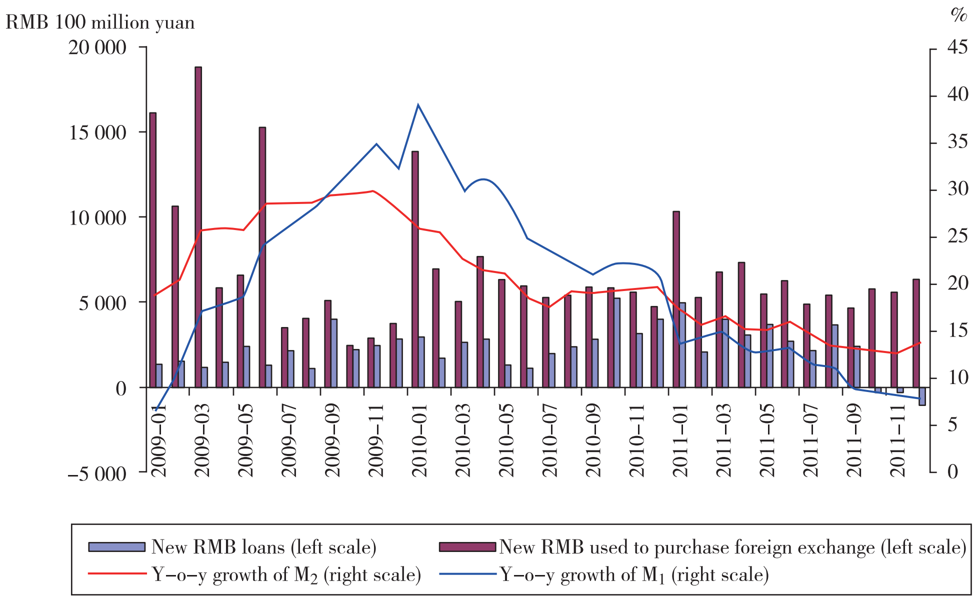


Source: The NBS.

5. The growth of money and credit went back to normal, and RMB exchange rate edged up while remaining generally stable

Facing enhancing inflationary pressure and relatively large BOP surplus, the PBC, in line with the principle made on the Central Economic Work Conference, took stabilizing the general price level as the top priority for macroeconomic policy in the financial sector. By adopting a mix of monetary policy instruments, the PBC implemented a prudent monetary policy and reinforced macro-prudential regulation. As a result, monetary and credit condition further normalized. At the end of 2011, outstanding value of M_2 registered RMB 85.16 trillion yuan, up 13.6% y-o-y, and a deceleration of 6.1 percentage points. Outstanding value of M_1 posted RMB 28.98 trillion yuan, a rise of 7.9% y-o-y, and a deceleration of 13.3 percentage points. During the whole year, new RMB loans registered 7.47 trillion yuan, a reduction of RMB 390.1 billion yuan (figure 1.8). Total financing to the real economy reached RMB 12.83 trillion yuan, a fall of RMB 1.11 trillion yuan y-o-y. In 2011, the reform of RMB exchange rate regime was furthered, and RMB exchange rate became more flexible. The RMB exchange rate experienced appreciations and depreciations with expectations diverged. The RMB appreciated 5.1% against the US dollar in 2011, and the daily average float of the central parity of RMB exchange rate was 44 basis points. The Bank for International Settlements (BIS) estimated that the real effective RMB exchange rate appreciated by 6.12% in 2011. The improvement of the RMB exchange rate regime has played a positive role in optimizing China's economic structure, promoting wide-covering, balanced and sustainable development and checking inflation.

Figure1.8 The Growth of New Loans and Money Supply



Source: The PBC.

Box 3 The Implementation of A Prudent Monetary Policy Under Strong Inflationary Pressure

After mid-2010, as the Chinese economy resumed relatively rapid growth, inflation began to climb, and the CPI rose to 4.7% in the fourth quarter. Entering 2011, inflationary pressure facing the economy was quite high due to local governments' crave for growth and strong demand for the expansion of investment as well as the supply of money and credit. CPI growth from Q1 through Q3 stood at 5.1%, 5.7% and 6.2% respectively. In this context, the PBC shifted the stance of monetary policy from "relatively loose" to "prudent" as decided by the CPC central committee and the State Council. With maintaining a basically stable price level as the top priority, the PBC flexibly adopted a mix of quantitative, price-based and macro-prudential policy tools, so as to manage the source of liquidity appropriately and curb price hike by keeping monetary condition at a proper level. The PBC also strengthened macro-prudential regulation, and made macroeconomic policies better-targeted, more flexible and forward-looking in line with latest developments, in order to strike a balance between stable and relatively rapid growth, restructuring and the management of inflationary pressure.

First, the adjustment of reserve requirement ratio and open market operations were adopted to sterilize excessive liquidity in the banking system. Against the background of sustained and large BOP surpluses, the PBC raised the reserve requirement ratio for financial institutions for 6 times by a total of 3 percentage points in the first half of 2011, absorbing excessive liquidity in an active and effective manner. Meanwhile, the PBC carried out open market operations with reasonable intensity and pace, managing a balance of liquidity supply and demand in the banking sector. A total of RMB 1.4 trillion yuan of central bank bills was issued in 2011, and the value of repo posted RMB 2.5 trillion yuan. At the end of 2011, outstanding value of central bank bills stood at RMB 1.9 trillion yuan.

Second, new macro-prudential instruments were introduced to carry out counter-cyclical guidance. Drawing on lessons of the global financial crisis, the PBC introduced the mechanism of dynamic adjustment of differentiated reserve requirement ratios, with a bid to carry out countercyclical guidance of aggregate credit supply in a transparent, foreseeable and standardized manner. This mechanism linked credit extension with the capital level as required for macro-prudential purposes, taking into consideration the change in economic climate, systemic importance, soundness and credit policy implementation of financial institutions. It could guide and incentivize financial institutions to maintain soundness in a self-disciplinary manner, conduct counter-cyclical credit extension, and guide the direction of credit, playing a positive role in credit adjustment. As a result, credit extension was significantly smoothed quarter by quarter and month by month.

Third, put the leveraging role of interest rate adjustment into better play. From Q1 through Q3 in 2011, the PBC raised benchmark RMB deposit and lending rates of financial institutions for three consecutive times. The 1-year benchmark deposit rate was enhanced from 2.75% to 3.50%, and the 1-year benchmark lending rate was raised from 5.81% to 6.56%. Meanwhile, efforts were made to guide an upward movement of inter-bank interest rates. In Q4, as domestic and international situations evolved and especially given gradually declining domestic price level, the benchmark deposit and lending rates were kept stable.

Fourth, the RMB exchange rate regime was improved. The PBC furthered the reform of RMB exchange regime in an active, controllable and gradual manner, enhanced exchange rate flexibility, and kept it basically stable on an equilibrium level based on market supply and demand in reference to a basket of currencies. In 2011, the RMB exchange rate appreciated slightly with fluctuations in both directions. At the end of 2011, the central parity of RMB exchange rate against the US dollar was 6.3009 yuan, appreciating by 5.11% compared with the beginning of 2011, and thus mitigating the influence of international commodity price increase on domestic inflation.

Fifth, total financing to the real economy was introduced as an intermediate variable for monitoring. For quite a long time, M_2 and new RMB loans had been taken as key indicators for macroeconomic monitoring and analysis. In recent years, with the progress in innovation of financial products and diversification of financial structure, the other financial assets such as trust, bonds and equities, except traditional financial variables including money and credit, had exerted increasing influence on the real economy. The introduction of total financing to the real economy adapted to and better reflected the change in financing structure. It also helped capture the whole picture of financing to the real economy, and played a role in guiding and developing direct financing.

Sixth, fine-tuning operations were carried out at opportune times with appropriate intensity, so as to make the policies better-targeted, more flexible and forward-looking. Against the background of decline in RMB issued for the purchase of foreign exchange, economic slowdown and lower inflation in Q4, the PBC fine-tuned its operations in a timely manner by suspending the issuance of 3-year central bank bills, adjusting the issuance amount of central bank bills of other maturities, injecting liquidity via reverse repo and maturity redemption of matured central bank bills, revising down the interest rate for issuing 1-year central bank bills, and reduced reserve requirement ratio by 0.5 percentage point. In the mean time, parameters of the dynamic adjustment mechanism of differentiated reserve requirement ratios have been improved to guide financial institutions with adequate capital, quality asset, sound legal person governance structure and credit structure in line with policy intention to lend more to ongoing key projects and weak links of national economy including small and micro-enterprises and agriculture, farmers and the rural area.

Generally speaking, the implementation of a prudent monetary policy was very effective in 2011. As a result, money and credit growth normalized from a high level, and total financing to the real economy remained reasonable. Besides, credit structure was improved. As monetary condition went back to sound level, the over rapidly rising momentum of prices was gradually reversed, with the CPI retreated to 4.6% in Q4 2011. Meanwhile, the economy remained stable and relatively rapid growth and the financial sector performed soundly.

III. Global Economic Outlook

Global economic outlook remains grim in 2012 due to rising instability and uncertainties for recovery. In the context of elusive solution to the European sovereign debt crisis, lower consumer demand in major advanced economies and heightened pressures of austerity, sluggish global demand may be the new normal, which will greatly undermine global recovery. Weaker external demand may slow the growth of emerging markets and developing economies. The IMF forecasted that global economic growth will decrease from 3.8% in 2011 to 3.5% in 2012, and the growth rates of developed countries, as well as emerging markets and developing countries will be 1.4% and 5.7% respectively, down 0.2 percentage point and 0.5 percentage point from 2011. Meanwhile, inflationary pressures will be subdued globally, but still remain in emerging markets and developing countries. The IMF estimated that inflation rate of developed countries, and of emerging markets and developing countries will be 1.9% and 6.2% respectively, down 0.8 percentage point and 0.9 percentage point from 2011. Generally speaking, global economy will face the following risks.

First, a new round of systemic risks would be triggered should the European sovereign debt crisis get out of control. Credit ratings of Euro area sovereigns and banks may be further downgraded. The strong expectation of further deterioration of European sovereign debt crisis, the widening funding gap of the European banking system and grim deleveraging outlook may form the negative feedback loop of sovereign debt crisis deterioration, heightened financing pressure of banks and aggravated downward risks. Weaker financing support from the financial sector to the real economy would enhance the probability of a euro area recession. The global financial market may take on a new round of risks from the European sovereign debt crisis and euro area banks via direct risk exposure, cross-border lending and capital flows.

Second, recovery of the U.S. economy will be sluggish dragged by greater uncertainties. The U.S. economy will face multiple uncertainties, and the spillover of the European sovereign debt crisis may impact the U.S. economy and financial system. Structural factors such as lack of long-term economic drivers, weak real estate and labor markets, difficulties in the growth of household consumption and deleveraging of the private sector would continue to drag U.S. recovery. The pending dispute over government debt ceiling may disable the U.S. government of launching a stimulus strong enough to ensure sustainable recovery, and may further hinder global growth.

Third, emerging economies will face more challenges in macroeconomic management. Weakening external demand due to slower growth of advanced countries and downward cyclical pressures domestically may further undermine future growth of the emerging markets. At the same time, inflationary pressures still remain, posing a dilemma between promoting growth and curbing inflation. Moreover, aggravated deleveraging of the banking systems in developed countries may lead to a reverse of capital flow for emerging markets.

Fourth, trade protectionism will be on a rise. Weak recovery limited the space for further stimulus, spelling stronger incentive for major advanced economies to divert domestic economic pressures via trade protectionism. If not to be nipped in the bud, the "beggar thy neighbor" protectionist policies may serve as a bad example and even usher exchange rate war or trade war, which will undermine recovery.

Fifth, political risks and geopolitical tension pose a threat to global recovery. In 2012, the presidential elections will be going on in many major economies including the U.S., France and Russia, heightening uncertainties for the formulation and coordination of economic policies. Furthermore, uncertainties in prospects of Middle East and other geopolitical events may result in a surge in oil and other commodities prices, boding ill for global economic stability and recovery.

IV. China's Economic Outlook in 2012

The year 2012 is a hinge year for China's implementation of the 12th Five-year plan, and China will still be in the strategically important time window for economic and social development. There is great potential for further increase of demand due to rapid progress of urbanization, industrialization, and the upgrade of consumption and industrial structure. Higher demand and enhanced competitiveness and resilience of enterprises are translated into remaining traditional advantages of economic development. At the same time, domestic and global outlook for economic growth was grim and complicated. China's economic growth is not yet on a balanced, coordinated and sustainable track. Potential risks in economic and financial sector performance, including downside growth pressures increasing and price movement still worth concern, business operation difficulties of some enterprises, grim outlook for emission reduction and energy saving, are not to be neglected. Furthermore, some new problems came to the front as China's development enters the current stage. Deeply-rooted and short-term problems are intertwined, raising more dilemmas for macroeconomic policy-making.

Faced with complicated and uncertain domestic and international environment, macroeconomic policies in 2012 will be consistent and stable on the one hand, and be better targeted, more flexible and forward-looking on the other hand, so as to strike a balance between relatively rapid economic growth, restructuring and managing inflationary expectations and to let endogenous drivers gradually replace stimulus measures in driving economic growth. First, the implementation of an active fiscal policy and a prudent monetary policy will be continued. A mix of monetary policy tools will be adopted as appropriate in view of economic and financial operation, so as to make reasonable adjustment to the supply of money and credit, provide adequate financing to the real economy, and to optimize credit structure and further consolidate the achievements made in addressing the recent global economic crisis. Second, the financial sector will better support the real economy. Efforts will be made to address the most prominent problems in the real economy, and to promote transformation of growth pattern and economic restructuring. While stabilizing external demand, concrete actions will be taken to stimulate domestic demand, consumption demand in particular. Measures will be taken to improve financial services to small and micro enterprises, optimize the structure and geographical deployment of industrial production in order to coordinate regional development, strengthen policy incentive for energy saving and emission reduction by leveraging on market mechanism. Third, reform of key areas will be advanced and the reform and opening-up will be furthered. Efforts will be made to advance the market-based interest rate reform, foster a market-based benchmark interest rate system, guide financial institutions to enhance the capability of pricing risks, and find better ways to further interest rate liberalization. The RMB exchange rate regime will be improved and the RMB exchange rate will be maintained at a basically stable level. Efforts will be made to promote the use of RMB in the settlement of cross-border trade transactions and investment. Fourth, the framework of countercyclical macro-prudential policy for the financial sector will be improved to prevent systemic financial risks. The toolkit of monetary policy instruments will be enriched and improved, and parameters for dynamic adjustment of differentiated reserve requirement ratio revised when appropriate to improve countercyclical adjustment, and thus to provide a facilitating financial environment for stable and relatively rapid economic growth in the long term.

Chapter II

Banking Sector

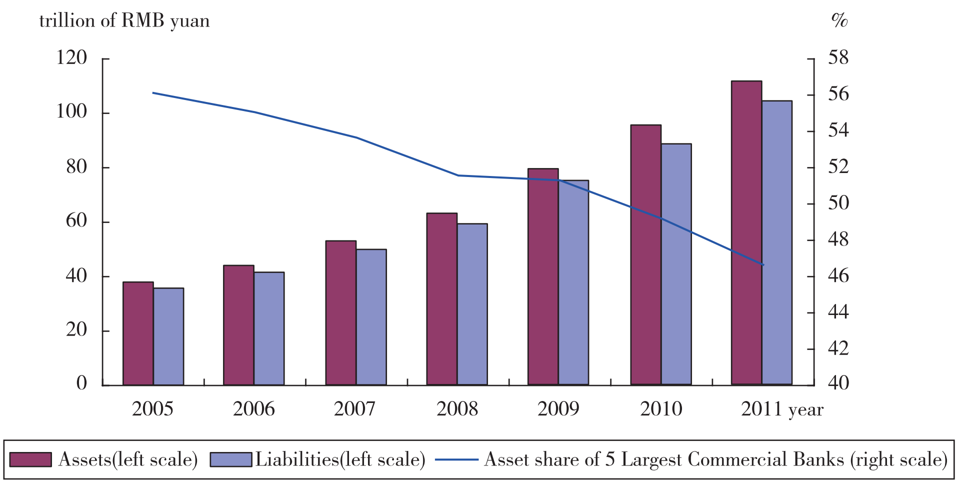
In 2011, China's banking sector has actively implemented macroeconomic management policies, maintained a reasonable pace of credit supply, steadily promoted financial reforms, and continuously improved banking services. All these efforts effectively bolstered a sustainable growth of the real economy. The Major indicators of China's banking sector remained to be fine and the sector generally displayed a sound development momentum.

I. Recent Developments

1. Banking Sector's Total Assets Increased Steadily, Better Serving the Real Economy

Total Assets and liabilities continued to increase. As of the end of 2011, total assets of banking institutions increased by RMB 17.98 trillion yuan or 18.87 percent on a y-o-y basis to RMB 113.29 trillion yuan, while total liabilities amounted to RMB 106.08 trillion yuan, a y-o-y growth of 18.56 percent or an increase of RMB 16.60 trillion yuan from the beginning of 2011(Figure 2.1). In terms of asset size, the 5 largest commercial banks accounted for 47.34 percent of the sector, 1.86 percentage points down from 2010. The asset shares of joint-stock commercial banks and city commercial banks in the sector increased by 0.59 and 0.57 percentage point respectively.

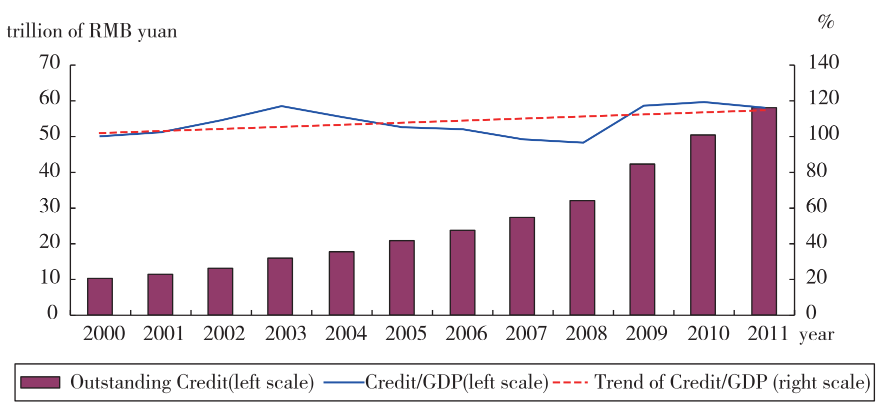
Figure 2.1 Total Assets and Liabilities of Banking Institutions



Source: The CBRC.

Banking sector's deposits and loans rose steadily. As of the end of 2011, the outstanding deposits of banking institutions denominated in both domestic and foreign currencies increased by RMB 9.9 trillion yuan or 13.5 percent y-o-y to RMB 82.7 trillion yuan. The outstanding loans were up by RMB 7.9 trillion yuan or 15.7 percent y-o-y to RMB 58.19 trillion yuan (Figure 2.2). In terms of maturities, the increment of short-term loans and bill financing climbed up by RMB 2.3 trillion yuan, while the increment of medium and long-term loans shrunk by RMB 2.1 trillion yuan. In terms of credit orientation, fixed assets loans closely correlated with project investments experienced an obvious slowdown, while the operating loans increased rapidly. Sticking to the national credit policies and industrial policies, China's banking institutions allocated more resources on modern service industries, strategic emerging industries, energy conservative industries, cultural industries and social welfare expenditures. Banking institutions were also requested to implement differentiated credit policy for residential mortgages, and to tighten credit allocated to high polluting, energy-intensive and over-capacity industries. The credit orientation effectively facilitated the transition of China's economic development pattern and economic restructuring.

Figure 2.2 Changes in Credit Exposures[①] of Banking Institutions

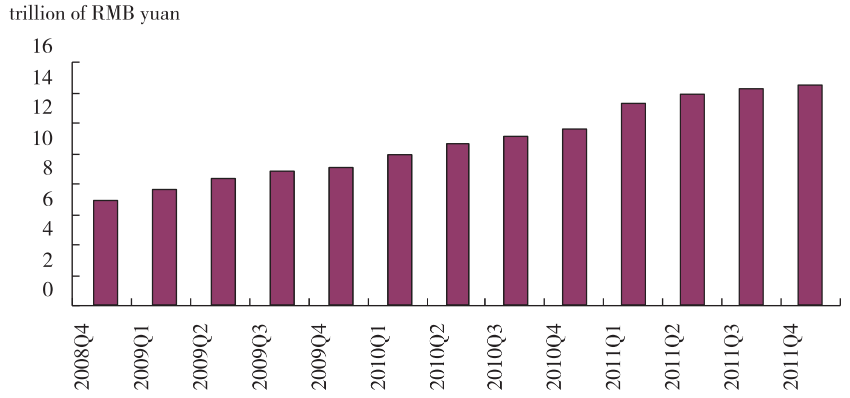


Source: The PBC and the NBS.

Financial services to agriculture, rural areas and farmers were further improved. As of the end of 2011, the outstanding agriculture-related loans reached RMB 14.6 trillion yuan, with a y-o-y growth of 24.9 percent and 9.2 percentage points higher than the average loan growth rate in the current period (Figure 2.3). As of the end of 2011, there were 212 rural commercial banks, 190 rural cooperative banks, 2 265 rural credit cooperatives, 635 village or township banks, 10 lending companies and 46 rural mutual cooperatives. The banking services have fully covered all the villages and towns nationwide. 17 provinces have achieved full coverage in terms of both banking service and branch outlets.

① It referred to the RMB loans here.

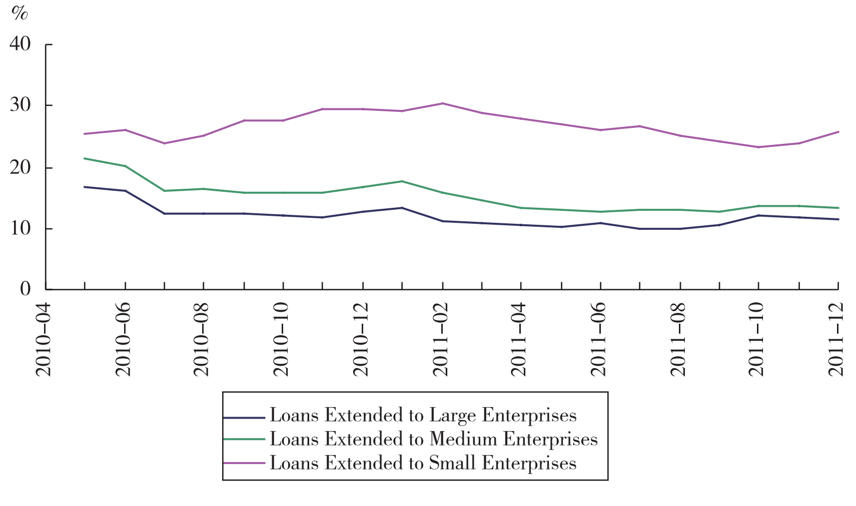
Figure2.3 Outstanding Agriculture-related Loans



Source: The PBC.

SMEs were better served by financial institutions. As of the end of 2011, loans extended to small enterprises totaled RMB 10.76 trillion yuan, with y-o-y growth of 25.8 percent and 14.2 percentage points higher than loan growth of large enterprises and 12.5 percentage points higher than loan growth of medium enterprises (Figure 2.4). In 2011, newly extended loans to small enterprises registered RMB 1.93 trillion yuan, accounting for 40.1 percent of new corporate loans and 24.3 percent of total new loans. Financial institutions have launched a series of measures to improve services to SMEs, and Specialized Business Units that exclusively served small enterprises flourished.

Figure2.4 Growth Rate of Outstanding Loans Extended to Large Enterprises, Medium Enterprises, and Small Enterprises



Source: The PBC.

2. The Ongoing Reforms Helped Bring a Further Steady Build-up of Strength in Banking Sector

Reforms of the large commercial banks were further deepened. The reforms of ICBC, ABC, BOC, CCB and BOCOM progressed well. Improvements continued to be made to the business structure, product innovations, corporate governance and decision making progress. As a result, the large commercial banks maintained a strong growth and sustainable profitability. At the end of 2011, CAR of the 5 largest commercial banks stood at 13.17 percent, 11.94 percent, 12.97 percent, 13.68 percent and 12.44 percent respectively. NPL ratio recorded 0.94 percent, 1.55 percent, 1.00 percent, 1.09 percent and 0.86 percent respectively. The whole year profit after tax registered RMB 208.4 billion yuan, RMB 122 billion yuan, RMB 130.3 billion yuan, RMB 169.4 billion yuan and RMB 50.7 billion yuan respectively.

Pilot reform of ABC's County Area Banking Division (CABD) extended coverage. The pilot reform of CABD enjoyed a series of favorable treatments, including business tax breaks, supervision fee relief, differentiated deposit reserve requirement, etc. These treatments actually indicated national policy orientations. The PBC paid close attention to the progress of the reform, and have conducted on-site inspections and assessments in the first 8 pilot provinces. In September 2011, the State Council approved to expand the pilot reform to county-level sub-branches of ABC in 370 counties in province of Heilongjiang, Henan, Hebei and Anhui . Meanwhile, ABC further refined its internal control mechanism, allocated more resources on county area banking services, and better served agriculture, farmers and rural areas.

Further progress was made in the reforms of policy banks and other financial institutions. In April 2011, National Council for Social Security Fund invested RMB 10 billion yuan in CDB, which boosted CDB's capital strength and enhanced CDB's capacity to serve the medium and long-term economic development strategy. Research on CEXIM's reform plan was moving forward and the related work was in continuous progress. In August 2011, ADBC's reform was initiated by establishing a reform working group, establishing coordination mechanisms, identifying work priorities and explicitly assigning responsibilities. China Cinda Asset management Co., Ltd actively promoted the introduction of strategic investors, and China Huarong Asset Management Corporation was making steady efforts to promote commercialization. The overall restructuring of the CITIC Group was advanced, with CITIC Group Corporation and CITIC Limited held their inaugural meeting in December 2011. The shareholding reform plan of PSBC became more elaborated, and the relationship between PSBC and China Post Group was gradually straightened out.

Box 4 Remarkable Progress was Made in the Reform of AMCs

In 1999, to effectively address the Asian financial crisis and mitigate financial risks, China established four AMCs, namely, China Cinda Asset Management Company, China Huarong Asset Management Company, China Orient Asset Management Company and China Great Wall Asset Management Company. The major responsibilities of the four AMCs were to purchase, manage and dispose the non-performing assets of China's large commercial banks. Since establishment, the AMCs had taken over RMB 1.4 trillion yuan worth of bad assets from ICBC, ABC, BOC, CCB and CDB. Since 2003, aligning with the shareholding reform of large commercial banks and resolution of financial institutions, four AMCs have disposed non-performing assets of related large commercial banks in a market-based way, and were delegated to resolve risky financial institutions. Ever since the establishment, the four AMCs took full advantage of favorable polices and sped up the disposal of non-performing assets. They have contributed tremendously to stabilize banking system, mitigate systemic financial risk, boost shareholding reform of large commercial banks, promote restructuring of state-owned enterprises, ensure sound organizational structure in financial sector, and foster market for non-performing assets. It was proved by practice that AMCs' establishment and development was a beneficial exploration in China's financial system reform, which posed an active and far-reaching influence on the steady development of China's banking sector.

However, as the non-performing assets tapered off and AMCs' commercialization deepened, the four AMCs' traditional business model which fit in with the needs of receiving and disposing the bad assets policies could no longer adapt to the new environment characterized by commercialized operation. The urgent call for AMCs' restructuring came to the forefront. In order to speed up the commercialization of the AMCs, the State Council authorized relevant authorities to establish a reform working group in 2008. The working group delved into topics such as financial restructuring, timing of reform, corporate governance, supervisory responsibilities assignment, etc. According to the principle of "one company one policy" and market orientation, the working group actively researched and promoted the reform of AMCs, and groped its way through diversification. The reform plan dedicated to individual AMCs would be kept in fermentation till it's concrete.

In 2010, the pilot reform of China Cinda Asset Management Company (Cinda) launched firstly. To establish modern financial enterprise mechanism, Cinda focused its business on non-performing asset disposal, with asset management as core business; it also vigorously explored financial services in response to market demand. By the end of June 2010, Cinda was restructured as a shareholding company. Since then, Cinda was continuously improved corporate governance, risk management and internal control. At the same time, Cinda's profitability and overall strength were greatly enhanced. Meanwhile, Cinda actively promoted the introduction of strategic investors, paving the way for an initial public offering. In March 2012, Cinda received RMB 10.37 billion yuan from 4 strategic investors, including the National Council for Social Security Fund, UBS AG, CITIC Capital and Standard Chartered and the strategic investors would own 16.54 percent of Cinda's equity. Cinda's new investors would help the firm build its business lines such as asset management, investment and financing, investment banking businesses. Cinda and the investors would also cooperate on corporate governance, risk management, straff training, etc.

With government support and own efforts, China Huarong Asset Management Company (CHAMC) has well prepared for restructuring. In 2011, CHAMC finished a series of pre-work, including auditing, assessment, legal inquiry, etc, which paved the way for restructuring. In January 2012, the State Council approved the reform plan of CHAMC. CHAMC would expand core businesses beyond non-performing assets disposal to bank-related businesses, such as banking, trust, leasing; while the securities business was kept. The overall objectives of CHAMC's commercialization was to deepen reform, upgrade operation mechanism, enhance competitiveness, and grow up as a modern financial service enterprise, which is characterized by good corporate governance, powerful internal control, professional services, advanced corporate culture and first-class performance. Currently, CHAMC carried on the restructuring plan steadily. In addition, China Great Wall Asset Company and China Orient Asset Management Company also accelerated the internal reform, actively preparing for commercialization.

3. Along with comprehensive involvement in the international banking supervisory reform, new regulatory standards framework was initially formed

Relevant authorities actively participated in the international banking supervisory reform. As members of the FSB and the BCBS, both the PBC and the CBRC were active participated in developing the international supervisory standards and rules. In 2011, a set of supervisory policies was formulated for Systemically Important

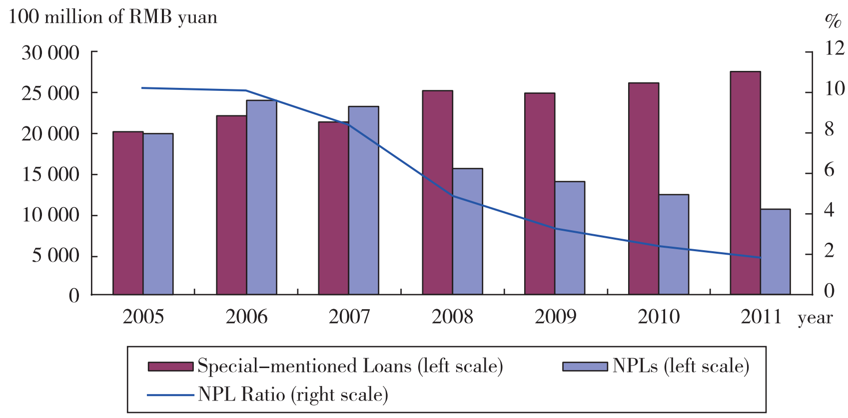
Financial Institutions (SIFIs). The BCBS clarified the assessment methodology and capital surcharge requirements for G-SIBs, while FSB published Key Attributes of Effective Resolution Regimes for Financial Institutions. These policies further refined the assessment, monitoring and resolution framework for SIFIs.

New international banking supervisory requirements were implemented in China steadily. Along with the promulgation of Basel III, China tailored the latest supervisory rules in domestic situations, drew on achievements of international banking supervisory reform and steadily initiated the implementation of Basel III in China.The PBC, together with other relevant authorities, took great efforts to research and set up a macro-prudential regulation regime and appropriate macro-prudential toolkits.The PBC launched the Dynamic Adjustment of Differentiated Reserve Requirement Ratio, guiding commercial banks to properly manage the pace and total amount of credit extensions. Beyond the minimum capital requirement, the design of countercyclical capital buffer regime was underway. Commercial banks were instructed to conduct stress tests, and to build up resilience to systemic financial risks. The CBRC promulgated Guidance on the Implementation of New Regulatory Standards in China's Banking Industry, mapping out the timetable to implement new regulatory standards. As a follow up, The CBRC proposed consultative documents on capital requirement and liquidity requirement, established regulatory on leverage ratio and loan loss provisions, and laid a foundation for the successfully promulgation of new regulatory rules.

II. Soundness Assessment

Asset quality continued to improve, while risk management in key areas still needed to be strengthened. In 2011, both the outstanding NPLs and the NPL ratio of banking institutions dropped evidently from a low level (Figure 2.5). As of the end of 2011, the outstanding NPLs of commercial banks registered at RMB 427.9 billion yuan, marking a decline of RMB 5.7 billion yuan from the beginning of the year. The NPL ratio stood at 0.96 percent, down by 0.17 percentage point y-o-y. The provision coverage ratio continued to stand at a high level. As of the end of 2011, the provision coverage ratio of commercial banks increased by 60.4 percentage points to 278.1 percent. The loan loss provision adequacy ratio was 295.1 percent, 64.4 percentage points higher than that in 2010. However, due to negative impact of business environment change and business structure adjustment, the prosperity indexes declined in some regions, industries or enterprises, NPLs in the banking sector were likely to rebound, and the proportion of overdue loans in some financial institutions climbed up remarkably.

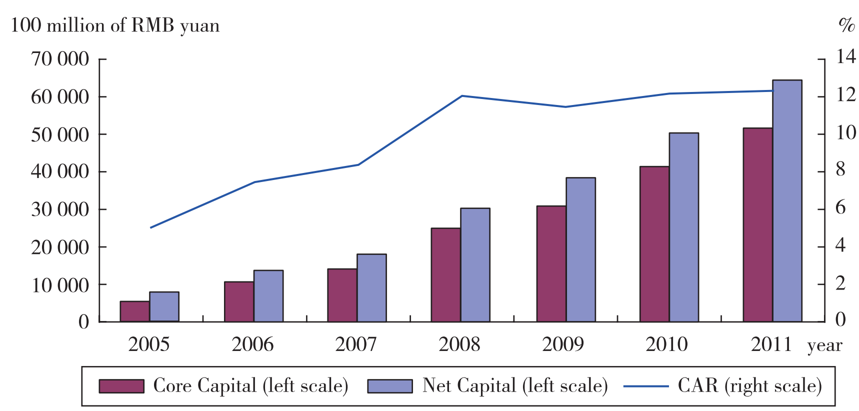
Figure 2.5 Changes of Special-mentioned Loans and NPLs



Source: The CBRC.

Capital adequacy position remained stable, while capital replenishment was under pressure. In 2011, the commercial banks got additional capital replenishments of RMB 1.4 trillion yuan, composed of retained earnings of RMB 896 billion yuan, equity financing of RMB 142.2 billion yuan, and hybrid bonds and subordinated bonds of RMB 302 billion yuan. As of the end of 2011, the CAR of commercial banks registered at 12.7 percent, with a y-o-y increase of 0.5 percentage point (Figure 2.6). In particular, the CAR of large commercial banks recorded 12.6 percent, up by 0.54 percentage point y-o-y. The CAR of joint stock commercial banks recorded 11.54 percent, up by 0.49 percentage point y-o-y. The CAR of city commercial banks recorded 13.57 percent, up by 0.73 percentage point y-o-y. In consideration of increasing demand for better financial services from the real economy and tightened regulatory standards, commercial banks would confront higher pressure of capital replenishment; capital replenishment and constraint mechanism needed to be further refined.

Figure 2.6 CAR and Capital Composition of Banking Financial Institutions in Recent Years



Source: The CBRC.

Box5 Enhance the Effectiveness of Capital Constraint Mechanism of Commercial Banks

Since the reform and opening-up in China, particularly the launch of shareholding reform of state-owned banks in 2003, China's commercial banks have attached great importance to capital constraint. Capital base has been continuously shored up, and capital plays a more important role in withstanding risks and promoting sound development of the commercial banks.

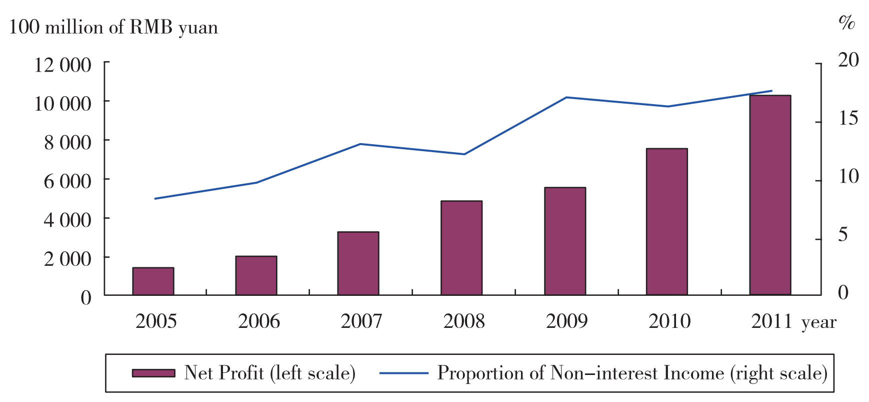
Since 2003, through the four steps of loan loss write-off, non-performing assets disposals, capital injection and public offering, China's large commercial banks have grown up as internationally competitive modern commercial banks, which are characterized by clear ownership, sufficient capital adequacy, rigorous internal control, safe operation, satisfactory services and profitability. At the same time, joint-stock commercial banks, such as CEB and CGB, and city commercial banks are bolstering capital strength by increasing share capital, restructuring, introducing strategic investors or going public offering. As of the end of 2011, net capital of the commercial banks amounted to RMB 6.78 trillion yuan, in which core capital totaled RMB 5.34 trillion yuan or 78.76 percent, while supplementary capital totaled RMB 1.44 trillion yuan or 21.24 percent. Core CAR registered 10.2 percent, while CAR registered 12.70 percent. The commercial banks maintained a sufficient level of high-quality capital with strong loss absorbency, and the capital constraint effect was emerging.

At present, refinement of capital constraint mechanism confronts new situation and challenges. First, China's economy continues its strong momentum currently and in near future, while the dominating role of indirect financing will barely change in the short run. While the real economy relies heavily on Bank loan for funding, credit extension would still maintain a certain growth rate, which inevitably exerts capital and cause replenishment pressures on China's commercial banks. Second, in accordance with Basel III, China's commercial banks have to comply with tougher regulatory rules, both on capital quantity/quality and internal risk management. Third, the credit expansion impetus in China's banking sector has not been completely eliminated. Capital constraint effect is much below its potential, and sometimes there is a anti-driving mechanism of credit expansion on capital replenishment .

Currently, to provide sustainable credit support within the capital constraint, China's banking sector should step up innovations and build up capital strength by squeezing risk-weighted assets and replenishing capital. On one hand, on the basis of simplicity, transparency and reasonable risk sharing, efforts are required to promote the securitization pilot program, stimulate financial innovations such as credit risk mitigation instruments, etc., enrich toolkit of adjusting asset-liability structure flexibly and spreading credit risk reasonably, improve bank asset management and save capital. On the other hand, it is necessary to explore and pilot fresh capital replenishment channels, such as contingent capital and preferred shares. The introduction of new capital instruments will help enrich capital structure and lower financing costs of the banking sector. Moreover, capital constraint should be further amplified, so as to effectively control irrational credit expansion and urge the commercial banks to properly manage the pace and total amount of credit extensions. Meanwhile, the proportion of direct lending should be lifted up continuously, and the current financing structure, which is dominated by indirect financing, should be changed as soon as possible, so that the real economy can be better served.

Profitability continued a significant increase; however, the high growth rate would be difficult to maintain. In 2011, banking institutions achieved a net profit of RMB 1.25 trillion yuan, with a y-o-y growth of 39.3 percent. Regarding commercial banks, the net profit was RMB 1.04 trillion yuan. The ROA went up by 0.17 percentage point y-o-y to 1.2 percent while ROE went up by 1.7 percentage point y-o-y to 19.2 percent. Non-interest income accounted for 19.3 percents of the total income, 1.8 percentage points higher than 2010 (Figure 2.7). As the reform dividend in banking sector gradually fading out, business environment becoming more and more complex, the pressure of NPO rebound increasing, the profit boom in recent years was likely unsustainable.

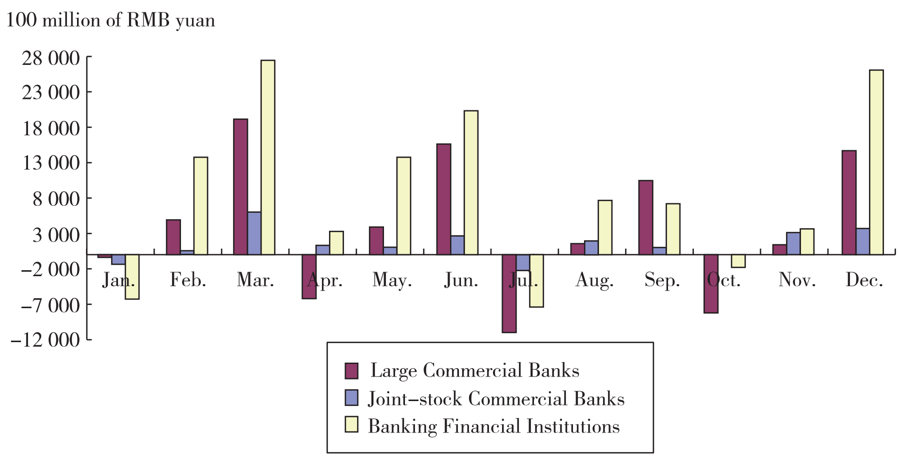
Figure 2.7　Profitability and Proportion of Non-interest Income



Source: The CBRC.

The deposit growth staggered, putting liquidity management under pressure. As of the end of 2011, the growth rate of deposits maintained by banking institutions appeared 6.3 percentage points lower compared to 2010. In breakdown, household deposits increased at a stable pace, while the deposit growth of non-financial institution slowed down broadly. Deposit competition among banking institutions became fiercer, and the liquidity management confronted pressure. As of the end of 2011, the average liquidity ratio of banking institutions increased by 1.03 percentage points y-o-y to 44.7 percent. The ratio of RMB excess reserve plus cash to total deposits hovered around at a low level. The two-way volatility of total deposits approached to RMB 3 trillion yuan. Deposits in January, July and October decreased by RMB 620 billion yuan, RMB 730 billion yuan and RMB180 billion yuan respectively. Overall, the liquidity management of banking institutions confronted high pressures.

Figure 2.8 Monthly Deposits of Banking Institutions in 2011



Source: The PBC, the CBRC.

Off-balance sheet businesses expanded rapidly, and great attention should be attached to risks of wealth management business. As of the end of 2011, outstanding balance on the off-balance sheet of banking institutions (including entrust loans and entrust investments) registered RMB 39.16 trillion yuan, accounting for 35.1% of the total assets on the balance sheet. The outstanding balance increased by RMB 5.96 trillion yuan, or 17.98 percent y-o-y. In 2011, in alignment with the macro management policy shift from moderately loose to prudent, bank accepted bills and entrust loans started to boom, with a total balance of RMB 6.68 trillion yuan and RMB 4.96 trillion yuan respectively. The growth rate was 20.14 percent and 29.38 percent respectively. Up to the end of 2011, the outstanding balance of wealth management business recorded RMB 4 trillion yuan.

Medium and long-term wealth management products might facilitate social funding and cater for consumers' financial needs; however, excessive growth of short-term wealth management products embedded risks. The excessive high expected yields, mixed asset pools, together with misconduct, would expose commercial banks to higher risks and affect the financial market discipline.

Non-financial institutions with financial functions boomed, and the oversight should be strengthened. As of the end of 2011, there were 4 282 Micro-credit companies, 5 237 pawn houses, 8 402 credit guarantee institutions. These institutions played active roles to better serve the agriculture, farmers and rural areas, as well as SMEs. In spite of the positive effect on social funding, these non-financial institutions confronted pressing needs to enhance internal disciplines and risk prevention capabilities. In addition to insufficient regulatory requirements, operations got out of line of the non-financial institutions happened occasionally. In certain regions, some non-financial institutions diverged from their main businesses to high-interest financing and illegal fund-raising, which eventually evolved as risk events in individual regions.

III. Outlook

Looking forward in 2012, banking institutions will confront a more sophisticated environment with fierce market competition. The task to support economic transition will become more arduous. Therefore, banking institutions should integrate challenges and opportunities, seek progress in a steadily way, continuously promote reforms and adjust business structure, so as to lay the solid ground for a sustainable development in future.

Ensure implementation of prudent monetary policy, effectively bolster real economy. Banking financial institutions should stick to their fundamental mission of supporting the real economy, ensure fund supply to real economy, make efforts to provide service for the transition of economic development pattern and improve the general quality of services for real economy. Financial resources should favor emerging strategic industries, energy conservative and environmental protection industries, new-tech industries, modern service industries, and culture industries. Differentiated policies for housing credit will continue to be implemented. Banking financial institutions are encouraged to support low-income housing projects and ordinary commercial housing projects. First-home loan for residents should be ensured. Extra efforts are required to address funding problems of rural areas and SMEs. More funding should be directed to key areas and weak parts such as agricultural technology and rural infrastructures. Financial support should more incline to SMEs that conform to the industrial polices and prudent credit qualifications. Financial product innovations and credit model innovations, which cater to SMEs, should be encouraged.

Deepen the reform of financial institutions, paving pathways to modern financial enterprises. Continued efforts should be taken to deepen the reform of large commercial banks, improve corporate governance, build up modern financial enterprise mechanism, refine internal control and risk management, and promote innovation capacity and international competitiveness. Push forward ABC's reform of CABD and improve its financial services to county-level areas. Coordinate the overall development of policy finance, keep on following the "one company one policy" principle, deepen CDB's market-oriented reform, and put forward the research on the reforms of EXIM and ADBC. Steadily deepen PSBC's reform and AMCs' commercialization.

Box6 Latest Progress of the Reform and Development of Policy Finance Worldwide

Policy finance plays an irreplaceable role in economic growth and social development across the world. The international evolution trend shows that the policy functions of policy financial institutions has been fading out and more and more policy-related business operated in market-based approach. However, in special times such as financial crisis, policy financial institutions strengthened their policy functions to address crisis and promote economic restructuring. A new trend in the reform and development of policy financial institution has been witnessed.

Policy financial institutions effectively boosted economies in many countries. In 2011, Export-Import Bank of the US authorized USD 32 billion for export credit, a 127 percent increase over authorizations in 2008. It achieved a successive high new level of authorizations in the past 3 years. In 2011, USD 6 billion for export credit was authorized to support US SMEs, a 20 percent increase compared with 2010. Export-Import Bank of Thailand showed vigorously support to SMEs exporters and extended export loans of 128.98 billion baht or 39 percent of the total loans to SMEs during the first 3 quarters of 2011. Development Bank of Japan (DBJ) initiated business including LME loans, commercial paper subscriptions and debt guarantees to LMEs. Japan Bank for International Cooperation (JBIC) increased credit facilities, started short and medium-term businesses, and expanded the scope of project financing.

Some countries reconsidered the reform plans of policy finance or postponed the commercialization of policy financial institutions. Firstly, Japan spin off JBIC as an independent body again, and put off the privatization of DBJ. In May 2011, JBIC Act was enacted. Its Highlights included: reiterate JBIC's nature as a policy financial institution; emphasize the objective of maintaining and enhancing Japan's international competitiveness; separate JBIC from JFC, and become an independent institution; endow JBIC to continue temporary measures in response to the global financial crisis as normal business. As set out in JBIC Act, the new JBIC was established in April 2012. In May 2011, the New DBJ Law was passed by the Japanese Congress. The law postponed DBJ's privatization as 5 to 7 years after April 2015, and stipulated pre-conditions to ensure DBJ's preparation for privatization. The pre-conditions covered financial strength, business operations, funding resources, etc. The government should maintain at least one-third shares in DBJ before the end of 2014 and continuously review the company's operations. Secondly, Korea delayed KDB's privatization process. In April 2009, KDB initiated its privatization procedure, and intended to re-shape into a commercial bank, KDB Holding (focused on investment banking business) and Korea Policy Financial Company (responsible for policy financial business). The Korean government would continue to provide debt guarantee to KDB before its stock shares fall blow 49 percent. However, in response to the recent financial crisis, Korean government postponed KDB's privatization plan till 2014. Although KDB itself actively intended to push for privatization, there was no substantive progress yet.

Some other countries were considering introducing export-oriented policy financial institutions. In September 2011, Vietnam announced that 7 insurance suppliers were selected to carry out a trial export credit insurance program during 2011-2013. In order to mitigate export credit risks and encourage exports, the state would pay 20 percent of the premium to exporters. Russia established an export insurance agency, as wholly-owned subsidiary of Vnesheconombank. The agency was specialized to provide financing guarantee and payment guarantee to non-energy or high-tech exports. The agency was created to substitute for traditional practice that the state directly extended preferable export loans or provided export credit guarantee.

Facilitate financial innovations to disperse risks in banking sector. Fitting in with the current economic development needs, especially the increasing financial needs from real economy, various kinds of financial innovations beneficial to serve the real economy should be encouraged with the aid of modern technologies. In order to disperse financial risks in banking sector, direct financing should be promoted and a multi-level capital market should be fostered. Securitization pilot program could be broadened actively on the basis of simplicity, transparency and reasonable risk sharing. The pilot project that allows commercial banks to establish fund management companies should be promoted on a sound way, so as to exert positive influences on healthy development of the capital market.

Improve regulatory framework drawing on international banking regulatory reforms. Taking full account of the progress of reform and development in the banking sector, a banking regulatory framework in line with international standards should be build up. Commercial banks should be incentivized steadily to implement the new regulatory standards, improve capital management, establish effective capital constraint mechanism, and refine liquidity management framework. Assessment methodology and supervisory rules that specifically target D-SIFIs are expected to be set down, while effective resolution mechanism for SIFIs should be steadily promoted.

Strengthen the risk management to further enhance sound performance of the banking sector. Banking financial institutions are expected to effectively increase the targeting and effectiveness on mitigating risks measures of real estate loans. Continue to strengthen management of LGFP loans, and effectively push forward the risk mitigation measures. While controlling risk, continue to support the construction of projects that have capability to repay and avoid their disruption of cash flow. The investment direction and actual usage of new loans extended to LGFP should be strictly under monitoring. In addition to establish a regular local government debt funding mechanism, a reasonable level of funding requirements from the local governments could be satisfied. Banking institutions should take active measures to deal with challenges posed by market-orientated interest rate reform, improve risk pricing and risk management capabilities, upgrade business models and growth pattern, and increase scientific pricing capacity of their products and services in market competition. Liquidity risk management should be enhanced; particularly for small and medium banking institutions, their funding channels should be further broadened to address the problem of singleness of deposit clients and high concentration of debts, so as to mitigate liquidity risks. Great attention should be attached to off-balance sheet risks, such as wealth management, credit assets transfer and inter-bank payments. Internal control should be reinforced in order to prevent illegal cases or material risk events.

Pay close attention to risks of non-financial institutions with financial functions, so as to maintain financial stability in a practical and effective way. Financing activities of the non-financial institutions, such as micro-credit companies, guaranty companies and pawn houses, should be monitored and assessed. Oversight over non-financial institutions should be strengthened, in order to guide them in developing with a regular manner. Rigorous measures should be taken to address misconduct of the non-financial institutions. As for risk events, principle of early identification, early alerts and early resolution should be followed with great efforts, preventing risks sprawling from partial area to regional area, even to system wide. Consumer education should be emphasized, while unlawful and criminal activities such as illegal fundraising must be cracked down. Financial institutions should take efforts to shield the banking system from risks originated in illegal fundraising, usury, financial pyramid selling, private financing, etc.

Chapter III

Securities and Futures Sector

In 2011, the securities and futures sector in China performed in a sound manner against the tough external environment. All the business lines developed steadily with more innovation pushed ahead, regulation was continuously reinforced and the risk management capacity of the whole sector was further lifted.

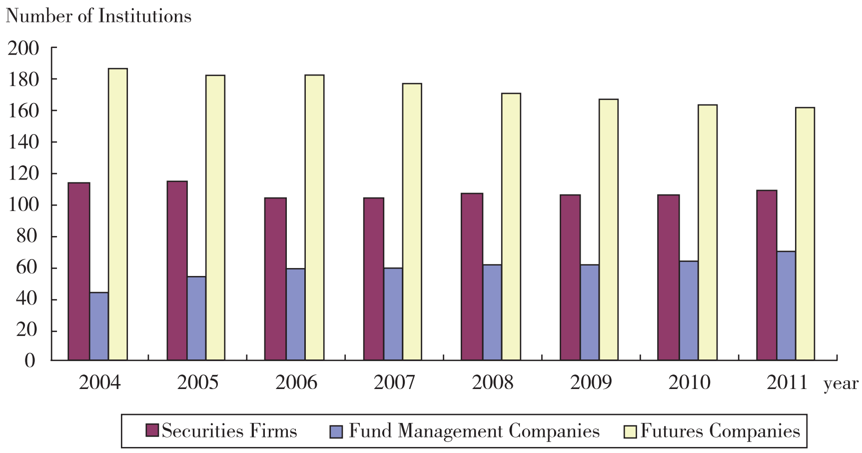
I. Recent Developments

1. All the business lines developed steadily

The number of market intermediaries increased. At the end of 2011, there were 109 securities firms, up by 3 y-o-y. Of which, 18 securities firms had been listed, up by 3 y-o-y. There were 161 futures firms , down by 2 y-o-y due to mergers and acquisitions. 69 companies were authorized to engage in the fund management sector, up by 6 y-o-y.

The size of the sector's asset kept its growth. At the end of 2011, the total assets of securities firms① amounted to RMB 901.09 billion yuan, up 18.3% and RMB 139.7 billion yuan y-o-y. The total assets of futures firms were reported to be RMB 40.2 billion yuan, up 20.35% and RMB 6.8 billion yuan y-o-y. 915 funds were managed by the fund management companies in total, with 2.65 trillion units and a total net asset value of RMB 2.19 trillion yuan, up 5.16% and down 13.02% respectively y-o-y.

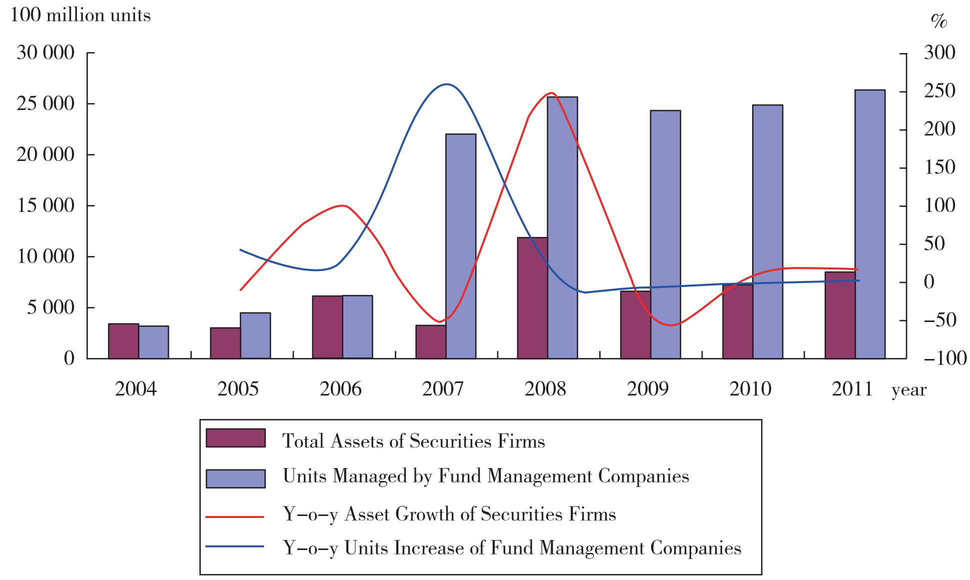
Figure3.1 Number of Institutions Operating in the Securities and Futures Sector, 2004–2011



Source: The CSRC.

① If the assets belonged to clients were included, the total amount would be RMB 1.57 trillion yuan, down 20.11% and RMB 0.39 trillion yuan y-o-y.

Figure3.2 Size and Growth of Securities Firms' Assets and Fund Management Companies' Units



Source: The CSRC.

2. More innovation was steadily pushed ahead

In 2011, the trading volume of margin trading increased significantly with better risk control in place and an orderly settlement and trading system. By the end of the year, 25 securities firms had been authorized to engage in this business, bringing the balance of margin lending up to RMB 37.6 billion yuan and short selling up to RMB 0.7 billion yuan. The issue of *The Trial Measure for the Supervision and Administration of Refinancing Business* (The Trial Measure for short) had authorized the incorporation of Securities Finance Company, delivering firm supports to the operation of securities refinancing business. Under *The Guidelines on Business Innovation for Securities Companies*, 8 securities firms had initialized three innovative pilot projects, including the repurchase through quotation, the mutual agreement and the cash management products. 4 subsidiaries of securities firms conducting the direct investment business were authorized to set up, raising the number to 34 in total. The investment advisory business of futures companies was launched successfully, with 47 futures companies got access approval. *The Trial Measures for Fund Management Companies to Provide Asset Management Services for Specific Clients* had been released, which supported the developing of asset management services for specific clients and facilitated the differentiation operation of fund management companies.

Box 7 Securities Refinancing

The refinancing business means that the Securities Finance Company lends the funds and securities of their own or lawfully raised to securities firms for their operation of margin trading. The launch of refinancing business will lay a solid foundation in infrastructure for margin trading and further improve the functions of securities market.

In March 2010 a pilot program of margin trading business was launched for securities firms. As one of the regular business lines in developed capital markets, the margin trading business enables investors to conduct short buying and short selling, thus improves the pricing function and liquidity condition of securities markets. While in the pilot period securities firms could only use their own funds and securities for this business, thus weakening its benefits and limiting its further expansion. In order to address this issue the securities regulator issued *The Trial Measure*, which clarified the rules for refinancing business and founded the Securities Financing Company.

Since the funds and securities owned by the Securities Financing Company were very limited and it needs to borrows funds and securities in order to provide refinancing business to securities firms. According to The Trial Measure, apart from the self-owned funds and securities, four categories of funds and securities can be raised by the Securities Financing Company for refinancing business as follows: corporate bonds issued according to the Company Law of the PRC and the Securities Law of the PRC, subordinated debts borrowed from the shareholders or other specific investors, funds and securities borrowed through the business platform of the stock exchanges, funds borrowed through the business platform of the Securities Financing Company itself.

The refinancing business involves several markets including capital market and money market, and it also involves different kinds of institutions such as banks, securities firms, insurance companies and fund management companies, thus obviously characterized by the cross-market and cross-institution nature. Therefore, the Securities Financing Company is the sole institution that provides refinancing business and bears various risks in the market, thus it is of systemically importance. To prevent potential risks, *The Trial Measure* had stipulated relevant risk management indicators and required to build a cross-guarantee fund at the sector level. However, the risk exposures of such an innovative refinancing business, especially during extreme market movements, had not been fully disclosed. It is necessary to establish the coordinated inter-agency surveillance mechanism to strengthen information sharing and push forward risk monitoring at the cross-market and cross-sector levels.

3. The Opening-Up of the Market progressed steadily

In 2011, progresses had been achieved in attracting international investors to invest in domestic markets, with 29 new Qualified Foreign Institutional Investors (QFII) approved during the year. By the year end, the investment quota amounting to USD 21.64 billion had been approved by the authorities and shared by 135 QFIIs. The RMB Qualified Foreign Institutional Investors (RQFII) pilot program was launched, with 9 fund management companies and 12 securities firms authorized to engage in this business. The ETF available for domestic investors in Hong Kong market was under active preparation. Meanwhile, the Qualified Domestic Institutional Investors (QDII) program proceeded successfully, with 22 newly raised QDII funds representing a total amount of RMB 18.85 billion yuan investment. The domestic securities firms and fund management companies were active in opening branches and subsidiaries in Hong Kong. By the year end, 16 subsidiaries of domestic securities firms and 15 subsidiaries of fund management companies started operation in Hong Kong respectively. At the opening front of the sector, 1 joint venture securities firm was approved to be founded by the authority within the year.

4. The regulation and supervision was continuously strengthened

To enhance the regulation of securities firms, the sector-wide stress testing was conducted to further improve the risk management capacity. The risk monitoring and analysis were enhanced with more focus placed on innovative businesses such as stock index futures, margin trading and so on. Stringent requirements were set forth for securities firms to implement the firewall system, in order to effectively prevent the conflicts of interests and insider trading between companies and customers as well as among different customers. To reinforce the supervision on futures companies, the categorized supervision system was modified to effectively guide futures companies better play its role as market intermediaries and encourage the expansion of high-quality companies through M&A. In order to be more effective and efficient, the supervision of futures companies was focused on the risk management capacity, information technology development, service capacity and potential risks. As far as the supervision on fund management companies was concerned, the regular monitoring and risk alert were intensified. The in-depth investigation and further enforcement into the credit risks arising from bond investments by fund managers and into the stop-to-evaluate events in the fund sector were carried out. 3 cases of Rat Trading in the fund sector were investigated and 2 suspected criminals were referred to public authorities, indicating a more stringent crack-down measures and education by authorities in response to illegal trading.

Box 8 Participate In International Security Regulation Rules Setting and Revision

After the global financial crisis, IOSCO changed its development strategy in response to the reforms in the international financial market and redefined itself as a global standard setter for securities market regulation. IOSCO revised *The Objectives and Principles of Securities Surveillance* and was heavily engaged in the research and rule making in securities regulation and systemic risk prevention. Guided by the requirement of participating in the international financial standard setting and revision that was put forward by the 12th Five-Year Plan, the CSRC had increased considerable resources into attending the standing committees under IOSCO, actively involved in the policy discussion and revision of international securities supervision rules, including capital supervision rules for market intermediaries, the supervision for investor appropriateness, the internal control system of rating agencies, and enhanced cross-border cooperation.

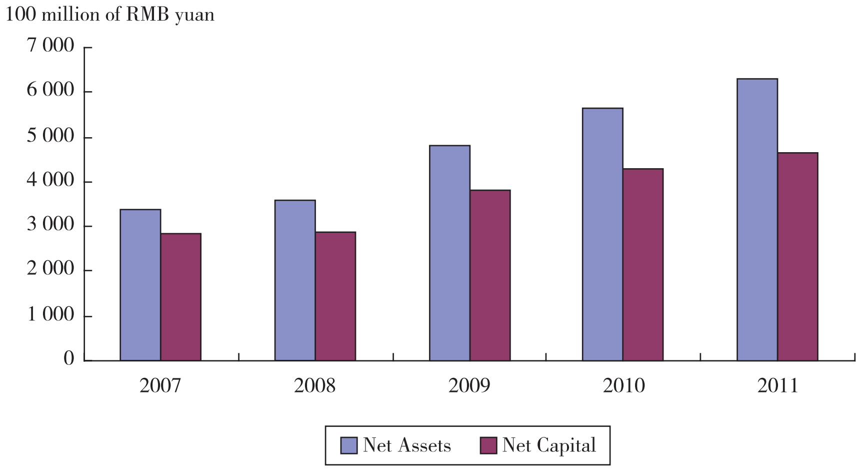
Meanwhile, the CSRC tried to tailor international regulatory experiences to country-specific circumstances in developing regulatory rules for China securities markets. As to strengthening capital regulation, the net-capital-based risk control system and stress-testing mechanism were improved to accommodate the more dynamic movements of risk control indicators and therefore to better support the business expansion and capital allocation efficiency of securities firms. As to investors protection, the concept of investor appropriateness was introduced and incorporated in the settings of several newly issued rules, including *Rules on Financial Product Sales by Securities Firms, Rules on Investment Advisory Subsidiaries of Securities Firms and Trial Measures on Asset Management of Customers of Securities Firms.*

II. Soundness Assessment

1. The Securities Firms Operated soundly with strengthened resilience

By the year end, the net assets and the net capital of securities firms had reached RMB 630.3 billion yuan and RMB 463.4 billion yuan respectively, marking the third consecutively increase year (Figure 3.3). The aggregate risk reserves of all securities firms amounted to RMB 105.7 billion yuan, with the ratio of net capital to all the risk reserves reached 439%, the ratio of net capital to net assets reached 74%, the ratio of net capital to total liabilities reached 49% and the ratio of net assets to total liabilities reached 67%. The increasingly strengthened trend showed by the risk control indicators indicates that the securities sector had adequate liquidity, relatively lower leverage and strong resilience against market risks. The sector-wide stress testing results showed that though faced with unexpected market movements, business line development and policy changes, the securities sector still would keep its sound operation.

Figure3.3 Changes of Net Assets and Net Capital of Securities Firms from 2007 to 2011



Source: The CSRC.

Table 3.1 Changes on Risk Monitoring Indicators for the Recent 3 Years

Year	2009	2010	2011	Regulatory Requirement
Net Capital/ Risk Reserves(%)	391.51	391.78	438.54	≥100
Net Capital/Net Assets(%)	78.91	76.12	73.53	≥40
Net Capital/ Liabilities(%)	24.73	30.83	49.17	≥8
Net Assets/ Liabilities(%)	31.34	40.50	66.87	≥20

Source: CSRC.

Box 9 The Stress Test of Securities Firms

In March 2011, as an important push to evaluate the risk profile of the securities sector and to promote the sector's sound operation, Guidance on Stress Testing of Securities Firms (Tentative) was issued by Securities Association of China, requiring securities firms build and strengthen the stress testing system to enhance risk management. According to the Guidance, the stress testing shall use qualitative analysis to test the soundness of various risk control indicators like net capital and financial indicators, hence to assess the securities firms' resilience and indicate further actions in response to potential risks. In July 2011, the CSRC undertook the sector-wide stress testing for the first time.

In this first sector-wide stress testing, the scenario was chosen by the CSRC① and was uniform for all the 106 securities firms (3 newly established in 2011 were excluded). The scenario was characterized by five indicators that have direct and great influence upon the sector, including the volatility on daily trading volume of A-share market, the volatility on strategic input of brokerage business by securities firms, the volatility on financing volume of A-share market, the volatility of CSI 300 index, the increase of the benchmark interest rate. The data pool for the stress testing was mainly based on the regulatory reports submitted by the securities firms, including the balance sheet, income statement and net asset report, in combination with the corporate operating plan and financial budget within the next 2 years. The outcome of the testing was supposed to reflect the resilience of various key financial indicators and regulatory indicators for securities firms under different stressed scenarios.

Table 3.2 Parameters for Sector-wide Stress Testing

Parameters	Mild scenario assumption		Severe scenario assumption	
	2011	2012	2011	2012
Volatility on Daily Trading Volume of A-share Market（%）	-20	-10	-30	-15
Volatility on Strategic Input of Brokerage Business（%）	20	10	30	15
Volatility on Financing Volume of A-share Market（%）	-30	-15	-45	-25
Volatility of CSI 300 Index（%）	-15	-5	-30	-10
Increase of Benchmark Interest Rate (BP)	100	25	150	50

Source: Securities Association of China.

① The scenario was only set for the stress testing purpose, and did not indicate any govermental prediction or judgement for the future performances of the real economy, the stock market and the securities sector.

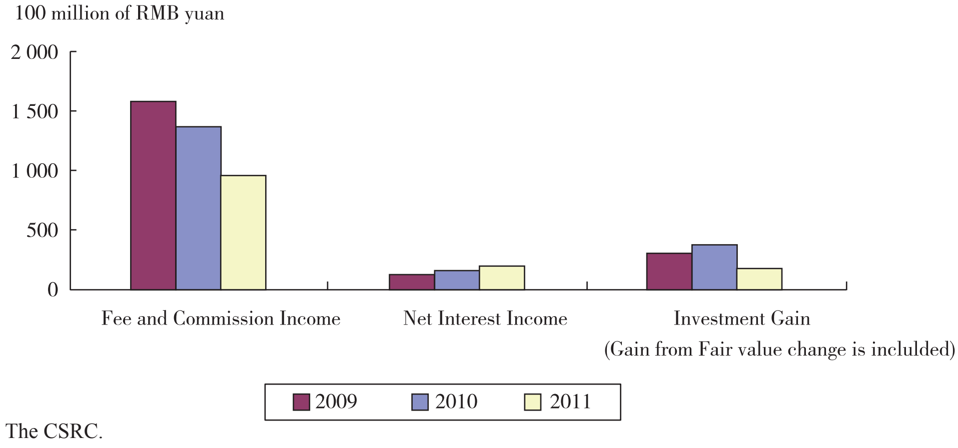
Given the testing time frame and the stressed scenarios, the results showed that the risk of the whole sector was controllable. Overall, even under the most stressed scenario, the net capital level of the sector could be kept at a sufficient level and the liquidity conditions of the sector would be still sound. However, some operating financial indicators would be very sensitive to the market movements, indicating the securities firms' over reliance on market performance. With the scenarios getting more and more stressed and the testing cycle being prolonged, the ratio of loss securities firms would increase, showing a strong pro-cyclical trend.

Currently, the stress testing system of securities firms was still under development, with data pooling, modeling and contingency planning yet to be further improved. Based on the experiences of the sector-wide testing, more efforts will be devoted to improve the stress testing as a risk management tool, in order to further promote the securities sector's sound operation.

2. The profits of securities firms relied heavily on market performance and the income structure need to be further improved

Influenced by the volatile market, the operating income of the securities sector amounted to RMB 136 billion yuan, dropping 29% from previous year, among which the fee and commission income contributed to RMB 95.5 billion yuan and reported a reduction of 30% y-o-y. The trading income, including investment gains and fair market value adjustments, reported to be RMB 18.5 billion yuan, dropping almost 50% from previous year. The interest rate margin income amounted to RMB 19.4 billion yuan, increasing 24% from previous year. The net profits of the sector reported to be RMB 39.4 billion yuan, dropping 50% from previous year.

Figure3.4 A Comparison of Securities Firms' Income Structure from 2009–2011



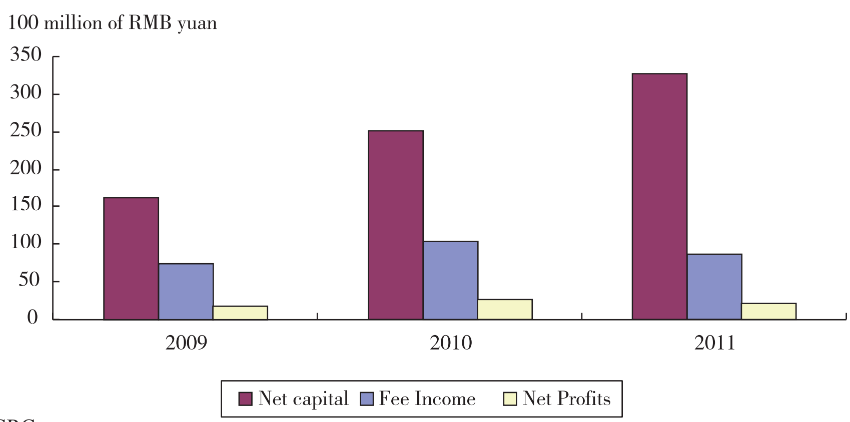
Source : The CSRC.

As far as the income structure was concerned, the brokerage income played a dominant role in the profits of securities firms. The contribution of brokerage business in total income reported to be 51%, a little bit lower than 56% in 2010, indicating the income structure of securities firms need to be further rebalanced. Meanwhile, the strong homogeneity of products and business offered by various securities firms was yet to be changed, the professional service capacity of the sector need to be further enhanced and more innovation should be encouraged to enable the sector better serve the real economy's financing needs.

3. The resolution regime had been established for the futures sector but the futures companies' operating capacity had yet to be strengthened

By the end of 2011, the margin for futures trading had totaled to RMB 159.4 billion yuan. The risk reserves specified for market risks amounted to RMB 10.85 billion yuan, among which the amount of RMB 1.9 billion yuan was set by futures companies, the amount of RMB 6.8 billion yuan was set by futures exchanges and the amount of RMB 2.15 billion yuan was accumulated by the Futures Investors Safeguard Fund, showing a stronger capacity to withhold the risks at the sector level. However, compared to other types of financial institutions, the operating capacity of futures companies remained weak. By the year end, there were 161 futures companies in total, with aggregate net capital of RMB3.29 billion yuan in total and RMB 0.2 billion yuan for each firm in average. The aggregate net capital, customers' margin and fee income of top 10 futures companies accounted for only 28%, 32% and 28% of the sector respectively. The income of futures companies mainly relied on fee income and interest income on customers' margin. In 2011, the annual operating income of 161 futures companies reported RMB 15.3 billion yuan, including RMB 9.98 billion yuan from fee income of brokerage business and RMB 3.2 billion yuan from interest income on customers' margin. The net profits of the sector were brought to RMB 2.3 billion yuan and some futures companies were reporting the losses for the year of 2011.

Figure 3.5 Changes of Major Indicators for Futures Companies



Source : The CSRC.

4. Securities Investment Funds developed steadily while the liquidity management of Money Market Funds faced challenges

By the end of 2011, the net asset value of the securities investment funds reported RMB 2.19 trillion yuan, with 94.4% was open-ended funds. The stock market funds and mixed funds accounted for 77.1% of the open-ended funds while the bond market funds and money market funds accounted for 20.1%. The risk reserves were required to be set up by regulatory authority to cope with possible compensation due to legal risks, technology malfunction and operational risks. By the year end, the risk reserves set aside by fund management companies had amounted to RMB 15.4 billion yuan, showing a stronger capacity by the sector to withhold risks. Overall, the securities investment fund sector developed soundly and steadily. However, the liquidity management was shown to pose challenges for some types of the funds like money market funds, due to unexpected redemption. As of June 2011, the money market fund units slide to 118.132 billion units from 153.277 billion units of 2010, indicating a drop of 22.9% within the first half of the year. The money market units did not increase until the second half of 2011 and reached RMB 294.895 billion yuan at the year end, representing an increase of 150% within the second half of the year. The wealth management products offered by commercial banks were regarded as the most influential factor among various factors leading to the volatility of money market funds. The apparent substitutability of short-term products offered by commercial banks and the more lucrative returns undoubtedly attracted investors and caused the redemption of money market funds. With regulation on commercial banks engaging in customer wealth management products strengthened by the regulatory authority in the second half of the year, the redemption then stopped and the net buying trend was formed for money market funds.

5. The rapid growth of private equity funds required more regulation and guidance

During the year of 2011, the private equity funds kept its rapid growth. According to statistics by Zero2IPO Research Center, 617 funds were raised within the year to make investments in mainland China, about 2.57 times of last year's level. The balance of the above funds reached USD 67.06 billion, about 1.3 times of last year's level. Some new trends appeared in the sector as follows. Firstly, various financial institutions began engaging in the private equity funds. Securities firms had been approved to launch funds for making direct investment, which enables the securities firms making equity investments using customers' funds. Insurance companies, like China Life and China Pingan Insurance etc.,had been able to invest in unlisted companies and make equity investments through investment funds. Secondly, more implementing rules concerning the pilot program of Qualified Foreign Limited Partner were issued. With the implementing rules developed by the local government in Shanghai, Beijing, Chongqing and Tianjin, more progresses can be expected in helping foreign institutional investors make domestic equity investments through the exchange of foreign currency to RMB funds. Thirdly, investors inclined to make more diversified equity investments, with increasing cases in the private offering of additional shares.

The booming of private equity funds sector was supportive in financing the SMEs, optimizing financing structure for enterprises as well as promoting the sector structure rebalancing. However, in respect of its short development history, regulation shall be further strengthened to address the potential problems arising from the sector's rapid growth.

Box 10 Private Equity Investment Funds

The private equity investment was generally made by entities through raising funds privately and making equity investments into enterprises as well as providing operational management and financial advisory services, with the aim of nurturing the enterprises' growth. The return on such equity investments can be realized by selling the equity. Based on the different development stages of the enterprise which receives the investment, the private equity investment funds can be classified into Venture Capital (VC for short) and non-VC capital.

Currently, there were four categories of private equity funds active in Chinese market. The first type was funds registered overseas but invested in domestic markets (like Blackstone group, Carlyle group etc.). The second type was funds registered domestically but with major contribution from overseas funding (like Beijing Hony Future Investment Advisory Ltd.). The third type was funds dominated by domestic state-owned funds, like Bohai Capital. The fourth type of funds was mainly from non-state enterprises.

The potential problems of the private equity investment funds sector arise as follows. Firstly, the investment structure is far from reasonable. Most private equity funds invested into companies prepared for the listing while few funds invested in enterprises at the launch or growing stage. The blind expansion of some private equity funds, in terms of the investment target and funding mechanism, may bear great risks at the macro level. Secondly, the operation of some private funds was found in a noncompliant manner implying illegally public offering, which poses potential risk on social stability. Thirdly, the regulation should be further intensified. The authority with the regulatory responsibilities has not been clarified yet, and current reporting requirements only covered private equity investment firms over a certain size, which may lead to weakness and gaps in ongoing supervision. Fourthly, the lack of professionals in this field may limit the value-added service of the sector.

In light of both international experiences and domestic circumstances, in order to guide the sector develop in a healthy and stable manner, moderate regulation was necessary and important, with the major focus placed on funds over a threshold size and funds regarded systemically important. The self-discipline should be stressed for the sector as well. Meanwhile, the investors protection should be further enhanced and market infrastructures should be strengthened to support a balanced development of VC and non-VC capital.

III. Outlook

In 2012, the external environment for the securities and futures sector may be more complicated and the task for the sector to enhance its service capacity became more urgent. For the next step, efforts should be delivered to deepen financial reforms, further propel the opening up of market as well as encourage innovation, in order to foster the sector's core competitiveness and its service capacity for real economy.

Promote the deepening of specific innovation pilot programs for securities firms and the optimization of the sector's income structure. The authority should further guide the securities firms strengthen the financial innovation and contribute more to the R&D of innovative products or services based on their own advantages. Efforts should also be delivered to track, monitor and analyze the progress of three pilot programs for securities firms, namely the repurchase through quotation and the mutual agreement and the cash management products, getting prepared for making these pilot programs further promoted as the regular business. Securities firms should be encouraged to pursue a more diversified business manner to achieve a balanced income structure. More implementation rules concerning the regulation on asset management business by securities firms should be developed to support the sector's asset management business development and strengthen relevant business capacity. Also, the implementation rules for securities firms selling financial products should be made to support the cross-sector expansion strategy of some securities firms.

Encourage fund management companies and futures companies strengthen innovation and service capacity. Sustained guidance should be made for fund management companies and futures companies to continue their efforts in financial innovation and ETF traded cross the exchanges should be prioritized. The progresses on revising laws and regulations on QDII should be continued to support the further expansion of QDII pilot program. The authority should keep close track of funds' involvement in refinancing business and margin trading and investigate the feasibility of the launch of Real Estate Investment Trusts (REITs). To propel the innovation by the futures companies and to lift the futures sector's operating capacity to better meet the financing needs of real economy, the back-testing mechanism should be introduced into futures companies to better accommodate the evaluation of innovation programs or pilot plan.

Strengthen the creditworthiness system and safeguard investors' interests. The development of electronic information disclosure system should be promoted steadily and the regulation on the creditworthiness of securities practitioners should be enhanced. Punishment for illegal and incredible conduct should be carried out firmly, and positive incentives should be built in a number of regulatory areas, including administrative approval, on-going supervision and financial innovation. Tough measures should be adopted in cracking down on any illegal behavior like insider trading, market manipulation, fraud listing and false information disclosure. For significant merger and acquisitions, the regulatory approval should be suspended if related insider trading was suspected.

Push ahead the opening-up of the securities and futures sector steadily and foster the sector's international competitiveness. The opening up of the securities and futures sector should be pushed ahead steadily based on several basic principles as follows. The opening-up should be based on domestic development needs, both competitiveness and corporation should be stressed equally, the opening-up speed should be gradual and the mutual interests should be satisfied in the cooperation. Under the CEPA framework, foreign institutional investors that were highly competitive in futures business should be invited to be the shareholders of domestic futures companies. Also, domestic futures companies should be further encouraged to explore business overseas, including acting as the domestic agency for foreign institutional investors. Support should be continuously delivered for fund management companies to go abroad as well, in terms of establishing subsidiaries in Hong Kong, Taiwan and overseas area. Domestic securities and futures companies should be encouraged to raise funds overseas. The progress of pushing forward QFII business should be accelerated with more investment quota and expansion of pilot scope. The cross-border ETF transacted bilaterally should be launched at appropriate time.

Chapter IV

Insurance Sector

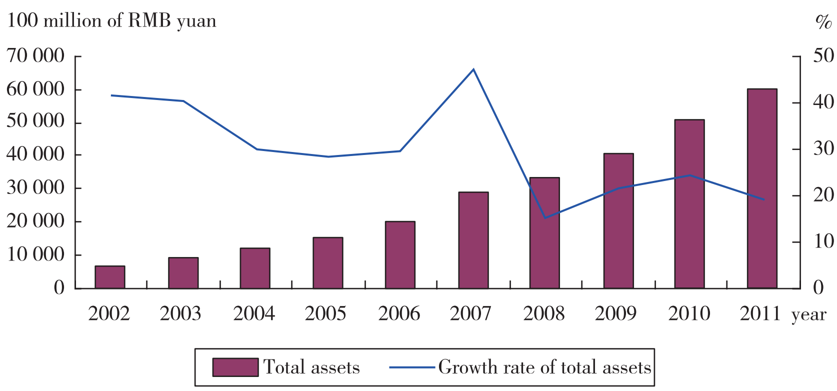
In 2011, China's insurance sector has further deepened institutional reform, expanded opening-up, improved supervisory system and regulated market order, generally maintained a sound development momentum. The risk was effectively prevented and the service capability was enhanced.

I. Recent Developments

1. Asset size continued to expand and sector structure improved

By the end of 2011, total assets of the insurance sector registered RMB 6.01 trillion yuan, increasing 18.99 percent y-o-y (Figure 4.1). The number of insurance institutions increased by 10 to 152, including 10 insurance groups and shareholding companies, 59 property insurance companies, 62 personal insurance companies, 8 reinsurance companies, 11 insurance asset management companies, 1 export credit insurance company and 1 rural insurance cooperative. The number of specialized insurance intermediaries rose from 2 550 to 2 554. Among the property insurance companies, the biggest one took 36.3 percent of the market share, decreasing 1.9 percentage points y-o-y; the five biggest companies accounted for 74.4 percent of the market share, down by 0.3 percentage point from last year. With regard to life insurance companies, the share of the biggest company rose 1.6 percentage points to 33.3 percent, and the share of the biggest five was 72.8 percent, on a par with 2010.

Figure 4.1 Total Assets and Growth Rate of the Insurance Sector

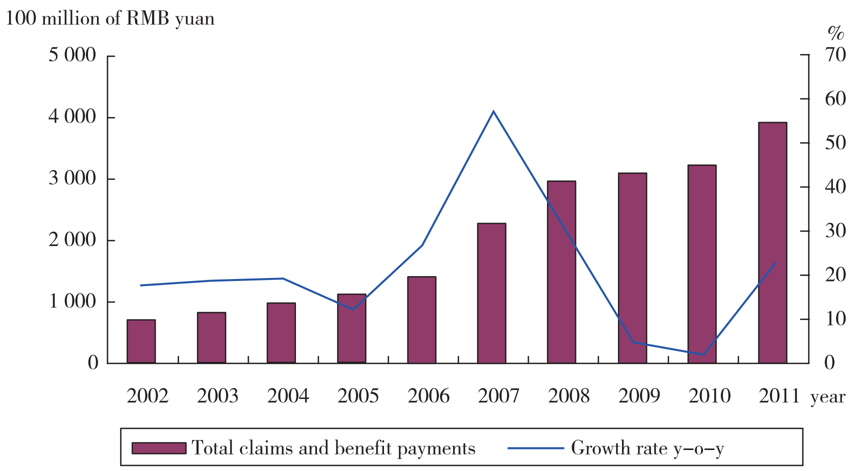


Source: The CIRC.

2. Premium income grew in a steady manner with further expansion of service

In 2011, premium income nationwide amounted to RMB 1.43 trillion yuan, with an increase of 10.4 percent y-o-y[①]. Claims and benefit payments amounted to RMB 392.94 billion yuan, with an increase of 22.8 percent y-o-y (Figure 4.2). The coverage of service continued to expand. The insurance sector accelerated development of health insurance and pension insurance, promoted rural micro-insurance pilots, participated in the operation of new rural cooperative medical system, and launched pilot program for variable annuity insurance in Shanghai, Beijing, Guangzhou, Shenzhen and Xiamen. Non-auto property insurance business lines grew fast, with the premium income from guarantee insurance, agricultural insurance, liability insurance and credit insurance reached RMB5.65 billion yuan, RMB 17.4 billion yuan, RMB 14.8 billion yuan and RMB 11.55 billion yuan respectively, increasing 146.6 percent, 28.1 percent, 27.7 percent and 20.3 percent y-o-y, among which the agricultural insurance provided risk coverage of RMB 652.3 billion yuan for the agricultural sector and the export credit insurance provided risk coverage of USD 216.24 billion for the export sector, strongly supporting China's economic development.

Figure4.2 Total Claims and Benefit Payments and Growth Rate



Source: The CIRC.

① Starting from 2011, the insurance sector adjusted the principle to recognize premium income according to *Interpretation No. 2 of the Accounting Standards for Business Enterprises* of the Ministry of Finance: those insurance policies that involve none or insignificant insurance risk should not be recognized as insurance contracts, and the revenue of these kind of policies should not go into premiums. Based on the new categorization, most of the revenues from investment-linked insurance policies and universal insurance policies will not be recognized as insurance premium. Here shows the value adjusted on a comparable basis.

3. Reforms and innovations were pushed forward with opening-up further promoted

In May 2011, the overall reform plan of the China Export & Credit Insurance Corporation (Sinosure) was approved by the State Council, and at the end of June, China Investment Corporation injected RMB 20 billion yuan in Sinosure. In June, the People's Insurance Company (Group) of China Limited introduced a strategic investor. In December, the New China Life Insurance Co., Ltd. successfully went public in both A and H share market, with funds raised reached about RMB 13.3 billion yuan. Through reform, the capital and resilience of insurance companies improved significantly. Meanwhile, the insurance sector started the pilot program for commercial banks to invest in equities of insurance companies, explored the establishment of captive insurance companies and rural insurance cooperatives and promoted the reform of sales-representatives management system. Within a decade after China joined the World Trade Organization (WTO), the insurance sector has basically realized all-around opening-up. Foreign investors can establish solely foreign-funded property insurance companies in China, and their investment in equities of personal insurance companies can reach 50 percent at the most. In addition, foreign-funded insurance companies can run business except for statutory ones. As of the end of 2011, insurance companies from 16 countries and regions have established 54 foreign-funded insurance companies in China, and the branches of which amounted to almost 1 300 ones. Foreign-funded insurance companies in Beijing, Shanghai, Guangdong and Shenzhen developed relatively faster, with market shares of 11.28 percent, 14 percent, 6.7 percent and 6.02 percent respectively.

Box 11 Reform of the People's Insurance Company (Group) of China Limited

The People's Insurance Company (Group) of China Limited (PICC Group Limited) was formerly known as the People's Insurance Company of China, which was renamed as the People's Insurance Company (Group) of China after the restructure in 1996 and consisted of four subsidiaries, including the People's Insurance (Property) Company of China, Ltd.. After the separate operation reform in 1998, the People's Insurance (Property) Company of China, Ltd. succeeded the name and brand of the People's Insurance Company of China. In 2003, the People's Insurance Company of China was restructured into the People's Insurance Holding Company of China, and established PICC Property and Casualty Company Limited and PICC Asset Management Company Limited (PICC P&C and PICC

Asset), in which PICC P&C went public in 2003. In June 2007, the People's Insurance Holding Company of China resumed its name of People's Insurance Company (Group) of China (PICC Group). As a solely state-owned enterprise, PICC Group owned 10 tie-one subsidiaries including PICC P&C and PICC Asset, and covered various insurance businesses such as property insurance, life insurance, health insurance, asset management, insurance brokerage, trust and fund.

As the financial system reform deepened and the opening-up of insurance market accelerated, problems of PICC Group began to stand out and needed to be addressed, such as incomplete corporate governance, cross share-holding of subsidiaries, excessive management hierarchy and lack of market-based capital replenishment channels. Drawing on the successful experiences of the large commercial banks shareholding reform, relevant government departments formulated the reform plan for PICC Group to resolve non-performing assets on its own, improve corporate governance, introduce strategic investors at appropriate time and go public in domestic and overseas markets for the entire group. At the request of establishing modern financial corporate system, the PICC Group was promoted to establish and complete modern corporate governance structure, transform operational mechanism and improve core competitiveness through deeper reform and strict management, and become a modern insurance (financial) group with adequate solvency, strict internal control, secure operation, sound service and profitability and strong competitiveness.

In June 2009, the State Council approved the reform plan of the PICC Group. In September, the Ministry of Finance exclusively sponsored the PICC Group Limited, with registered capital of RMB 30.6 billion yuan. After the reform, the PICC Group Limited has established an organizational structure of *Three Meetings and One level*, namely the general meeting of shareholders, the board of directors, the board of supervisors and the senior management. It has formulated and implemented a series of management rules including the rules of procedures of the *Three Meetings and Boards*, working rules and authorizing plans of special committees, initially establishing a relatively standard corporate governance structure. Efforts have been taken to enhance the overall management capacity in terms of human resource, finance, risk and brands, promote internal resource integration, and properly tackle the cross share-holding issues within the group, strengthen the building-up of information system and centralized data management, improve the services' safeguards at the mid to back-end. Work has been done to establish and improve the internal risk control system that covered the whole group to promote risk management In June 2011, the PICC Group Limited successfully brought in National Council for Social Security Fund as strategic investor, which invested RMB 10 billion yuan and acquired 11.28 percent of PICC Group Limited's shares. The investment of the National Council for Social Security Fund further improved the shareholding structure of the PICC Group Limited and enhanced its capital adequacy.

After the reform, the corporate governance, internal control and operational management of the PICC Group Limited were further improved and its profitability greatly enhanced. In 2011, the premium income for PICC Group Limited reached RMB 249.6 billion yuan, RMB 105 billion yuan higher than before the reform in 2008. Net profits were RMB 7.4 billion yuan, an increase of RMB 7.1 billion yuan than 2008. At the end of 2011, the total assets of the PICC Group Limited were RMB 585.6 billion yuan, RMB 350.2 billion yuan more than that of 2008, and the net assets were RMB 50.3 billion yuan, RMB 25.7 billion yuan higher than 2008. Currently, the PICC Group Limited is actively seeking public listing for the whole group.

4. Regulation and supervision were continuously improved and financial consumers' rights better protected

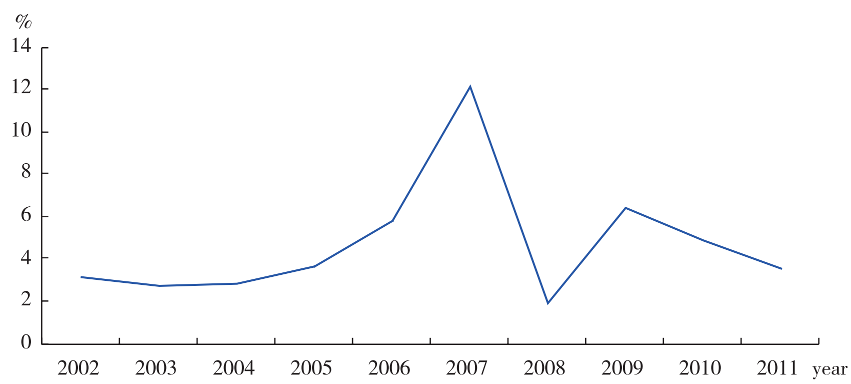
In 2011, insurance supervisors formulated and released the 12th *Five-year plan for development of insurance sector in China*, clarifying the overall requirements and major tasks of the insurance sector during the 12th five-year including strengthening capital management, improving capital replenishment mechanism, modifying the *Administrative Measures on Subordinated Term Debts of Insurance Companies*, which added the qualification requirements for fund-raisers and regulated the management, repayment and use of subordinated debts. They also enhanced insurance market exit mechanism, released the *Interim Measures for the Administration of Transfer of Insurance Business by Insurance Companies* to regulate transfer of insurance business by insurance companies. They also strengthened transparency regulation, completed information disclosure mechanism, and for the first time ensured public disclosure of annual reports by all insurance companies except for those under restructure. At the same time, in order to protect legitimate rights of policyholders, the insured and the beneficiaries, an insurance consumer protection bureau was established, a preliminary nationwide united information platform of compulsory vehicle liability insurance and commercial auto insurance was set up, and the rules on personal insurance business and regulations for insurance practitioners were formulated. In addition, relevant agencies jointly released the *Regulatory Guidelines for Bancassurance Business of Commercial Banks* to regulate insurance business operated by banks.

II. Soundness Assessment

1. ROI of Insurance Fund Decreased While Insurance Assets Management Became More Difficult

In 2011, the outstanding balance of insurance investment funds was RMB 5.5 trillion yuan, with an increase of 20.47 percent y-o-y, among which bank deposits were RMB 1.77 trillion yuan, accounting for 31.97 percent; bond investment was RMB 2.6 trillion yuan, accounting for 47.09 percent; equities investment was RMB 575.5 billion yuan, accounting for 10.37 percent; and securities investment fund investment was RMB 291.6 billion yuan, accounting for 5.26 percent. Return on fund investment was RMB 182.59 billion yuan, and the average Return on Investment (ROI) was 3.57 percent, down 1.27 percentage points compared with last year (Figure 4.3). Due to the fluctuation of the bond market and decline of the stock markets, insurance companies adjusted investment structure, with the share of deposits rising 1.8 percentage points and shares of bonds, equities and securities investment funds decreasing 2.8, 0.7 and 0.4 percentage point respectively. However, since securities investment accounted for over 60 percent of total investment, ROI was still heavily affected. In the first three quarters, the annualized rate of return for insurance funds was only 2.7 percent, which rose to 3.6 percent in Q4 and was only a little more than the 3.5 percent 1-year savings rate of bank deposits. The decline of investment return increased pressure on liquidity and solvency management of insurance companies.

Figure 4.3　Average ROI of Insurance Funds

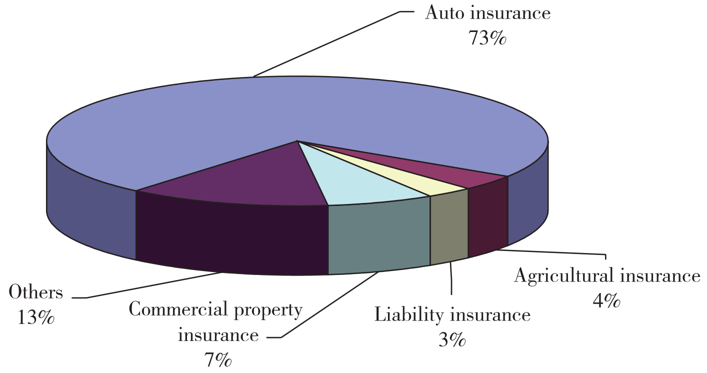


Source: The CIRC.

2. Premium income growth of property insurance slowed down and underwriting profits reached record high of recent years

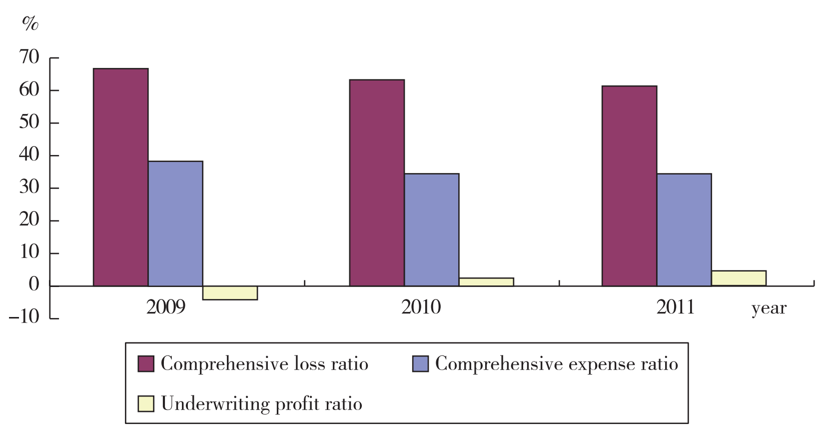
In 2011, affected by slowing economic growth and policies such as adjustment to auto purchase subsidy and the auto purchase limit, property insurance premium growth rate eased from last year. The total property insurance premium registered RMB 461.79 billion yuan, increasing 18.5 percent y-o-y, and the growth rate declined 17 percentage points compared with 2010 (Figure 4.4). Nevertheless, pre-tax profits still amounted to RMB 29.92 billion yuan for the whole year, up 32.6 percent y-o-y (Figure 4.7), which mainly benefited from enhanced management of property insurance companies and improvement in industry order. For one thing, property insurance companies changed development model and enhanced management; for another, supervisors strengthened examination on corporate finance and promoted nationwide united information platform construction of auto insurance, which to some extent improved market order. With the combined efforts above, both loss ratio and comprehensive expense ratio decreased and underwriting profit ratio reached 4.74 percent, a record high in recent years (Figure 4.5).

Figure 4.4 Distribution of Property Insurance Premiums in 2011



Source: The CIRC.

Figure 4.5 Underwriting Business Performance of Property Insurance Companies in Recent Years

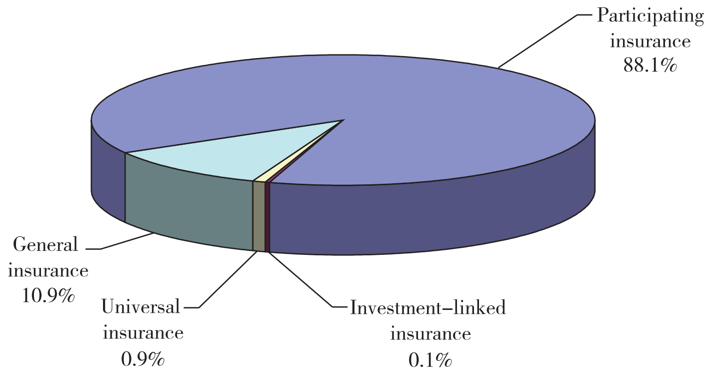


Source: The CIRC.

3. Growth of life insurance premiums fell while structure adjustment was steadily pushed forward

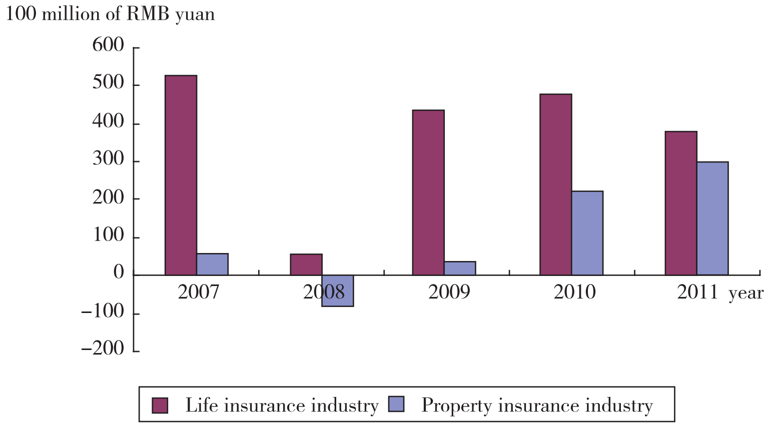
In 2011, premium growth of personal insurance took a big drop, with premium income of RMB 969.98 billion yuan (in which life insurance premium was RMB 869.56 billion yuan), an increase of 6.8 percent y-o-y (Figure 4.6). On one hand, the fall of investment return of insurance companies led to low yields and low competitiveness of deposit substitutes such as participating insurance. On the other hand, fast development of bank's wealth management products that were more flexible in investment means and yielded higher have resulted in substitution for life insurance products to certain extent. Meanwhile, the releases of *Notice on Further Strengthening the Sales Compliance and Risk Management of the Bancassurance Business of Commercial Banks* and *Regulatory Guidelines for Bancassurance Business of Commercial Banks* brought relatively large impact on the bancassurance channel of insurance companies. According to statistics, within three quarters after the releases of the above notices, premium income through this channel declined 3.5 percent y-o-y. Under the collective effect of various factors, pre-tax profits for the life insurance in 2011 were RMB 37.42 billion yuan, a decrease of 43.3 percent compared with last year (Figure 4.7). At the same time, structure adjustment of life insurance business was steadily pushed forward. Sales through personal channel grew 11.7 percent y-o-y, and installment business above 10 years went up 9.6 percent y-o-y. Traditional protection business developed fairly fast and the growth of business value was much quicker than that of scale.

Figure4.6　Distribution of Life Insurance Premiums in 2011



Source: The CIRC.

Figure4.7 Pre-tax Profits of Life Insurance and Property Insurance

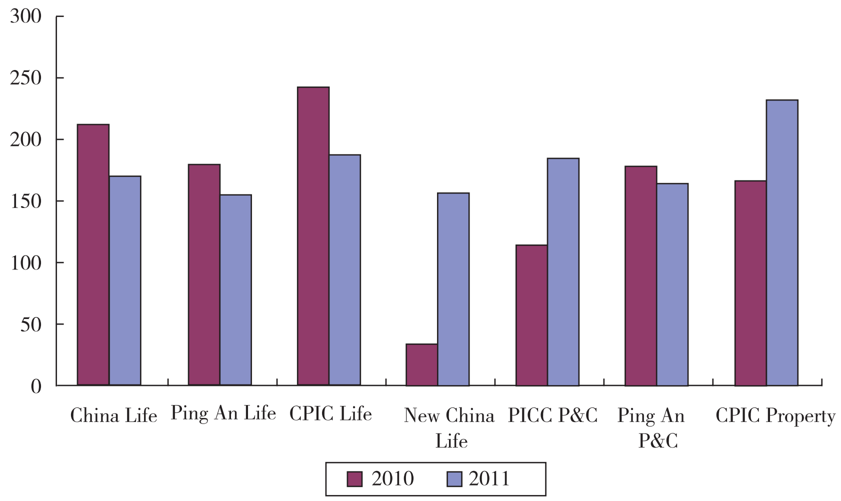


Source: The CIRC.

4. The Solvency of Insurers Declined as a Whole and Pressure to Replenish Capital Ascended

In 2011, insurance sector as a whole experienced large fall of solvency, and some life insurance companies' solvency adequacy ratio declined over 60 percentage points compared with beginning of the year, which posed great pressure on capital replenishment (Figure 4.8). During 2011, the number of companies that raised capital and the scale of funds collected far exceeded those of 2010, with 66 insurance companies raised capital of RMB 90 billion yuan and 15 insurance companies approved to issue subordinated debt worth RMB 60.05 billion yuan. Due to the measures such as restrictions on scale and disapproval of branch offices on those companies with inadequate solvency CIRC and inadequate capital, insurance companies generally strengthened capital management and tried various channels to raise solvency level. At the end of the year, inadequate solvent companies decreased from 7 at year beginning to 5, and the risk profiles of those companies were gradually improved.

Figure4.8 Solvency Adequacy Ratios of Listed Insurance Companies in 2010–2011



Source: Annual reports of listed insurance companies.

Box 12 The Stress Test of Insurance Companies

In 2003, International Association of Insurance Supervisors (IAIS) released the *Stress Testing by Insurers Guidance Paper,* which regulated in principle the procedures, methods, risks to be covered, usage of results, and etc. of insurance company stress tests. Since 2007, in order to strengthen insurance sector risk monitoring, alert and protection and to safeguard the interests of insurance consumers, China's insurance supervisors have released a series of regulations and established China's insurance company stress test mechanism focusing on dynamic solvency and cash flow test.

The purpose of dynamic solvency test is to forecast and evaluate the solvency condition of an insurance company for a certain period in the future to avoid insolvency risk that might arise. Test scenarios can be divided into basic scenario and adverse scenario. The basic scenario gives the optimum estimates about a set of assumptions such as premium growth rate, premium retention ratio, premium earnings ratio, loss rate, payment mode, expense rate, investment return, and etc. during a certain period of time in the future that are based on the development plan of the insurance company and reasonable forecast of the trend in the future. The adverse scenario refers to scenario that may happen in the future and could pose significant pressure on solvency of the insurance company. Supervisors set three compulsory adverse scenarios for property and life insurance companies respectively (Chart 4.1).

Chart4.1 Compulsory Adverse Scenarios of Dynamic Solvency Tests for Insurance Companies

	Property insurance company	Life insurance company
Scenario 1	(1) Increase loss rate for the whole financial year in the basic scenario by 5 percentage points; (2) Increase expense rate for the whole financial year in the basic scenario by 5 percentage points.	(1) Decrease ROI of investment assets in the basic scenario by 0.5 percentage point; (2) Multiply expense rate in the basic scenario by 120%; (3)Multiply dividend expenses for the insured in the basic scenario by 120%.
Scenario 2	Increase premium growth rate in the basic scenario by 20 percentage points.	Increase new business premium growth rate in the basic scenario by 20 percentage points.
Scenario 3	Maintaining the investment portfolios in basic scenario, listed stocks and funds lose 30 percent in the first year after the reporting year, and investment income was 0 in the second year after the reporting year.	Maintaining the investment portfolios in basic scenario, listed stocks and funds lose 30 percent in the first year after the reporting year, and investment income was 0 in the second and third year after the reporting year.

Cash flow test refers to forecast of cash flow of the insurance company as a whole and of various business lines under stress scenarios based on established cash flow forecast models. The basic scenario is the same with that of dynamic solvency test, while stress scenario includes policy surrender, asset price falls, decline of new business premiums, and etc.. (Chart 4.2).

Chart4.2 Stress scenarios of cash flow tests for insurance companies

Categories	Scenarios
Surrender stress test	Multiply the surrender rates of investment-linked insurance and universal insurance by 200%, and multiply those of other businesses by 150%
Asset prices stress test	Maintaining investment portfolios in the basic scenario, impose a one-time cut of 30 percent of the fair values of equity assets (including stocks and funds) and then stay unchanged
New business stress test	In the next four quarters, decrease premiums of new businesses by 40 percent y-o-y, and then stay unchanged for the following years
Comprehensive stress test	Run the above three stress tests together

According to the stress test mechanism of insurance sector, insurance companies have to conduct compulsory stress tests regularly and report to supervisors the process and results of tests. The dynamic solvency test of insurance companies in 2011 showed that under normal operation assumptions, most insurance companies, particularly the large ones, have adequate capital, and will not encounter insolvency even in some extremely adverse scenarios. In Q3 of 2011, in response to the depression in capital market and rapid rise in surrender rate, supervisors mainly required stress tests about surrender scenario. The results of the test showed that the whole insurance sector held adequate cash flow and the majority could pass surrender stress test. In all, the stress tests of insurance companies in recent years indicated that China's insurance sector has relatively strong resilience, adequate solvency and low cash flow pressure.

With the combined efforts of supervisors and insurance companies, stress test has played an increasingly important role in estimation of the risk management and solvency capabilities of China's insurance sector. In the next stage, insurance supervisors should fully draw on the experience and standards of international insurance sector stress tests, improve the techniques and methodologies of stress tests, add macroeconomic factor scenarios such as economic growth rate and inflation rate, and give stress tests full play in identifying insurers with solvency vulnerability and promoting insurance companies' business structure adjustment, size and growth rate control, capital management and operational management, and etc..

III. Outlook

In 2012, changes in international and domestic situations will affect the underwriting business, investment and capital replenishment of the insurance sector in many ways through financial market, real economy and insurance consumers, and etc., which increased the pressure and difficulty in sector development and risk prevention. The insurance sector will actively seek transformation in development model, optimize business structure and promote innovation to maintain healthy development and better serve the society and real economy.

1. Optimize life insurance business structure and enhance management of sales channels

Compared with other financial products, the core competitiveness of life insurance products lies in risk protection and long-term management of assets. The life insurance sector will play to its advantages, encourage potential demand of clients and strengthen efforts in developing long-term insurance, installment insurance and other products with protection functions. Meanwhile, it will also take initiative in exploring practical sales modes, deepen cooperation with banks, promote commercialization of sales channels of banks and reform on management mechanism of life insurance sales representatives, improve quality of sales representatives and expand new sales channels such as telephone lines and networks.

2. Promote innovation in property insurance to better serve the real economy

The property insurance companies should seize the opportunity of the development of emerging industries and the adjustment of economic structure, actively develop emerging businesses such as green insurance, technology insurance and culture industry insurance, and further expand export credit insurance and shipping insurance. They should accelerate development of agricultural insurance and construction of multi-layer catastrophe insurance system to promote new socialist countryside construction. They should, in line with public service innovation, speed up development of liability insurance products that are closely linked to public interests such as environmental pollution liability insurance and safe production liability insurance, and further improve compulsory liability insurance for vehicles.

Box 13 International operational modes of compulsory liability insurance for vehicles and implications

Compulsory liability insurance for vehicles is a compulsory insurance mechanism, which has become an internationally accepted effective institutional arrangement to protect the interests of traffic accident victims. International operation of compulsory liability insurance for vehicles can be generally divided into three modes, namely commercialized operation, agency operation and national social security operation.

In the mode of commercialized operation, insurance companies run the market-based business independently. They have the rights to determine the policy terms and rates and to refuse services to *highly-risky* automobiles, and they assume sole responsibility for profits or losses. The regulation policies for compulsory liability insurance for vehicles are the same with those of commercial insurance. Most European countries, the United States and Korea adopt this mode. In agency mode, insurance companies do not run compulsory liability insurance for vehicles for profits. They act only as agents while the government plays the leading role. The government will set standard rates and liability limits sticking to 'break-even' principle, and assume all operational risks. Insurance companies charge only fixed agency fees, manage and record compulsory liability insurance for vehicles separately from commercial insurance, and cannot refuse application for any automobile. Japan is representative of this mode. In national social security mode, government establishes accident compensation program and provides unified compensation to all traffic accident casualties. New Zealand is typical of this mode.

Since the launch of compulsory liability insurance for vehicles in China, the insurance has played an active role in settling traffic accident conflicts and maintaining social stability. However, due to the ambiguity in operational mode, compulsory liability insurance for vehicles results in great losses. China needs to draw international experiences, further clarify the operational mode of compulsory liability insurance for vehicles, establish a more reasonable and flexible rate adjustment system, and improve the external environment for operation of compulsory liability insurance for vehicles.

3. Improve insurance regulatory system and promote coordination of regulatory rules with international standards

Insurance supervisors will study the timing and means of pricing mechanism reform of traditional life insurance, health insurance and pension insurance to let the law of value play a larger role. Supervisors will deepen market-based reform of regulation on insurance fund investment and gradually increase the categories of unsecured enterprise (corporation) bond instruments that insurance funds can be invested in. The construction of solvency supervision system in line with the development stage of China's insurance sector should be accelerated. The entry and exit mechanism of insurance market should be improved to promote competition. Meanwhile, supervisors should learn from the *Insurance Core Principles, Standards, Guidance and Assessment Methodology* published by IAIS, draw on the latest accomplishments of international financial regulatory reform in areas such as macro-prudential management, group regulation, solvency regulatory framework, capital replenishment mechanism and disclosure to increase coordination of insurance regulatory rules with international standards.

Box 14 New Changes to Insurance Core Principles

The recent global financial crisis not only exposed problems in corporate governance and risk management of insurance companies, but also indicated that current international insurance supervision standards, policies and methods could not meet the need of market development. Drawing experiences of the Financial Sector Assessment Program (FSAP) conducted by the IMF and the World Bank, the IAIS built on the supervisory concept proposed by the G20 Finance Ministers and Central Bank Governors Meeting, Financial Stability Board and the new Basel accord, further improved the Insurance Core Principles (ICPs) and formally published the revised version of *Insurance Core Principles, Standards, Guidance and Assessment Methodology* in October 2011.

The new ICPs mainly improved in the following aspects. First of all, it introduced the philosophy of macro-prudential surveillance. It requires the supervisors to design a macro-prudential surveillance approaches, adopt qualitative and quantitative methods to identify, monitor, and analyze market and financial developments and other environmental factors that may impact insurers and insurance markets and use this information in the supervision. In addition, supervisors should strengthen identification and supervision of systemic importance of insurers. Secondly, it calls for the establishment of comprehensive enterprise risk management (ERM) frameworks. Insurers are required to establish ERM that cover the process of identifying, assessing, measuring, monitoring, controlling and mitigating risks . Thirdly, it underlines the importance of capital adequacy. Supervisors will adopt total balance sheet approach to assess solvency of insurers, establish regulatory capital requirements and solvency control levels, require that insurers maintain sufficient capital resources so that they can absorb significant unforeseen losses. Fourthly, it strengthens group-wide supervision. Supervisors should supervise insurers on a legal entity and group-wide basis, and establish group-wide supervision framework on the basis of considering various factors such as size, nature, complexity of the insurance group and preconditions and the ultimate objectives of effective group-wide supervision. Fifthly, it enhances the valuation of assets and liabilities. Supervisors should *approve of* the values of assets and liabilities with the purpose of ensuring full repayment of clients' debts. Sixthly, it regulates business behaviors. Supervisors should regulate insurance business to ensure that clients get fair treatment before, in and after sales, which improves consumer protection and reduces reputation risk for insurers. Seventhly, it requires supervisors to strengthen cross-border cooperation and coordination.

4. Regulate operational behaviors of insurance companies and strengthen consumer rights protection

In response to the prominent problems such as misleading sales and difficulties in insurances claims, insurance supervisors will prioritize comprehensively resolving these problems, further improve regulations and rules on misleading sales, formulate standards on claims service and regulatory indicators and increase penalties. Insurance companies should strengthen management of services before, in and after product sales, strengthen integrity compliance and information disclosure, establish timely and fair claim service policies and procedures, and strengthen management on sales channels and sales representatives to truly protect legitimate rights of insurance consumers and improve the social profile of insurance sector.

5. Create favorable external environment to promote stable and relatively fast development of the insurance sector

In response to the mismatch of assets and liabilities of life insurance companies due to lack of long-term products in China's bond market, capital market construction should be accelerated to offer more long-term investment instruments for insurance companies. Insurance education and promulgation should be enhanced to improve insurance awareness and risk awareness of the public. At the same time, policy coordination should be strengthened to promote the launch of *Agriculture Insurance Regulation*, which should provide a united institutional framework for agricultural insurance at the legislative level. Catastrophe insurance legislation should be promoted and catastrophe insurance system should be integrated into national comprehensive disaster protection system. The supportive role of fiscal taxation policy should be fully promoted, and personal deferred tax pension insurance products should be developed to improve the multi-layer pension security system.

Chapter V

Financial Market

In 2011, China's financial markets continued to perform in a sound and stable manner against the backdrop of reform and innovation, and maintained a steady development momentum. It brought the role of allocating resources and supporting the development of real economy into full play, thus contributing to the effective implementation of macroeconomic policies.

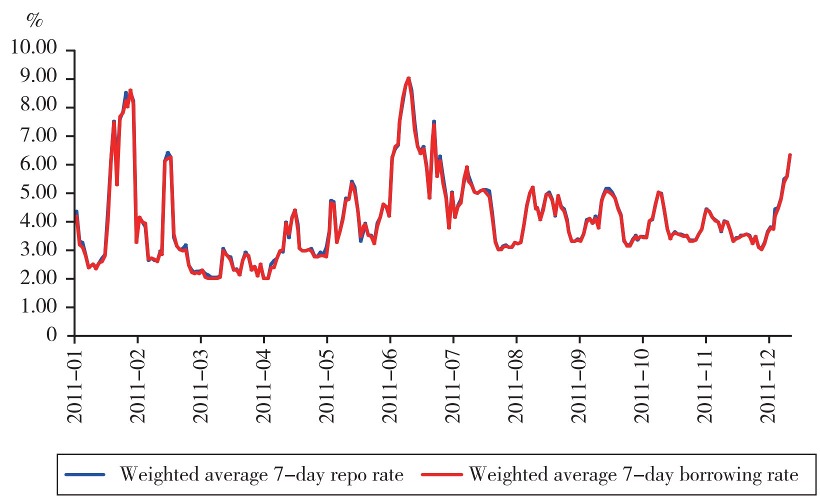
I. Market Overview

1. Trading on the Money Market Remained Brisk

The volume of money market maintained notable growth and short-term transactions accounted for a large share of total trading. In 2011, the market liquidity was generally abundant and trading on the money market was brisk with continuously growing turnover volume. The turnover of inter-bank borrowing registered RMB 33.4 trillion yuan accumulatively with a y-o-y increase of 20.0 percent; the turnover of bond repos reached RMB 99.5 trillion yuan with a y-o-y increase of 13.6 percent; Among which, short-term transactions accounted for a large share of the total, with turnover of overnight inter-bank borrowing reaching RMB 27.3 trillion yuan, about 87.9 percent of the total inter-bank borrowing, and 1-day bond pledged repo totaling RMB 72.9 trillion yuan, accounting for 73.3 percent of the total bond repos.

Interest rates on the money market fluctuated by a large margin. On March 15, the weighted average interest rate of 7-day bond repo dropped to the year low of 1.99 percent and on June 23, it touched the year high at 9.04 percent. In December, the weighted average interest rates of inter-bank borrowing and bond pledged repo registered 3.33 percent and 3.37 percent, down 37 and 92 basis points from January respectively (Figure 5.1).

Figure5.1 Interest Rate Movements on the Money Market in 2011

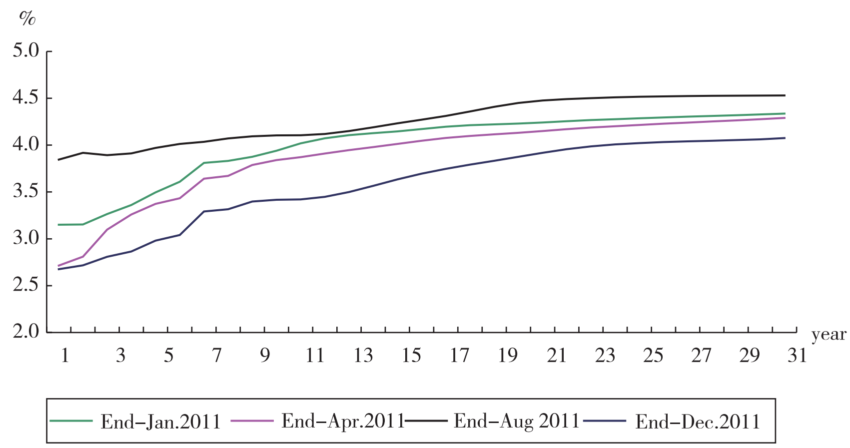


Source: National Interbank Funding Center.

2. The Bond Market Grew Stably

Market turnover remained stable and bond indices edged up. In 2011, the turnover of spot bond transactions totaled RMB 63.7 trillion yuan, down 0.7 percent y-o-y. Among those, the turnover of cash bond trading on the interbank market registered RMB 63.6 trillion yuan, down 0.6 percent y-o-y, and total turnover of spot government securities transactions on the stock exchanges reached RMB 125.32 billion yuan, down 24.6 percent y-o-y. In general, bond price indices climbed up, with the inter-bank bond index rising from the 132.93 in the beginning of the year to 139.75 in the year-end, up 5.1 percent. And government bond index traded on the stock exchanges picked up from the 126.32 in the beginning of the year to 131.39 in the year-end, up 4.0 percent. Yield curves of treasuries plummeted sharply (Figure 5.2).

Figure5.2 Yield Curves of Treasury Securities Traded on the Inter-bank Market in 2011



Source: China Government Securities Depository Trust and Clearing Co., Ltd.

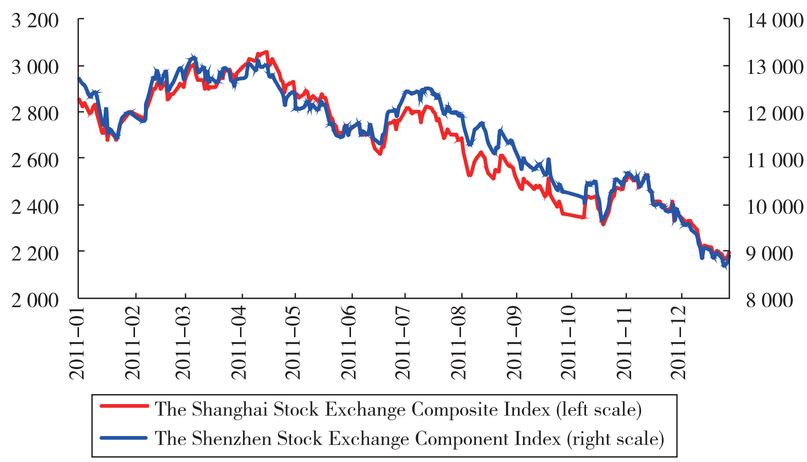
Investors in the bond market diversified further. By the end of 2011, there had been 11 162 participants in the interbank bond market, an increase of 927 participants compared with last year. Participants in the inter-bank market diversified further with increasing collective fund investors. And the pilot program of RMB investment in the interbank bond market by offshore institutions is progressing steadily. By the end of 2011, 51 offshore institutions had been approved to make investment in the inter-bank market as part of the pilot program. The inter-bank market had become an important platform for various market participants to raise fund and make investment, and a multi-layer investment structure with market markers at the core, financial institutions as the main force and other institutions as participants has been formed.

3. The Stock and Futures Markets Experienced Large Corrections

Both stock prices and transaction volumes

declined. In 2011, the stock market weakened across the board. The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Component Index closed the year at 2 199.42 and 8 918.82 respectively, down 21.68 percent and 28.41 percent y-o-y (Figure 5.3). A total of 2 342 companies were listed in Shanghai and Shenzhen, among which 279 were newly added in the year. The A-share market capitalization of the Shanghai and Shenzhen Stock Exchange reached RMB 21.48 trillion yuan, down 19.07 percent y-o-y; and the tradable market capitalization registered RMB 16.49 trillion yuan, down 14.6 percent y-o-y. Trade volume fell quarter by quarter, with the average daily trading volume for the four quarters standing at RMB 233.7 billion yuan, 186.2 billion yuan, 156.1 billion yuan and 122.1 billion yuan respectively, and the average daily trading volume for the year was RMB 172.8 billion yuan, down 23.37 percent y-o-y.

Figure5.3 The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Compenent Index in 2011



Source：Wind.

Trade volume plummeted on the commodity futures market, while the financial futures market grew steadily. In 2011, total trading volume on the futures market registered 1.054 billion lots, and the trade amount reached RMB137.52 trillion yuan, down 32.72 percent and 11.03 percent y-o-y respectively. Trade volume and amount of the commodity futures were 1.004 lots and RMB 93.75 trillion yuan respectively, down 34.01 percent and 17.40 percent. Market prices remained volatile. The CSI Commodity Futures Composite Index closed the year at 174.88. It once reached the year high of 218.57 and touched the bottom of 172.01 (Figure 5.4). Trade volume of stock index futures was 0.05 billion lots and total trade amount was RMB 43.77 trillion yuan, a y-o-y increase of 9.89 percent and 6.56 percent respectively.

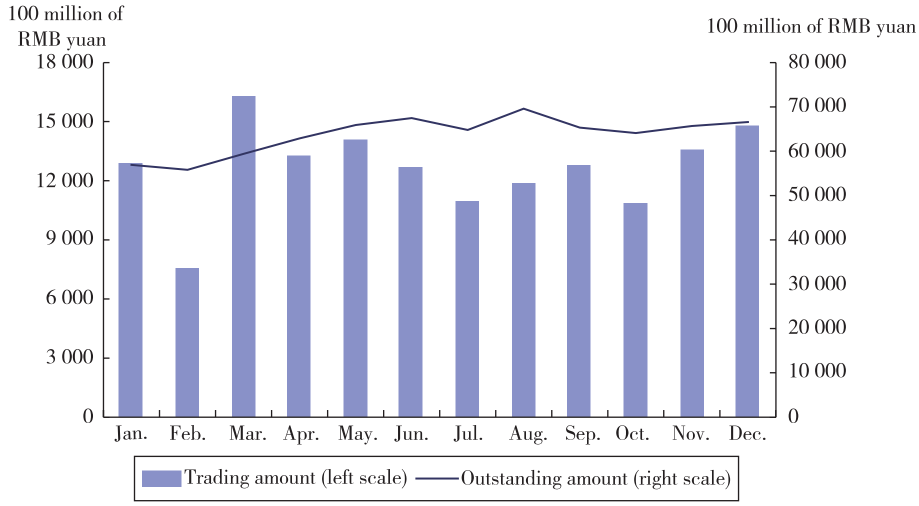
Figure5.4 CSI Commodity Futures Composite Index in 2011

Source：Wind.

4. The Bill Market Grew Rapidly

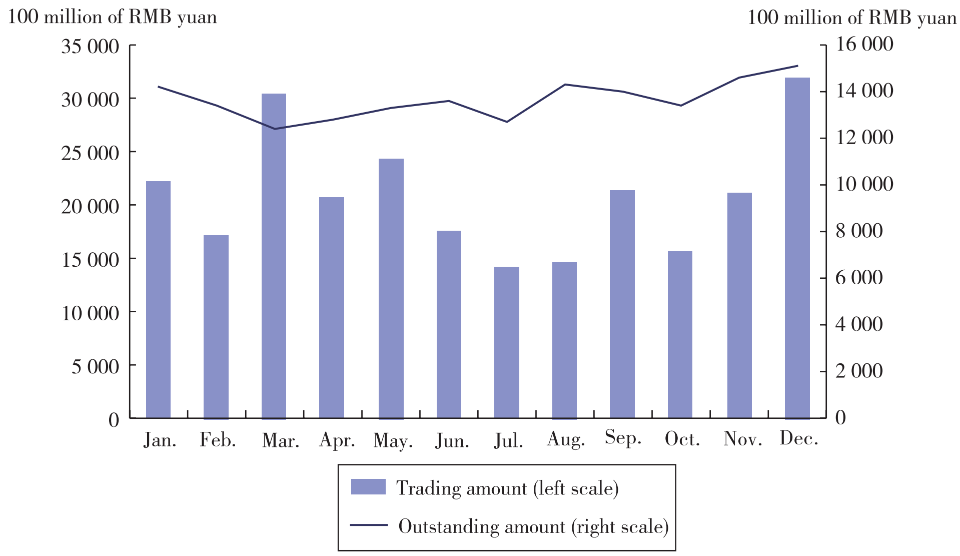
In 2011, a total of RMB 15.06 trillion yuan of commercial drafts were issued, an increase of 25.92 percent y-o-y (Figure 5.5).Discounted bills registered RMB 25.03 trillion yuan, down 51.46 percent y-o-y (Figure 5.6). Rediscounted bills amounted to RMB 194.566 billion yuan with 16.46 percent y-o-y increase. At the end of 2011, outstanding commercial bills stood at RMB 6.66 trillion yuan, up by 18.72 percent y-o-y. Outstanding discounted bills increased y-o-y by 2.02 percent to RMB 1.51 trillion yuan. And outstanding rediscounted bills saw a 56.31 percent decrease to RMB 44.542 billion yuan.

Figure5.5 Draft issuance in 2011



Source：PBC.

Figure5.6　Draft discount in 2011



Source：PBC.

5. The Foreign Exchange Market Traded Briskly

In 2011, the turnover of spot foreign exchange totaled USD 3.55 trillion, representing an increase of 16.7 percent y-o-y. The turnover of RMB foreign exchange swap transactions totaled USD 1.77 trillion, representing an increase of 38.0 percent compared with last year. The turnover on the RMB foreign exchange forward market totaled USD 214.6 billion, up 556.8 percent y-o-y. And the turnover of foreign currency pair transactions amounted to USD 94.67 billion, an increase of 42.1 percent year on year. The number of participants on the foreign exchange market further expanded. At the end of 2011, there were 318 members on the foreign exchange spot market, 73 members on the foreign exchange forward market, 71 members on the foreign exchange swap market, 27 members on the foreign exchange options market, 26 market-makers on the foreign exchange spot market, and 20 market-makers on the foreign exchange forward market.

6. The Gold Market Saw Remarkably Increased Volume of Transactions

The movement of domestic gold prices kept pace with that on the international market. During the year, the highest price on the Shanghai Gold Exchange (AU99.95) was RMB 396 yuan per gram, and the price closed at RMB 319.8 yuan per gram, up 5.9 percent from the beginning of the year. The weighted average price of gold was RMB 327.5 yuan per gram, up RMB 61.7 yuan from the previous year. The trading volume of gold on the Shanghai Gold Exchange was 7 438.5 tons, an increase of 22.9 percent y-o-y, and its turnover posted RMB 2.48 trillion yuan, an increase of 53.5 percent y-o-y. The trading volume of silver was 247 000 tons, an increase of 235.6 percent y-o-y, and its turnover posted RMB 1.94 trillion yuan, an increase of 402.2 percent y-o-y. The trading volume of platinum was 65.0 tons, an increase of 18.9 percent y-o-y, and its turnover posted RMB 20 billion yuan, an increase of 20.5 percent y-o-y.

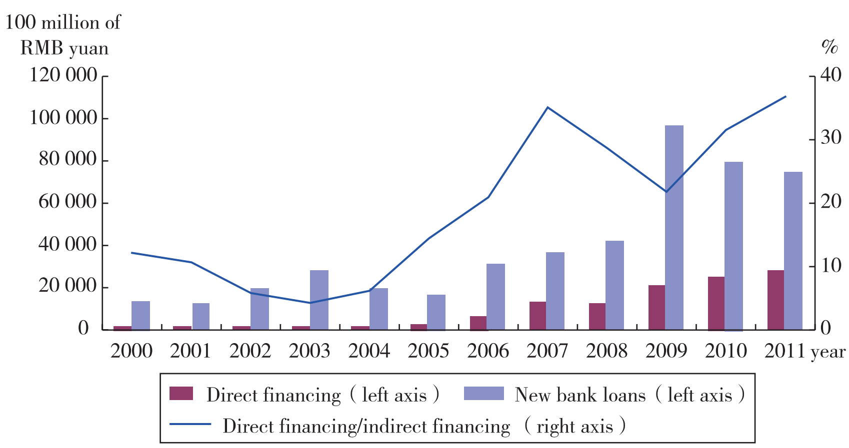
II. Overview of Financing in the Market

In 2011, financing on the stock market declined by a large margin but bond issuance grew steadily, especially that the issuance of corporate credit-type bonds grew rapidly. The financing structure continued to diversify.

1. The Financial Market Played a More and More Important Role in Direct Financing, with Further Optimized Financial Structure

In 2011, direct financing in China totaled RMB2.75 trillion yuan, among which, financing through corporate credit-type bonds registered RMB 2.2 trillion yuan, up 38.8 percent y-o-y; equity financing reached RMB 548.9 billion yuan, down 42.75 percent y-o-y. In terms of financing through corporate credit-type bonds, short-term commercial papers registered RMB 224.0 billion yuan, commercial paper RMB 802.9 billion yuan, medium-term notes RMB 727.0 billion yuan, SME collective note RMB 5.2 billion yuan, private placement notes（PPNs）RMB 89.9 billion yuan, enterprise bonds RMB 247.3 billion yuan, corporate bonds RMB 124.1 billion yuan. In terms of equity financing, financing through stocks reached RMB 507.3 billion yuan, convertible bonds RMB 41.3 billion yuan, bonds with detachable warrants RMB 3.2 billion yuan. Financing structure further optimized, with the ratio of direct financing to indirect financing stood at 36.8 percent, up 5.3 percentage points from last year (Figure 5.7).

Figure5.7 Size of Direct and Indirect Financing and Their Ratio in 2000–2011



Source：The PBC and the CIRC.

2. Bond Financing Developed Rapidly with Enriched Product Types and Maturities

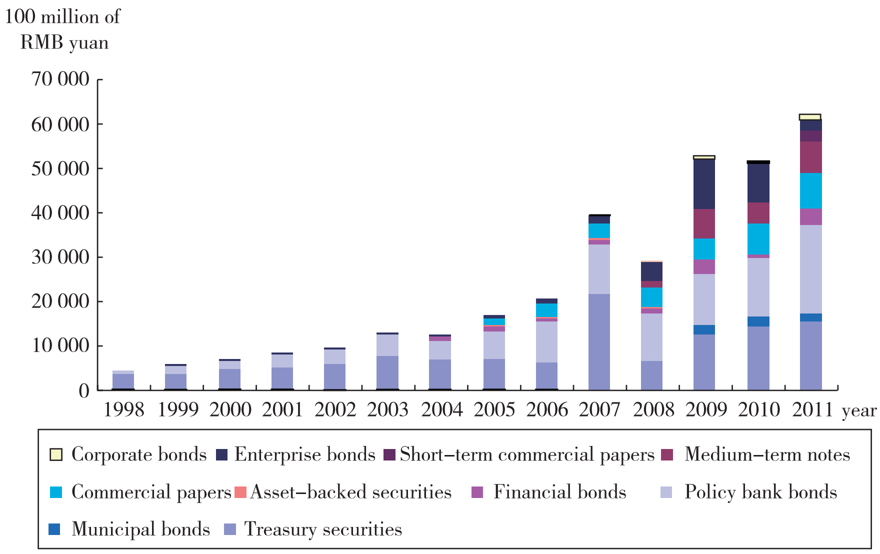
In 2011, a total of RMB 6.4 trillion yuan (excluding central bank bills) RMB bonds were issued, representing a y-o-y increase of 25.5 percent (Table 5.1). The issuance of treasury securities and central bank bills fell compared with the last year. However, the issuance of policy bank bonds and financial bonds increased compared with the last year, and the size of corporate credit-type bonds grew by a large margin (Figure 5.8). At the end of the year, outstanding bonds were a total of RMB 22.1 trillion yuan, among which, RMB 21.4 trillion yuan were on the inter-bank market, and RMB 0.7 trillion yuan were on the exchange market. Major issuers included Ministry of Finance, Ministry of Railway, policy banks, international development organizations, commercial banks, non-banking financial institutions and non-financial enterprises, reflecting a multi-layered credit structure. In terms of the term structure of the bonds issued, short-term and medium-term dominated, with 52.9 percent bonds issued with less than 5-years' maturity, 29.8 percent with 5 (included) to 10-years' maturity, 17.3 percent with more than 10-years' (included) maturity, up 12.9 percentage points, down 4.9 percentage points and down 8 percentage points respectively.

Table5.1 Issuances of Major Bonds in 2011

Type of bonds	Issuances(RMB100 million yuan)	Y-o-y growth(%)
Treasury securities	17 398	-13.4
Of which: Municipal bonds	2 000	0
Policy bank bonds issued by the China Development Bank and other policy banks	19 973	51.4
Financial bonds	3 529	260.2
Corporate credit-type bonds	22 204	38.8
Of which：commercial papers	8 029	19.1
short-term commercial papers	2 240	1 393.3
Medium-term notes	7 270	47.6
Collective note of SMEs	52	11.4
Enterprise bonds	2 473	-31.8
Corporate bonds	1 241	142.7

Source: The PBC.

Figure5.8 Amounts of Major Bonds Issued in Recent Years



Source：China Government Securities Depository Trust and Clearing Co., Ltd., Wind.

III. Market Institutional Construction

The regulation on bonds issuance was strengthened to safeguard the order of bonds issuance. In 2011, the PBC released *Notice on Issues Concerning Issuance of Municipal Bonds by Pilot Provinces and Municipalities*, which introduced specific requirements for the information disclosure of municipal bonds and facilitated the establishment of a market-based debt-financing mechanism for local governments. In November, local governments of Shanghai, Guangdong, Zhejiang and Shenzhen issued a total of RMB 22.9 billion yuan municipal bonds on the inter-bank market on a pilot basis. The PBC also released the *Administrative Measures on Management of Bond Tendering and Issuances on the Interbank Bond Market*, which further regulated the tendering and issuance of bonds on the inter-bank market, ensured that the tendering and issuance were carried out in a fair, square and orderly way, and safeguard the rights of various parties in the issuance of bonds.

The institutional innovation was emphasized to facilitate the regulated development of market. In April 2011, jointly with the Ministry of Finance, the PBC released a public notice to introduce a two-way quotation mechanism for key maturities of new issues of treasury securities, which set up the market making institutional framework for key maturities of new issues of government securities, enhanced market's role in price finding and improved the yield curves of government bonds. Several arrangements have been made to improve the transparency of the market, establish and improve the filing of bonds transaction information, and promote the effective collection of transaction information on the market. A disclosure system for abnormal material transaction and an ex-ante reporting and filing system for abnormal transactions had been introduced to let market play in full the role of supervision.

Box15 Development and Innovation of the Financial Market under the Prudent Monetary Policy

The aim of prudent monetary policy is to maintain a proper growth of money and credit while satisfy the investment and financing demand of the real economy. To this end, policies about actively promoting the development of financial market and encouraging financial innovations should be earnestly implemented. And new products and mechanisms, which could meet both the financing demand of real economy and the requirements of macro-adjustment and risk prevention, should be introduced. In 2011, while fighting against international financial crisis and improving financial macro adjustment, and together with other relevant authorities, the PBC actively promoted the innovation of financial products to facilitate economic and social development, diversified sources of financing, kept social financing at an appropriate level to satisfy rational demand for capital, enhanced the management of financial market and infrastructure construction, further opened up the financial market, so that the financial sector could better support the real economy.

Financial innovation with the aim of providing services to the real economy mushroomed. New products such as debt financing tools and private issuance effectively expanded financing sources for the enterprises and helped them save a lot of funding costs. With the rapid development of subordinated bonds, hybrid bonds, loan transfer business and the progress of the pilot program of credit asset securitization banks' ability to replenish capital for risk prevention and support the real economy has improved. Local governments and financial institutions made an experimental usage of PPNs to ensure funding for the building of indemnificatory apartments. Four provinces (municipalities) issued municipal bonds on the inter-bank markets for the first time, which was an important try for the establishment of a regulated financing mechanism for local governments to effectively reduce credit risks. New products such as SME collective notes, financial bonds specifically for supporting SMEs, collective modes and bond insurance supplemented each other and helped to solve the difficulties faced by small- and medium- sized enterprises (SMEs) in their funding, including limited access and high costs. In 2011, 207 SMEs in 14 municipalities issued a total of RMB 13.435 billion yuan's bonds. Innovative modes and methods such as investor-pay and dual rating were worked over, and the role of bond insurance in discovering risks and strengthening market discipline was enhanced. Those innovations became the engine behind market development, and promoted market function in properly allocating resources, managing risks and supporting the real economy.

Regulation on the market was gradually enhancing. Regulation on bond issuance was enhanced to safeguard the orderly issuance. Administrative rules on on-site management of bond issuances on the interbank bond market were specified to improve the underwriting of bonds and information disclosure. Mechanism innovation was emphasized to facilitate regulated development of market and the market maker system was improved. A disclosure system for abnormal material transactions and an ex-ante reporting and filing system for abnormal transactions were introduced. To guide and regulate the intermediary institutions on the inter-bank bond market, management rules for Shanghai Clearing House, China Foreign Exchange Trading System, China government Securities Depository Trust & Clearing Co. Ltd., and Shanghai Gold Exchange were published. Regulation on market transactions was enhanced to prevent market risks, agent business for bond settlement was standardized, and regulation on money brokerage business was also strengthened. To safeguard the order in gold market, illegal gold and gold derivative trading platform was closed. Those measures effectively improved market rules, and stroke a sound basis for market innovation and development.

The construction of market infrastructure was steadily progressing. On the basis of the international regulatory experience drawn from the recent global crisis, central clearing of the OTC market and the effective centralization of trade information were promoted. The net clearing of spot bond transactions was launched on the Shanghai Clearing House, and information filing system for bond transactions was set up by China Foreign Exchange Trading System. The infrastructure for market monitoring and analysis was improved and the inter-bank market information system was successfully launched. The development of the construction of infrastructure further improved the efficiency of the settlement of transactions and the market transparency, which paved the way for the healthy and sustainable development of the market.

The financial market was further opened up in a steady manner. Domestic institutions were encouraged to issue RMB denominated bonds in Hong Kong as a measure to promote the development of RMB market in Hong Kong. In 2011, under the approval of the State Council, domestic financial institutions and non-financial enterprises issued a total of RMB 50 billion yuan's RMB bonds in Hong Kong. The pilot program of RMB investment in the interbank bond market by overseas institutions was progressing steadily. By the end of the year, 51 overseas institutions were approved to make investment on the inter-bank bond market. BOC Hong Kong and BOC Macao's participation in domestic inter-bank market, and the management on the RMB accounts between overseas participating banks and domestic agent banks gave strong support to the pilot program of cross-border RMB settlement. The comprehensive deployment of "introducing in" and "going out" strategies in the financial market promoted market's role in allocating resources in a wider scope and on a higher level.

Management on market transactions and market infrastructure building were strengthened. In April 2011, the PBC published an announcement to further clarify the definition of agent bond settlement and the supervisory responsibilities of settlement agents for their clients. In August, the *Notice on Further Strengthening Regulation of the Agent Bond Settlement Business on the National Inter-bank bond Market* was published, which enforced requirements for agent bond settlement business on the inter-bank market and regulated this business. Management on money brokerage was enhanced, reflected in stricter requirements on risk management, type of clients and business scope for money brokerage companies. To further improve market efficiency, the net clearing of cash bond transactions was launched on the Shanghai Clearing House.

Illegal gold trading platforms were closed to promote a regulated development of the market. In December 2011, jointly with Ministry of Public Security, State Administration of Industry and Commerce, China Banking Regulatory Commission and China Securities Regulatory Commission, the PBC published the *Notice on strengthening Regulation on the Gold Exchange and Other Gold Trading Platforms* to close illegal trading platforms for gold and gold derivatives and keep market order.

Information disclosure mechanism was further enhanced on the stock market, which contributed to improved market transparency. The *Rules for identifying the Administrative Responsibility for Illegal Information Disclosure* was published to further clarify the rules for identifying the responsibilities for illegal information disclosure, to promote issuers and listed companies to improve the quality of disclosed information and optimize their governance structure. Listed companies were required to establish recording and management mechanism for persons close to inside information and make relevant registration and confidentiality protection for inside information, so as to ensure information disclosure is carried out in a fair and timely manner.

The variety of commodity products was further increased to improve market functions. In 2011, three new types of commodity futures were launched, including lead, coke and methanol. Commodity contracts and delivery rules for natural rubber, fuel oil, and palm oil futures, which had already been traded, were revised. And reform of hedging with commodity futures such as lead and gold futures was started on a pilot basis. QFIIs and trust companies were encouraged to participate in the stock index futures market.

Box16 The Real Estate Sector and Credit Supply to the Sector in 2011

In January 2011, the General Office of the State Council issued the *Notice of the General Office of the State Council on Issues Relating to Further Improvements in Regulating the Real Estate Market*, aimed at strengthening regulation over the real estate market through land supply, taxation, financial and other policy measures. To implement the opinions of the State Council, relevant government agencies and local governments launched various policy measures. With those policies put into place, the real estate market gradually stabilized, and construction of low-income housing accelerated, real estate loans by major financial institutions slowed down.

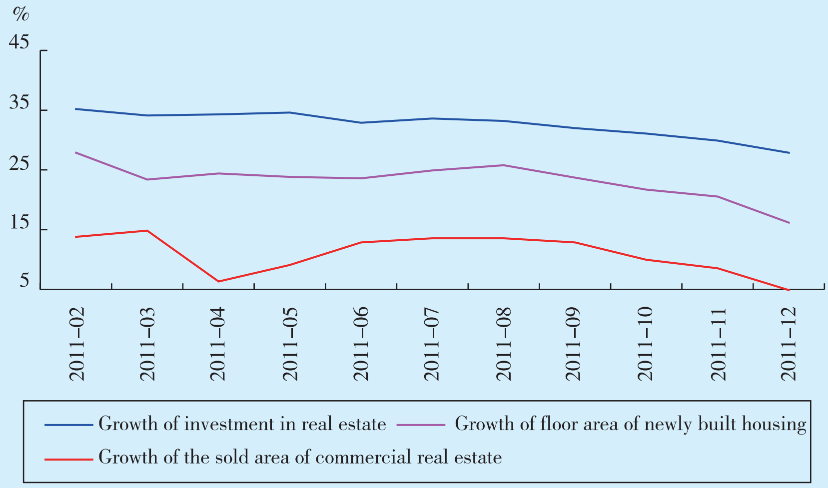
1. Real estate market condition

More cities witnessed month-on-month declines in housing prices. In December, the prices of newly built commercial residential housing dropped month on month in 52 out of 70 large- and medium-sized cities, 49 more than in January, and remained flat in 16 cities; and among the cities with month-on-month price hikes, no cities reported growth higher than 0.1 percent. The price of pre-occupied residential housing fell in month-on-month terms in 51 cities, 48 more than in January, and remained flat in 16 cities; among the cities with month-on-month price hikes, no cities reported an increase higher than 0.2 percent.

Sales of commercial real estate decelerated. In 2011, the sold area of commercial real estate posted 1.099 billion square meters, up 4.9 percent y-o-y, a deceleration of 5.7 percentage points from the previous year. Sales of commercial real estate were up 12.1 percent y-o-y to RMB 5.9 trillion yuan, representing a deceleration of 6.8 percentage points from 2010. Investment in real estate development slowed down gradually from an elevated level. In 2011, investment in real estate development totaled RMB 6.17 trillion yuan, up 27.9

percent y-o-y, representing a deceleration of 5.3 percentage points from the previous year. The growth of floor area of newly built housing slowed down gradually, maintaining the downward momentum Since May 2010. On 2011, the floor area of newly built housing grew 16.2 percent to 1.901 billion square meters, a deceleration of 24.4 percentage points from the previous year (Figure 5.9).

Figure5.9 Growth of Real Estate Investment, Floor Area of Newly Built Housing and Sold Area of Real Estate



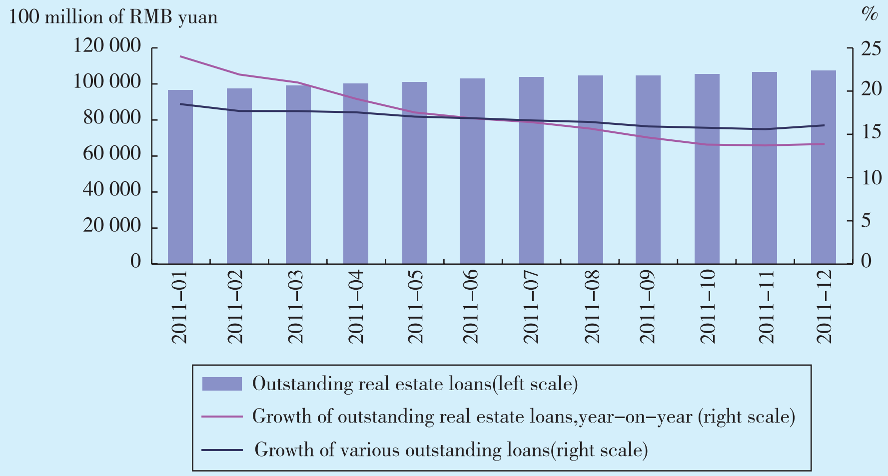
Source: National Bureau of Statistics.

The construction of low-income housing units was progressing rapidly. In 2011, over 10 million units of low-income housing and renovations of shanty housing broke ground in the urban areas, meeting the target set at the beginning of the year.

2. Credit to real estate sector

Growth of real estate loans decelerated across the board. As of the end of 2011, the real estate loans of the major financial institutions (including foreign financial institutions) posted RMB 10.73 trillion yuan, an increase of 13.9 percent y-o-y and a deceleration of 13.5 percent from the end of 2010 or 32.5 percentage points from the height reached in April 2010. Outstanding real estate loans accounted for 20.1 percent of the total outstanding loans of major financial institutions, down 0.3 percentage points from the previous year. And new real estate loans registered RMB 1.26 trillion yuan, down RMB 770.4 billion yuan y-o-y, accounting for about 17.5 percent of total new loans and down 9.4 percentage points from the previous year.

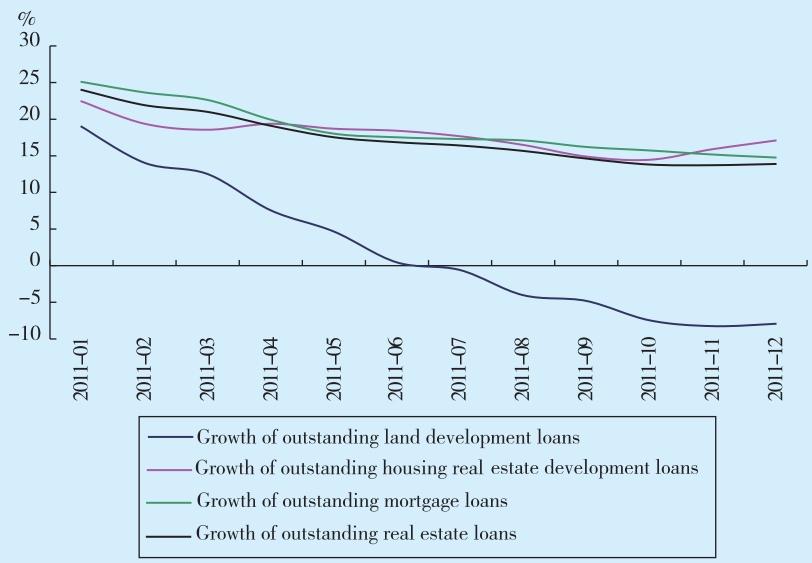
Figure5.10 Outstanding Real Estate Loans of Major Financial Institutions and Their Growth



Source：The PBC.

Real estate loans showed the following several characteristics: first, growth of land development loans dropped by a large margin and the outstanding amount continued to fall in the second half of the year to RMB 768 billion yuan at the end of December, down 7.9 percent y-o-y, where as of the end of 2010 there had registered a y-o-y increase of 24.7 percent; second, growth of housing estates development loans moderated throughout the year but picked up a bit in the end of the year; Outstanding housing estates development loans grew by 17.1 percent y-o-y to RMB 2.72 trillion yuan, representing a deceleration of 5.9 percent from the end of the previous year; third, growth of mortgage loans slowed down for consecutive twenty months, with outstanding mortgage loans standing at RMB 6.6 trillion yuan, a y-o-y increase of 14.8 percent (Figure 5.11); fourth, the proportion of development loans for low-income housing increased significantly, with new loans in 2011 posting RMB 175.1 billion yuan, accounting for 50.1 percent of the total new real estate development loans.

Figure 5.11 Growth of Various Outstanding Real Estate Loans of the Major Financial Institutions



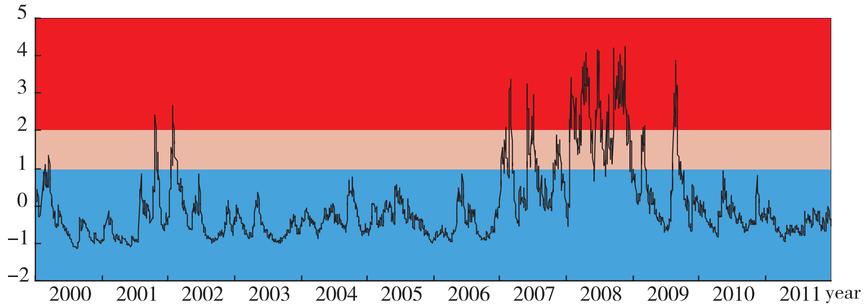
Source：The PBC.

Housing provident fund loans grew steadily. By the end of 2011, total deposit of provident funds in China reached RMB 4.06 trillion yuan and total outstanding amount registered RMB 2.19 trillion yuan, up 24.97 percent and 23.60 percent y-o-y respectively. Outstanding personal housing provident fund loans stood at RMB 1.3 trillion yuan, about 19.7 percent of the commercial personal mortgage loans in the same period of time, representing a 19.1 percent y-o-y growth and down 4.7 percentage points since the end of last year. New personal housing provident fund loans stood at RMB 208.5 billion yuan, down RMB 1 billion yuan from the same period of last year.

IV. Stability Assessment

The stock market moved downward and market evaluation dropped to historic low. At the end of 2011, the Shanghai Composite Index declined by 21.68 percent from the beginning of the year and average market evaluation fell across the board. The P/E ratios of AB shares, SHSZ300 shares, Small and Medium Enterprises shares and ChiNext shares were 14.35, 12.06, 29.37 and 40.21 respectively, down 20.14%、17.68%、34.31% and 39% year-on-year . And the P/B ratio of AB shares, SHSZ300 shares, Small and Medium Enterprises shares and ChiNext shares were 2.15, 1.91, 3.67 and 4.12 respectively, down 19.17%、18.03%、28.46% and 16.43% y-o-y. Market evaluation stood at historic low. In terms of the stock market stress index, the fluctuation of the index was not only smaller than that in financial crisis 2008-2009, but also smaller than that in 2010. Only several trading days in January saw fluctuations larger than the average level since 2000, and the deviation was no larger than one standard deviation. Throughout the year, the stress index of the stock market remained in the blue area. Limited fluctuations reflected a stable market performance (Figure 5.12).

Figure5.12 Stock Market Stress Index 2000–2011



Source： Calculation based on Wind data.

Box17 Stock Market Stress Index

Stock market stress index is a measurement of stock market volatility. Generally speaking, the more volatile the stock market, the huger the risks faced by the market participants and the higher the stock market stress index. Currently, several international organizations and central banks began to use stock market stress index in monitoring of financial market conditions. In 2008, the IMF started to utilize financial stress index to capture and analyze the financial stress periods in various nations and areas. In 2010, the Central Bank of Sweden and the Monetary Authority of Singapore began to use financial stress index to analyze financial conditions in their financial stability reports.

To make a quantitative analysis of the Chinese stock market, a generalized autoregressive conditional heteroscedasticity (GARCH) model was built, based on the Shanghai Stock Exchange Composite Index data collected from January 4, 2000 to December 30, 2011. And the volatility was standardized to build stock market stress index (Figure

5.12). For simple observation, several pre-warning areas were set up for the stress index, as follows:

Blue area: stress index is smaller or equals 1, indicating small volatility on the stock market and smooth functioning of the market;

Orange area: stress index larger than 1 but smaller than 2, indicating large volatility on the stock market;

Red area: stress index equals or larger than 2, indicating dramatic volatility on the market.

The bond market developed very fast but credit risks called for attention. In recent years, the bond market of China developed rapidly with steadily increased size, gradually enriched product types and maturities, and vivid trading. However, since the development was only for a relatively short period of time, the infrastructure and risk sharing mechanism were yet to be improved. First, domestic rating agencies lacked credibility, reflected in exaggerated ratings and skeptical market feedback. Second, the role of credit enhancement was limited because of the limited capital base of credit enhancement institutions and weak guarantee capability. Third, slow development of the derivatives market led to a lack of effective risk hedging tools. With the development of the market, when a certain bond was influenced by economic cycle or ad hoc events, underlying credit risks would show up gradually.

Rectification of the disorderly operations of various exchanges went on successfully to address the potential risks. In the past several years, various exchanges engaging in property right, artworks and commodity futures mushroomed in some localities. Due to a lack of regulations and standards, irregularities and illegal activities emerged, resulting in rising risks. In order to prevent financial risks and regulate the market, the State Council published Decision of the State Council on Clearing up and Rectifying Various Exchanges to Effectively Prevent Financial Risks, which clarified the objectives, scope, focus, labor division and details of the policies in the clearing and rectifying of various exchanges, and required that provincial governments should set up working groups to carry out the rectification. Up till now, relevant work was progressing steadily.

V. Outlook

Looking forward, in line with the overall arrangements of the Central Economic Work Conference and the National Financial Work Conference and in accordance with guiding spirit and detailed requirements of the 12th Five-year plan, relevant government agencies will follow the theme of sustainable development and the development rules of the financial markets, choose scientific and appropriate development pattern, facilitate coordinated and sustainable growth of the financial markets, so as to build an effective financial market system with a complete range of products, all necessary functions and increased size, which could serve the development of national economy, better allocate market resources for the growth of real economy and facilitate the adjustment of economic structure and the transformation of development pattern.

Actively promote the healthy development of the bond market. Market-based reform would be continued, commercial credit be cultivated, market discipline and risk sharing mechanism be enhanced to improve market transparency, so as to create a good institutional environment for the development of bond market. The bond market size would be steadily expanded to facilitate the creation and diversification of products. Insurance companies and security companies would be encouraged to issue subordinated bonds and commercial papers so as to find more sources for capital replenishment and more methods for liquidity management. The management mechanism of the bond issuance would be improved, to put more emphasis on cooperation and coordination, enhance information disclosure standards, clarify accountability and strengthen the infrastructure construction of the bond market.

Continue to press ahead with IPO reform. The IPO approval mechanism would be improved with the focus on sufficient, complete and accurate information disclosure. Administrative approval would be weakened, while capital constraint, market discipline and credit constraint would be enhanced. IPO pricing mechanism would be improved and IPO underwriting mechanism be reformed to encourage underwriters to decide inquiry, pricing and underwriting methods independently. The subscription ratio of institutional investors would be increased. Inquiry institutions would be promoted to provide rational quotations, so as to improve the price inquiry, quotation and pricing. Researches would be made on the issuance mechanism of lock-up shares, and speculations on new shares in the secondary market shall be curbed.

Forster market exit mechanism reform steadily. Guided by the principle of the good prevailing over the bad and with comprehensive consideration of the performance, assets condition and trading prices of companies, the market exit criteria of listed companies would be further improved. Pilot program of market exit mechanism for GEM market would press ahead to accumulate experience for main board and SMEs board, so as to form a market-based, multi-layer market exit system. Market exit accountability mechanism would be improved to strike a sound basis for risks resolution and steady market exits. Conditions for re-listing would be elaborated to form a smooth board-transferring system.

Facilitate the building up of the OTC equity market. While facilitating the development of the main board, the building of the OTC equity market also should be facilitated so as to expand the coverage of capital market and build a multi-layer market, which could provide differentiated services to enterprises with different sizes, types and development stages. Take a comprehensive consideration of the role of the OTC equity market in a multi-layer market and build a multi-layer OTC equity market. The characteristics of the OTC markets should be fully reflected in the design of the mechanisms for market accessibility of enterprises and ongoing supervision. And the funding and share transfer needs of SMEs should be met to solve the problem of difficult accessibility and high cost in their funding.

Chapter VI

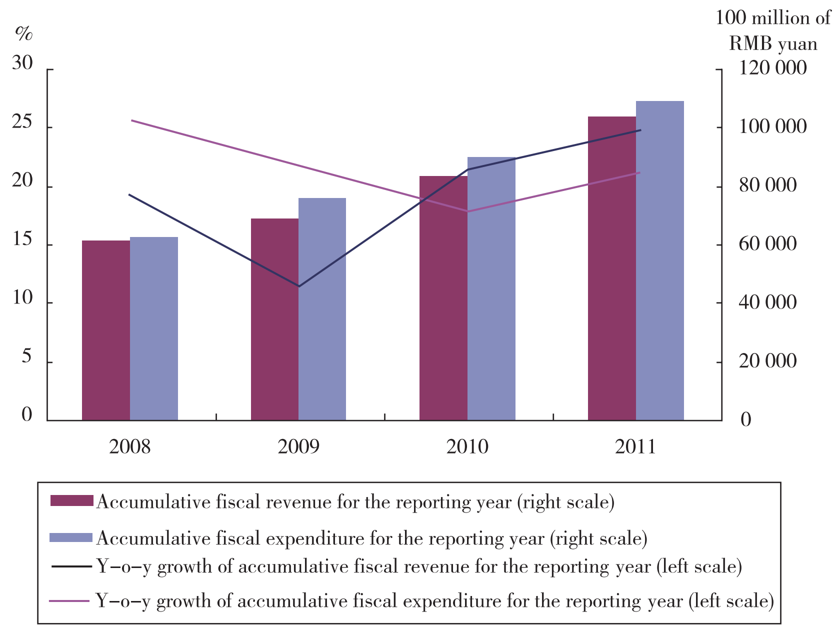
Financial Analysis of the Government, Corporate and Household Sectors

In 2011, the financial condition of the government sector was fairly good with a roughly safe and controllable debt level. The growth of corporate profit slumped with falling domestic and foreign demand, however, as the pressure of raw material cost alleviated, overall debt-servicing capacity was still good. Financial assets held by the household sector continued to increase and its structure kept improving. The overall indebtedness of the household sector was subdued with a low probability of default.

I. Government Sector

Fiscal revenue grew at a rapid pace. In 2011, the total national fiscal revenue① amounted to RMB 10.37 trillion yuan, a y-o-y growth of 24.8 percent, up 3.5 percentage points from the previous year (Figure 6.1). In terms of revenue structure, tax revenue posted RMB 8.97 trillion yuan, accounting for 86.5 percent; non-tax revenue posted RMB 1.4 trillion yuan, accounting for 13.5 percent. Among the tax revenue, domestic VAT, corporate income tax and business tax were the main sources of revenue, posting RMB 2.43 trillion yuan, RMB 1.68 trillion yuan and RMB 1.37 trillion yuan, or with y-o-y growth rates of 15 percent, 30.5 percent and 22.6 percent respectively. Annual non-tax revenue increased by RMB 412.9 billion yuan y-o-y, or 41.7 percent, down 31.8 percentage points from the previous year.

Figure 6.1 Accumulative Fiscal Revenue and its y-o-y Growth in 2008–2011



Source: The NBS.

① Once the final settlement of account is published the figuers used in this chapter might change.

Fiscal expenditures increased. Fiscal expenditures in 2011 posted RMB 10.89 trillion yuan, an increase of 21.2 percent y-o-y, up 3.4 percentage points (Figure 6.1). Of the top five expenditure items, expenditures on education posted RMB 1.61 trillion yuan, accounting for 14.8 percent of total expenditures, and up 28.4 percent y-o-y; expenditures on social security and employment posted RMB 1.11 trillion yuan, accounting for 10.2 percent, and up 22 percent y-o-y; expenditures on general public services posted RMB 1.11 trillion yuan, accounting for 10.2 percent, and up 19 percent y-o-y; expenditures on the agricultural sector, forestry and water utilities posted RMB 989 billion yuan, accounting for 9.1 percent, and up 21.7 percent y-o-y; expenditures on urban and rural communities affairs posted RMB 765 billion yuan, accounting for 7 percent, and up 27.8 percent y-o-y.

The overall indebtedness level of the government sector was relatively low, safe and under control. Fiscal deficit in 2011 posted RMB 850 billion yuan (Figure 6.2), accounting for 1.8 percent of GDP. At the end of 2011, outstanding central government bonds posted RMB 7.2 trillion yuan, RMB 449.6 billion yuan more than that in the previous year, or a y-o-y growth of 6.7 percent, and accounting for 15.27 percent of GDP. Overall, the debt-GDP ratio and deficit ratio of China are lower than that of a number of developed and emerging market economies and have remained at a relatively low level. Debt management and risk mitigation of the local governments was strengthened. The outstanding debt continued to be managed according to the principles of categorized management, differentiated treatment and gradual resolution. Issuance of new debt was under strict control. In 2011 the local government debt increased by RMB 300 million yuan. The local government debt has played an active role in economic and social development and transformed into enormous high quality assets. However, some potential risks still remain, especially the regional risk in some areas with weak fiscal strength.

Box18 The Analysis on Sovereign Debt of Europe and U.S.

In 2011 the debt crisis of some peripheral European countries deteriorated and spread to the core European countries. The U.S. sovereign debt was getting close to the limit and its sovereign debt rating was downgraded. The European and U.S. sovereign debt issues had an direct impact on European and U.S. economic growth, shocked the European and U.S. banking system, and triggered fluctuations at the global financial markets, hence the uncertainties for the global economic recovery.

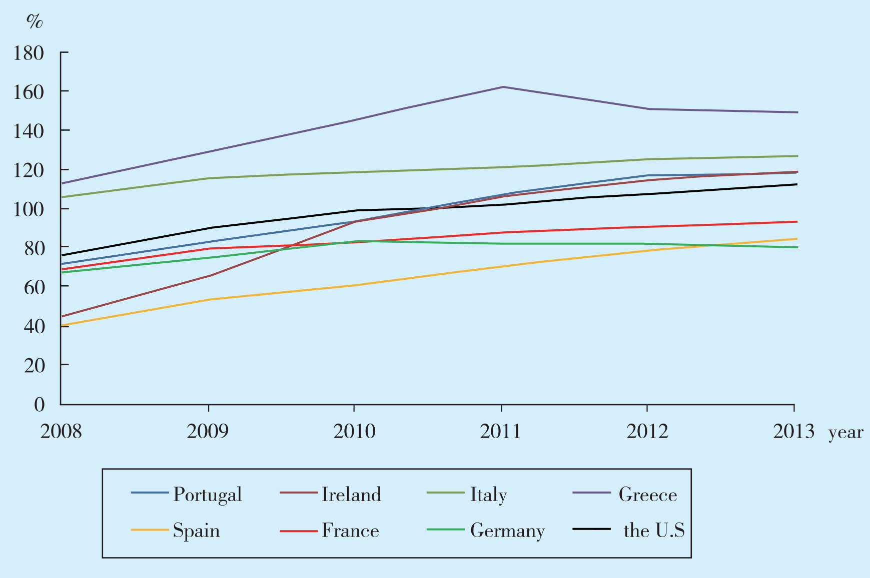
1. The European sovereign debt crisis

At the end of 2009, the big three international rating agencies downgraded the sovereign debt ratings of Greece successively and the European sovereign debt crisis (henceforth, the European crisis) broke out. Then crisis also erupted in Ireland and Portugal. Since the third quarter of 2011 the crisis had began to spread to the core European countries. Italy, Spain, Belgium and France were affected more or less and there were sharp increase in their Sovereign bond yields. Currently, the sovereign debt rating of all the European countries except Germany, Netherlands, Finland and Luxemburg were downgraded. The European crisis had a shock on the European banking system, induced financial markets turbulence globally, and became a main factor dragging the global economic recovery.

The main reason of the outbreak and spread of the European crisis lies in: first, in recent years in order to address the global crisis the European countries increased the fiscal expenditure while the fiscal revenue decreased sharply, causing the debt/GDP ratio and fiscal/GDP ratio increased rapidly (Figure 6.2, 6.3). Second, the economic structure in European peripheral countries was getting more and more unbalanced and competitiveness continued to descend. The current account deficit and debt level increased successively. Meanwhile, the aging population and rigid labor market caused fiscal expenditure to grow with an upward trend. Third, although the Euro Zone adopts a uniform monetary policy but it lacks an effective constraint on fiscal policies at the member states.

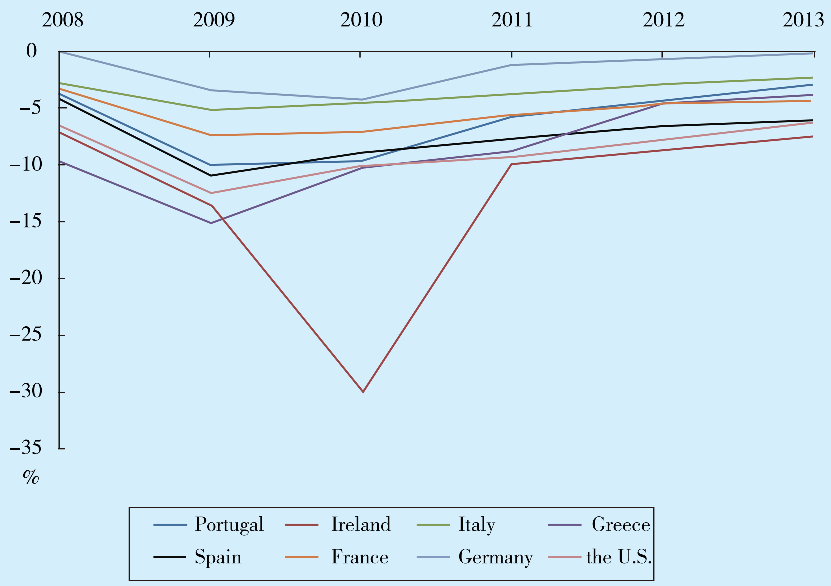
After the European crisis broke out

Figure6.2 The Sovereign debt/GDP



Source: IMF, "Fiscal Monitor Update" (January 2012)、IMF Country Report No. 11/351、No. 11/356 和 No. 11/363。Figures for 2011-2013 were projected.

Figure6.3 The Government deficit/GDP



Source: IMF, "Fiscal Monitor Update" (January 2012)、IMF Country Report No. 11/351、No. 11/356 和 No. 11/363。Figures for 2011-2013 were projected

the European Union strived to take various measures to address the crisis. First, reforms were advanced and fiscal disciplines were strengthened. In early 2012 a new fiscal compact was signed by 25 EU leaders including a requirement for stricter national budgets discipline and the balanced budget rule must be incorporated into the member states' national legal systems. Second, the financial firewalls were bolstered. The European Financial Stability Facility (EFSF), European Financial Stability Mechanism (EFSM) and European Stability Mechanism (ESM) were established to provide bailout for crisis countries. Third, more bailout funds were added. After several rounds of bailout to crisis countries in early 2012 the finance ministers meeting of Euro Zone approved a new bailout package to Greece totaling of 130 billion Euros and proposed to private holders of Greek Government bonds a voluntary debt exchange program. After the above measures were taken the European crisis was smoothed somewhat. But its future trend is still uncertain: first, the European economic recovery prospect is not optimistic and the fiscal consolidation target for heavily indebted countries is hard to meet. According to IMF forecast in the next two years the debt level for southern European countries are still high (Figure 6.2, 6.3). Second, there are still uncertainties in whether the bailout measures for Greece could be implemented smoothly and an effective firewall could be established. And new instability elements might be aroused. Third, there still existed a risk that the crisis could spread to core European countries and banking system. The future development of European crisis relies on how the European peripheral economies build their competitiveness and how Euro Zone improve its mechanism.

2. The U.S. sovereign debt issue

Since the global crisis broke out the U.S. sovereign debt increased sharply and the outstanding government bond was getting close to the debt limit set by the 2010 legislation. In early August 2011 ,the U.S. government passed a bill on debt limit and deficit reduction and the debt limit was raised by at least USD 2.1 trillion . This avoided the U.S. sovereign default and developed a medium and long term deficit reduction target and roadmap. However, the international rating agency Standard and Poor's believed that the medium and long term fiscal consolidation plan of U.S. cannot guarantee its debt stability in medium term and on August 7, 2011 decided to downgraded the U.S. sovereign debt rating from AAA to AA+, which was the first time since Moody's rated the U.S. debt as Aaa[①] in 1917 and echoed by fluctuations in global financial markets.

The main reasons of U.S. sovereign debt issue lie in: First, U.S. adopted a debt relied economic growth model in a long history and maintained the growth of fiscal expenditure outpacing the growth of fiscal revenue. Second, since outbreak of global financial crisis the U.S. fiscal revenue growth slowed due to high unemployment rates and falling household income, while its fiscal expenditure increased rapidly due to addressing crisis (financial institutions bailouts and economic stimulus), aging population, enhanced medical care coverage and level.

Compared to Europe ,the U.S. sovereign debt is relatively stable although its potential risk still worth concerns. In the short term since the U.S. boasts the advantage of reserve currency of Dollars and international financial centers and its government bonds have an attraction to investors due to European crisis. Hence the U.S. sovereign risk is relatively low. However in the medium and long term if the U.S. does not make fundamental fiscal reform and takes strong fiscal consolidation measures its debt level would continue to grow and hence leading to an unsustainable finance.

① Aaa is the top credit rating of Moody's, equivalent to AAA of Standard and Poor's.

II. Corporate Sector

1. Growth in corporate profit decelerated and operating cycle was protracted

Growth rate of corporate sales fell. In 2011 main business income of enterprises above designated size① increased by 27.2 percent y-o-y, down 4.6 percentage points②. Sales of 5 000 industrial enterprises which the PBC monitors (hereinafter referred to as 5 000 industrial enterprises) increased by 12.5 percent y-o-y, down 16.6 percentage points from the previous year; and gross industrial products increased by 11.6 percent y-o-y, down 16.1 percentage points.

The growth rate of total corporate profit fell remarkably. In 2011 profits of enterprises above designated size increased by 25.4 percent y-o-y, down 24 percentage points. Total profits of 5 000 industrial enterprises increased by 3.4 percent y-o-y, down 40.7 percentage points③.

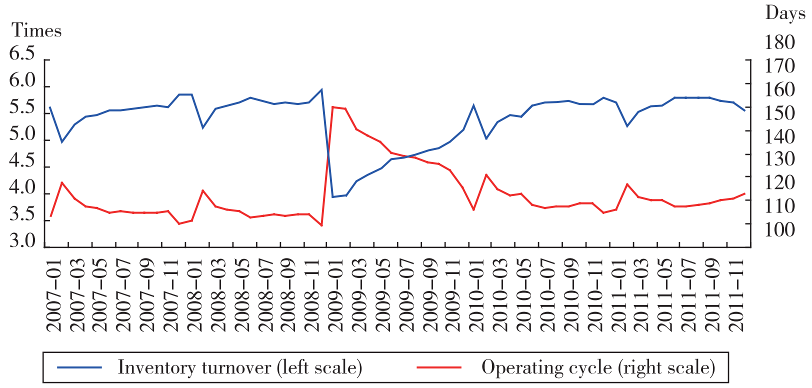
Corporate asset turnover slightly slowed and operating cycle was protracted. In 2011, the inventory turnover of 5 000 industrial enterprises was 5.6 times, down 0.2 times, in which, finished products turnover was 21.5 times, down 1.2 times; raw material turnover was 14.7 times, down 0.3 times, total assets turnover was 0.93 times, down 0.3 times. The operating cycle of 5 000 industrial enterprises was 122.8 days, up 8.2 days y-o-y (Figure 6.4).

① In January 2011 the enterprises above designated size surveyed by NBS was adjusted from main business income of 5 million yuan to main business income of 20 million yuan; the starting point of surveying the fixed income investment project was adjusted from 0.5 million yuan to 5 million yuan. After the starting point was raised the enterprises above the threshold is surveyed in detail while enterprises below the threshold is surveyed by sampling or scientific calculation.

② Currently, as to full-scale profitability data of industrial enterprises above designated size, NBS only has data for January-February, January-May, January-August and January-November. For other months and the full-year data, only data for 22 provinces and municipalities on a consolidated basis is available. Therefore, data for January-November is used here to reflect the production and operation of industrial enterprises above designated size.

③ Since the adjustment time of sampling enterprises and data reporting time was not consistent the y-o-y growth rate of gross profit at end-2011 was the unadjusted data. While the adjusted data for end-2010 was 44.12 percent.

Figure6.4 Inventory Turnover and Operating Cycle of 5 000 Industrial Enterprises

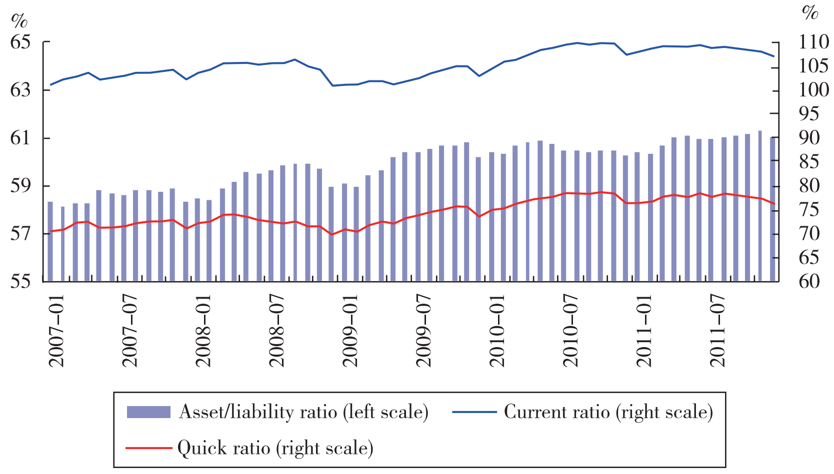


Source: The PBC.

2. The corporate debt-servicing capacity declined from a high level

The corporate debt-servicing capacity declined from a high level and asset liability ratio rose slightly. As of the end of 2011, the current ratio of industrial enterprises above designated size was 106.7 percent, down 0.6 percentage point y-o-y. The quick ratio of 5 000 industrial enterprises was 76.3 percent, at par with previous year. The interest coverage multiplier of 5 000 industrial enterprises was 6.5, down 1 y-o-y, the capacity of enterprises to repay debts weakened. The liabilities/assets ratio of industrial enterprises above designated size was 61 percent, up 0.8 percentage point (Figure 6.5).

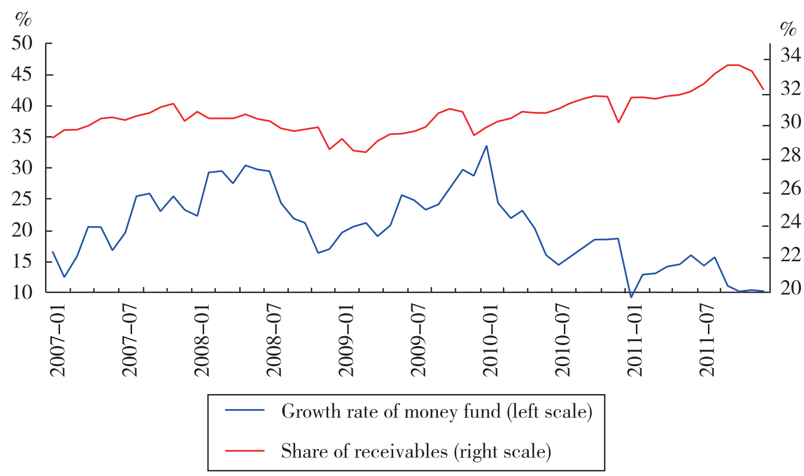
Figure6.5 Asset/liability Ratio, Current Ratio and Quick Ratio of 5 000 Industrial Enterprises



Source: The PBC.

The growth rate of money fund slowed and net receivables increased rapidly. As of the end of 2011, money fund of 5 000 industrial enterprises increased by 10.3 percent, down 8.5 percentage points. Among which money fund of large-sized enterprises increased by 11.3 percent, down 6.5 percentage points; money fund of medium-sized enterprises increased by 4.6 percent, down 20.6 percentage points; money fund of small-sized enterprises increased by 6.6 percent, down 18.4 percentage points. The receivables of industrial enterprises above designated size increased by 19.6 percent, down 2.8, percentage points. Finished products fund increased by 20.8 percent, up 9.6 percentage points. In 2011 the net receivables of 5 000 industrial enterprises increased by 22.3 percent, up 7.1 percentage points (Figure 6.6).

Figure6.6 Growth Rate of Money Fund and Share of Receivables of 5 000 Industrial Enterprises



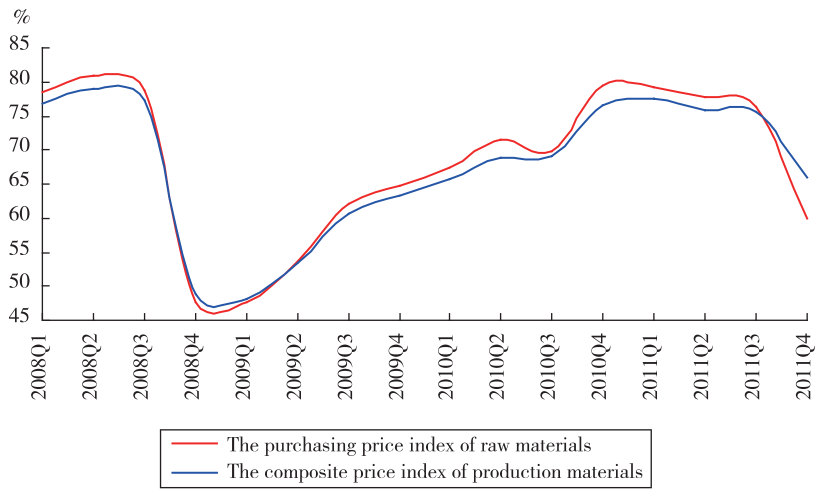
Source:The PBC.

3. The pressure of rising raw material costs of enterprises eased and inflation expectation declined

In 2011 the purchasing price index of raw materials and the composite price index of production materials declined quarter by quarter and most entrepreneurs felt the cost pressure eased compared to the previous year. In Q4 of 2011 the purchasing price index of raw materials and the composite price index of production materials registered 68.2 percent and 68.6 percent respectively, down 11.2 and 8 percentage points (Figure 6.7). It was anticipated that the downward trend in the price level would become more evident in Q1 2012. In Q4 2011 the anticipated purchasing price index of raw materials and the anticipated composite price index of production materials were 66.3 percent and 66.4 percent, down 6.3

and 6 percentage points compared to Q1 2011. 33.1 percent of entrepreneurs anticipated the cost would go up in the following quarter, down 4.8 percentage points y-o-y, reflecting the corporate cost pressure eased gradually.

Figure6.7 Movement of the Purchasing Price Index of Raw Materials and the Composite Price Index of Production Materials for 5 000 Industrial Enterprises



Source:The PBC.

4. Both domestic and foreign demands fell

The Export Order Index went up first, and then fell. At Q4 of 2011, the Export Order Index was 48.7 percent, down 3.3 percentage points y-o-y. In particular, the number of sectors with a falling index increased from 19 in Q4 2010 to 23 and thus sectors facing falling external demand increased by 14.8 percent. In term of expectation, the Export Oder Anticipated Index was 49 percent, down 1.6 percentage points.

The Domestic Order Index continued to fall quarter by quarter. At Q4 of 2011 Domestic Order Index was 53.2 percent, down 4.7 percentage points and fell for four consecutive quarters. The Domestic Order Anticipated Index was 52.5 percent, down 4.1 percentage points.

III. Household Sector

1. Financial assets of the household sector increased relatively rapidly and the households pay more attention to wealth management

Financial assets of the household sector increased relatively rapidly but the per capita asset was still low. As of the end of

2010 total financial assets of the household sector stood at RMB 49.5 trillion yuan, a y-o-y growth of 20.4 percent. But from a per capita perspective, household financial asset was still low (Table 6.1). In terms of US Dollars, China's per capita financial assets at end-2010 was only USD 5 591, while that of the U.S., the U.K., Germany and Japan were USD 157 000, USD 112 000, USD 81 000 and USD 150 000 respectively①.

Table6.1 Financial Assets and Liabilities of the Household Sector

Unit: 100 million of RMB yuan

	2004	2005	2006	2007	2008	2009	2010
Financial assets	180 369	209 083	251 600	335 495	342 870	410 869	494 832
Domestic currencies	17 820	19 945	22 469	25 211	28 622	31 982	37 691
Deposits	129 575	150 551	171 737	181 840	228 478	268 650	315 642
Securities	15 190	14 399	23 945	58 311	25 139	49 997	59 169
Bonds	6 293	6 534	6 944	6 707	4 981	2 623	2 692
Equities	8 897	7 865	17 001	51 604	20 157	47 374	56 477
Shares in Securities Investment Funds	1 905	2 449	5 618	29 716	17 011	8 383	7 346
Customer Margins	1 339	1 566	3 128	9 904	4 760	5 695	4 447
Technical reserve of insurance	14 113	18 315	22 680	27 097	37 831	46 226	52 667
Wealth management in financial institutions	—	—	—	—	—	—	14 975
Equities in trust fund schemes	—	—	—	—	—	—	3 088
Settlement funds	-77	23	17	0	0	0	0
Others (net)	504	1 835	2 005	3 415	1 030	-64	-193
Financial liabilities	29 431	32 972	39 636	50 652	57 892	82 744	117 094
Loans	29 431	32 972	39 636	50 652	57 892	82 744	117 094
Net financial assets	150 938	176 111	211 964	284 843	284 978	328 125	377 738

Source: The PBC.

① The financial assets and liabilities of US, UK, Germany and Japan derived from stock data of their respective "Flow of Funds Accounts", if not indicated otherwise. Among which, data for financial assets of US was for the end of 2011, data for UK was for the end of March 2011, data for Germany was the end of July 2011, while data for Japan was for end-September 2011. The data of share of deposits and financial assets/liability ratios in the following chapter have the same cutoff dates. The household sector included the household sector and non-profit organizations that provided services to the household sector.

The share of wealth management products and equities in trust schemes increased remarkably. As household income increased continuously, the size of wealth grew accordingly and households care more about keeping the value of their assets and diversifying asset allocation. In recent years the share of deposits in financial assets declined continuously. At the end of 2010 deposits' share in total financial assets was 63.8 percent, down 8 percentage points since the end of 2004.The share of financial assets, such as securities, investment fund shares and margins, changed dramatically between 2007 and 2008, due to fluctuations in the capital markets. However, in recent years, the share of such financial assets keeps around 15 percent. The wealth management products and trust fund equities purchased by households increased markedly. At the end of 2010, wealth management and trust fund schemes of financial Institutions amounted to RMB 1.8 trillion yuan and accounting to 3.7 percent of total financial assets held by households (Table 6.2).

Table6.2 Structure of Financial Assets of the Household Sector

Unit: %

	2004	2005	2006	2007	2008	2009	2010
Domestic currencies	9.9	9.5	8.9	7.5	8.3	7.8	7.6
Deposits	71.8	72.0	68.3	54.2	66.6	65.4	63.8
Securities	8.4	6.9	9.5	17.4	7.3	12.2	12.0
Treasury bonds	3.5	3.1	2.8	2.0	1.5	0.6	0.5
Equities	4.9	3.8	6.8	15.4	5.9	11.5	11.4
Shares in Securities investment funds	1.1	1.2	2.2	8.9	5.0	2.0	1.5
Margins of customers	0.7	0.7	1.2	3.0	1.4	1.4	0.9
Technical reserves of insurance	7.8	8.8	9.0	8.1	11.0	11.3	10.6
Wealth management in financial Institutions	—	—	—	—	—	—	3.0
Equities in trust fund schemes	—	—	—	—	—	—	0.6

Source: The PBC.

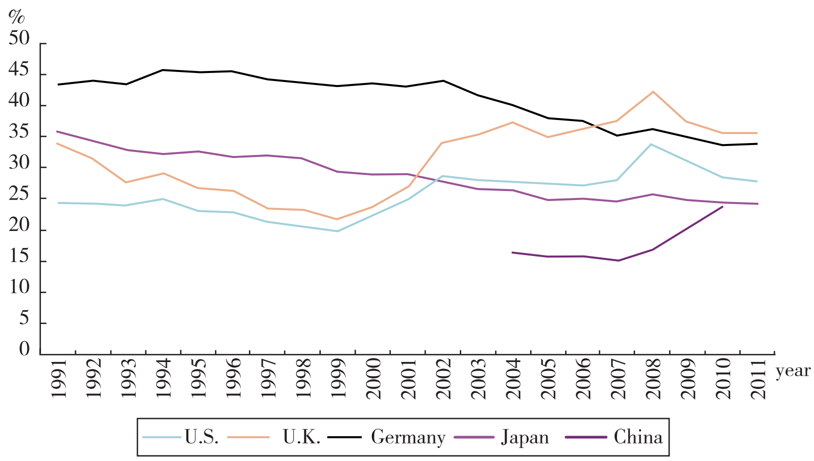
Allocation of household financial assets has to be more diversified. In terms of the structure of financial assets, the share of deposits was far more than that in some developed countries, the share of security related products, such as equities, bonds and investment funds, was catching up with that in developed countries, and the share of insurance and pension was still low. Compared to developed countries, the household sector consumed much less in insurance products and the share of insurance reserves was 10.6 percent at the end of 2010.

In contrast, the share of such financial assets in the U.S., the U.K., Germany and Japan were 29.2 percent, 53.4 percent, 36.1 percent and 28.6 percent, respectively, at the end of 2010.

2. The indebtedness of the household sector was low and the overall quality of personal loans was good

Indebtedness of the household sector was low. Financial liabilities/assets ratio① is a good indicator to depict household sector debt risk. In 2004–2010, this ratio for the household sector in China was between 15 percent and 24 percent, indicating a relatively low debt level in the household sector (Table 6.8). In 2011 the liabilities/assets ratios for the US, the UK, Germany and Japan were 28.1 percent, 35.4 percent, 33.3 percent and 24.1 percent, respectively.

Figure6.8 International Comparison of the Financial Liabilities/Assets Ratio



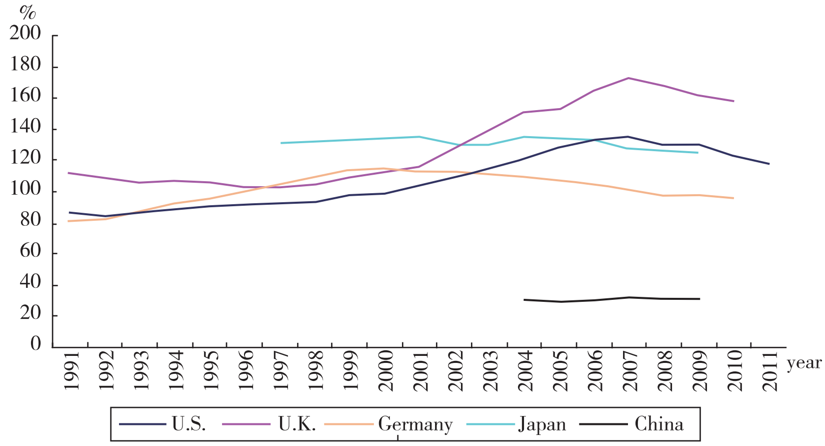
Source: Statistics from the Flow of Funds Accounts of reporting countries.

The debt-servicing capacity of the household sector was relatively strong. The ratio of financial liabilities to disposable income could reflect the debt-servicing capacity and financial sustainability of households. Between 2004 and 2008, this ratio for the household sector in China stood around 30 percent and 32 percent② (Figure 6.9), while such ratios were over 100 percent in the U.S., the U.K. and Japan, etc. Compared to the developed countries the financial sustainability of the household sector in China was robust.

① The ratio of total financial liabilities/total financial assets.

② Data on China's personal disposable income comes from the *Flow of Funds Accounts (Real Transactions).*

Figure6.9 International Comparison of the Financial Liabilities/Disposable Income Ratio

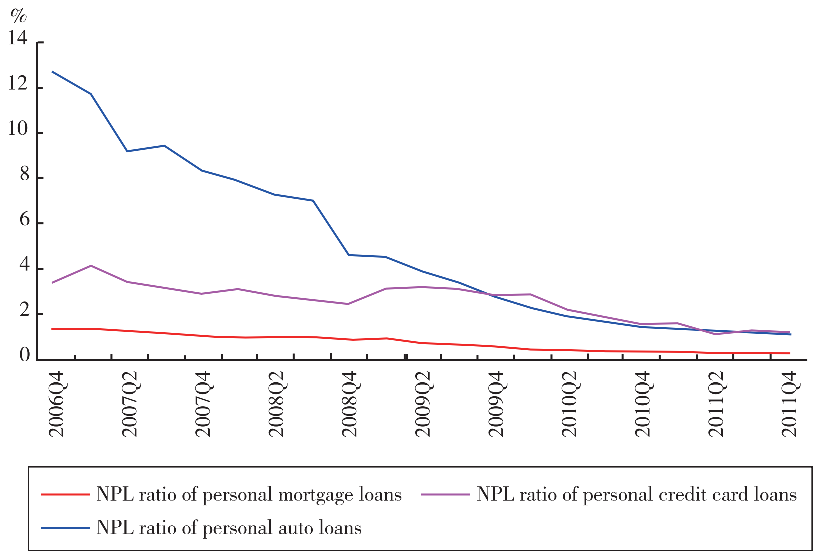


Source: Statistics from Flow of Funds Accounts of reporting countries, among which statistics for U.S. was data of 2011, statistics for Germany and U.K. were data of 2010 and, statistics for Japan was data of 2009.

The quality of loans to the household sector was generally good. In recent years, both outstanding NPLs and NPL ratio① for domestic personal loans (excluding personal business loans) kept falling. At the end of 2011, the outstanding personal NPLs posted RMB 71.7 billion yuan, RMB 10.5 billion yuan less than that at the beginning of the year; the NPL ratio was 0.8 percent, 0.3 percentage point lower than that at the beginning of the year. In particular, outstanding NPLs for personal mortgage loans posted RMB 19.7 billion yuan, RMB 1.4 billion yuan less than that at the beginning of the year, and the NPL ratio was 0.3 percent, down 0.1 percentage points. The NPL ratio for auto loans was 1.1percent, down 0.3 percentage point. Outstanding NPLs for credit card loans posted RMB 10.2 billion yuan, RMB 2 800 million yuan more than that at the beginning of the year, and the NPL ratio was 1.2 percent, down 0.4 percentage points (Figure 6.10).

① The NPL data came from CBRC, and the institutional coverage in 2007-2008 included state policy banks, state-owned commercial banks, JSCBs, city commercial banks, rural commercial banks, rural cooperative banks, foreign-funded financial institutions with legal person status and their branches, branches of foreign banks, UCCs (including single legal person UCCs and retained UCCs), RCCs, financial companies of enterprise groups, trust investment companies, financial leasing companies and auto financing companies. The institutional coverage expanded from 2009 onwards to include PSBC.

Figure 6.10 Personal NPL ratio



Source: The CBRC.

Chapter Ⅶ

Financial Infrastructure

In 2011, steady progress was made in improving financial infrastructure in China, new progress was made in building payment, clearing and settlement systems, financial laws and regulations were enhanced, accounting standards were further improved, credit environment was gradually optimized, and anti-money laundering (AML) work was deepened, fostering the improvement of financial ecological environment and soundness of financial system.

I. Payment, Clearing and Settlement Systems

1. New progress was made in the development of payment, clearing and settlement systems

Steady progress was made in establishing the payment systems, which operated in a stable and safe manner. Turnover of transactions processed by payment systems nationwide kept increasing rapidly, totaling RMB 1 991.90 trillion yuan in 15 523 million transactions, up 29.3 percent and 19.7 percent y-o-y respectively. The stable operation of payment systems ensured more efficient settlement, and continued to underpin safe and efficient functioning of the financial system. The interbank clearing system for online payments was adopted nationwide, enhancing the efficiency of cross-bank clearing of online payments and other new forms of electronic payments. Development of the second generation of payment system and the central bank accounting data centralization system (ACS) was pushed ahead steadily.

The regulatory regime was improved as regulations were enhanced. First, the *Guidance on Development of China's Payment System (2011-2015)* was issued, setting out policy stances on the future development of payment, clearing and settlement systems. Second, a regulatory framework to strengthen management of new payment services including online payments, mobile payments and prepaid cards was established. Third, supervisory inspections on payment and settlement businesses were carried out to improve the order of payment and settlement services and protect relevant parties' legitimate rights. Fourth, the China Payment and Clearing Association was established, the mechanism of self-management, self-discipline and innovation by market participants was introduced while government regulation and supervision strengthened. Fifth, a working mechanism for payment services supervision featured by government regulation, industry self-discipline, corporate governance and self-constraint was set up.

Non-cash payment instruments were widely used. In 2011, a total of 33 830 million payment transactions worth RMB 1 104.35 trillion yuan were made in bills, bankcards and other non-cash payment instruments, a y-o-y rise of 22.1 percent and 22.0 percent respectively, while cash in circulation (M_0) dropped steadily as a share of GDP to 10.8 percent from 12.8 percent in 2006. A diversified non-cash payment instrument system in line with the needs of enterprises, public institutions and households came into shape. Bankcards were the most popular payment instruments for individuals. The PBC promoted the issuance and use of bankcards in rural areas by developing bankcards tailored to migrant workers and offering bankcards money withdrawals services to farmers, ensuring agriculture-related funds and funds benefiting farmers are transferred in a timely manner. The use of electronic bills and online payments also increased rapidly.

Central bond settlement and centralized clearing grew rapidly. In 2011, the central comprehensive bond business system handled 740 500 RMB bond settlements totaling RMB 232.48 trillion yuan, up 51.36 percent and 14.35 percent y-o-y respectively. The Delivery Versus Payment (DVP) business continued to grow, further mitigating liquidity risks in the interbank bond market and improving settlement efficiency. The DVP was adopted by 1 728 institutions, an increase of 721 from last year, and DVP settlements reached 664 300, totaling RMB 218.09 trillion yuan, rising 52.54 percent and 14.71 percent from 2010 respectively. The bond system was further enhanced as the China Central Depository and Clearing Co., Ltd. successfully launched its upgraded clients and a management system for pledge business and the Shanghai Clearing House provided clearing services for the net position of spot foreign exchange auction and centralized clearing for spot bond transactions, achieving the centralized registration, clearing and monitoring of some OTC products, helped prevent systemic risks.

2. Outlook

The *Guidance on China's Payment System Development (2011-2015)* will be implemented in an effort to promote balanced development of payment, clearing and settlement systems and ensure their safe and sound operation. First, efforts will be made to further enhance the regulations on payment and settlement and strengthen risk management on payment systems. It will set up institutional arrangements for electronic payment services by banks and payment service providers, and improve the pricing mechanism for payment, clearing and settlement services. Second, work will be done to continuously improve infrastructure to make the payment systems safer and more reliable. It will encourage all kinds of market participants to continuously improve retail payments to ensure public access to a safer, easier and low cost payment services, and promote the coordinated development of payment systems, foreign exchange settlement systems, securities settlement systems and central counterparty arrangements， research should be conducted to foster the connection of the foreign exchange systems, securities settlement systems to domestic and overseas settlement systems. Third, measures should be taken to strengthen regulation on the payment services market by stepping up regular oversight over banks and clearing and payment institutions comprehensively and improving inter-agency supervision coordination. It will continue to implement the policy that requires real-name registration for opening financial accounts, enhance security management on bankcards and supervision on key payment systems and payment institutions. Fourth, efforts will be made to improve the payment environment in rural areas, promote the use of new payment instruments in rural areas and encourage rural financial institutions access to the payment system in various ways.

II. Legal Environment

1. Financial laws and regulations were improved

Laws were developed to further enhance the legal foundation of financial sector. The *Eighth Amendment to the Criminal Law* was passed in February 2011, setting out provisions for the forced transaction crime, which helps improve the order in the financial markets. The *Administrative Compulsion Law* was passed in June, detailing the design and implementation of administrative compulsion and provides for the legal foundations, implementation procedures as well as rights and obligations of parties concerned for freezing and transferring deposits and remittance, ensuring better cooperation from financial institutions when they are required to work with government agencies and preventing possible legal risks. In October, the *Decision of the Standing Commission of the National People's Congress on Issues Regarding Strengthening Counter-terrorism* was passed, clearing legal obstacles for financial institutions and specific non-financial institutions to quickly freeze terrorism-related assets. Furthermore, the State Council released a series of regulations that helped maintain the order of financial markets, regulate investments and financing activities and prevent systemic financial risks.

Box 19 Financial Consumer Protection

In the wake of the global financial crisis, financial consumer protection was identified by major advanced economies, the OECD and other international organizations as a key element to maintain confidence in the financial system, boost consumption, support economic development and promote financial stability. The G20 released a declaration that contains principles for financial consumer protection at its Cannes Summit in November 2011, while the U.S., UK, Canada, Australia and other countries have developed or are studying measures to enhance financial consumer protection.

Currently, financial consumer protection in China needs to be improved in terms of institutional and organizational arrangements. The violations of financial consumer interests have occurred from time to time in recent years as the lack of a comprehensive law system for financial consumer protection, inadequate procedures for rights-protection and weak supervision to strengthen financial consumer protection. The State Council has approved respectively the establishments of special bodies under the PBC, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the China Insurance Regulatory Commission (CIRC). Financial consumer protection in China has been improving.

The PBC launched a pilot program on financial consumer protection in 2010, and deepened it in 2011. As of the end of 2011, a total of 563 PBC branches have carried out financial consumer protection work in 29 provinces (autonomous regions or municipalities), and set up 454 financial consumer protection centers independently or jointly with local governments. The PBC branches have resolved over 4000 financial disputes by setting up assessment mechanisms for handling financial complaints, disputes resolving mechanisms, reporting and information sharing of complaint cases, with a nearly 100 percent consumer satisfaction rate. Taking advantage of its wide coverage of branches, the PBC also handled complaints on banking, securities and insurance issues in some regions. Overall, the PBC's pilot program on financial consumer protection has been quite successful.

To protect the legitimate rights and interests of depositors and other customers, the CBRC has set up a Public Education Service Area and launched Public Education Net, stressed commercial banks' responsibility as services providers, developed and released regulations and rules on sales of wealth management products, credit cards, sales of insurance products and charged services to regulate banks' operation and protect consumers' rights of information, choice and privacy, fair deals and other legitimate rights and interests. The CIRC has initiated intensive educational outreach on investor protection, promoted to build up dispute resolving mechanisms and explored ways to use online platforms for investor protection. The CIRC has continuously enhanced organizational system for supervising consumer protection, set up insurance disputes resolving mechanisms, supervising insurance claiming services and handling complaints, vigorously carried out insurance consumer education, publicized and popularized the knowledge of insurance, and improved the public's risk awareness and ability to defend their rights. In particular, the CIRC addressed difficulties in vehicle insurance claims and misleading in life insurance sales by developing special policies and meting out harsh punishments.

2. Judicial interpretations were made to safeguard stable operation of the financial system

In 2011, the Supreme People's Court issued a series of judicial interpretations including the *Notice of the Supreme People's Court on the application of Relevant Judicial Interpretations and Judicial Policies to the Trial of Cases concerning the Agricultural Bank of China Limited's Disposal of Non-performing Assets Resulting from Divesture in Share Reform, Notice of the Supreme People's Court on Printing and Distributing the Minutes of the Seminar on evidence-related Issues in the Trials of Securities Administrative Punishment Cases, Notice of the Supreme People's Court on the Determination of Nature of Criminal Cases on Illegal Fund-Raising, Notice of the Supreme People's Court on Legally and Properly Hearing Cases on Disputes over Private lending to Promote Economic Development and Maintain Social Stability, and Several Provisions of the Supreme People's Court on the Assessments Entrusted and Auctions by the People's Courts*, which played an important role in preventing loss of state-owned assets, promoting legally administration by supervisors, protecting the legitimate rights and interests of investors, properly resolving disputes over private lending and maintaining social stability.

3. Regulations were developed to promote soundness of the financial market

The PBC issued the *Administrative Measures for the Pilot RMB Settlement of Outward Direct Investment, Administrative Rules on Testing and Certification of the Payment Service Business System by Non-financial Institutions,* and *Administrative Measures for Settlement of Foreign Direct Investment in RMB*, which supported the settlement of outward direct investment in RMB by banking financial institutions and domestic institutions, strengthened management of information security and prevention of technical risks in payment services provided by non-financial institutions, and regulated settlement of foreign direct investment in RMB by banking financial investment. Supervisors also developed the *Administrative Measures for the Leverage ratio of Commercial Banks, Administrative Measures for the Loan Loss Provisions of Commercial Banks, Administrative Measures for the Sales of Wealth Management Products of Commercial Banks, Trial Measures for the Futures Investment Consulting Business of Futures Companies, Pilot Measures for Fund Management Companies to Provide Asset Management for Specific Clients, Administrative Measures for the Sales of Securities Investment Funds, Trial Measures for the Administration of the Refinancing Services, Provisional Measures for the Administration of the Transfer of Insurance Services by Insurance Companies*, improving supervision in relevant sectors.

4. Outlook

Continuous efforts will be made to push forward the amendment of the *Law on Securities Investment Fund* and the *Budget Law*. Amendment of the *Measures on Balance* *of Payment Statistics Declaration* and the *Regulation on Futures Transactions*, as well as promulgation of the *Regulation on Credit Reference* is expected to be completed in accordance with the *State Council Legislation Plan for 2012*. Work will be done to make sure the *Regulation on Regulation and Supervision of Public Companies,* the *Regulation on Banking Financial Institution Bankruptcy* and the *Regulation on Agricultural Insurance* are promulgated in due time, while efforts will be done to study the development of the *Regulation on the Gold Market*, the *Regulation on Deposit Insurance,* the *Regulation on Financial Statistics,* the *Regulation on the Investor Protection Fund* and the amendment of the *Interim Regulation on Cash Management, the Regulation on the Settlement, Sales and Payment of Foreign Exchange,* and the *Regulation on Compulsory Automobile Traffic Accident Liability Insurance.*

III. Accounting standards

1. Accounting standards and internal control regulation system were further improved

Development and implementation of accounting standards were pushed forward. First, the *Accounting Standards for Small Enterprises* was issued and will be put into practice in 2013, representing a further improvement of China's accounting standards system. Second, the general taxonomy of the Extensible Business Reporting Language (XBRL) of enterprise accounting standards were implemented in selected institutions including the China Development Bank and the China Life Insurance Co., Ltd., and will be applied in all listed commercial banks in 2012. Efforts were made to promote the development of expanded taxonomy for the banking sector under the general taxonomy for enterprise accounting standards, and develop a preliminary set of uniform standards for electronic finance reporting statistics.

Establishment and implementation of internal control regulation system were promoted. The *Supplementary Guidance to Enterprise Internal Control* was applied initially to companies listed in both domestic and overseas markets and then gradually to all companies listed in the main board, the SMEs board and the GEM board, marking the establishment of enterprise internal control regulation system in China.

2. Outlook

Continued efforts will be made to advance the financial accounting reform and development in China, promote the convergence and equivalence of enterprise accounting standards in China, continuously maintain the convergence of domestic enterprises accounting standards with international financial reporting standards in line with progress in international financial reporting standards reform and China's circumstances, so as to provide high-quality accounting information for counter-cyclical macro-prudential regulation. Actions will be taken to expeditiously achieve final equivalence with European accounting standards and to promote bilateral equivalence with accounting standards in the U.S., Russia and other key global capital markets in an effort to lower the funding costs for enterprises. Meanwhile, measures will be taken to further improve the accounting standards system, advance financial accounting reform and development, and continue to guide financial enterprises to improve their internal control system according to the requests of the 12th Five-year plan.

Box 20 Management on Central Banks' Balance Sheets

In response to the recent global financial crisis, many central banks in advanced economies implemented unconventional monetary policy by changing the structure and size of their balance sheets. The major instruments are as follows, the first is new tools for margin trading and short selling that are invented to inject liquidity. the Federal Reserve Board (Fed) successively innovated 10 financial instruments including the Short Auction Facility for loans extended to the financial system and private sector or for direct purchases of financial assets, the Bank of England's Special Liquidity Scheme (SLS) and Asset Purchase Facility (APF) allow it to buy government bonds and other assets in the secondary market by increasing issuance of currency, and the ECB's Asset-backed Securities Purchase Program aims at purchasing securities backed by mortgage loans or public sector lending in batches. After the outbreak of the Greek sovereign debt crisis, ECB launched Securities Market Plan (SMP), which allows it to ensure liquidity supply by buying bonds issued by euro area member governments in the secondary market. The second is paying interest on reserves placed by deposits-taking institutions. The Fed paid interest equivalent to federal funds target rate on deposits-taking institutions' reserve accounts to encourage them to hold their funds in the Fed, and the Bank of Japan initiated a similar plan—the Complementary Deposit Facility. The third is rescuing the systemically important financial institutions (SIFIs). The central banks of U.S., UK, Swiss, Germany, France, Italy and Netherland supported failed SIFIs by either injecting liquidity or nationalization. The fourth is extraordinary easy monetary policy. With two quantitatively easing monetary programs, the Fed purchased long-term treasury bonds, mortgage-backed securities and other financial instruments with a total amount of USD 1.65 trillion, The fifth is special entities set up for special policy purposes, such as the three companies set up by the Fed to acquire assets of Bear Stearns and AIG and to purchase mortgage-backed securities issued and guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae, as well as the Asset

Purchase Facility Fund built by the Bank of England to finance its APF scheme.

The reason why central banks are able to implement unconventional monetary policies by altering the structure and size of their balance sheets is that they build assets and liabilities in a special way: central banks, as authorities that issue money, can create liabilities such as deposits by commercial banks and the government through credit supply, discounting, securities purchases and other operations. Opposite to the way that commercial entities build their assets and liabilities, this allows central banks to adjust their balance sheets in a discretionary manner. Unconventional monetary policies impact central bank balance sheets in two ways. First, it leads to expansion of balance sheets, as reflected in the growth of assets of the Fed, Bank of England and the ECB, which increased by 169 percent, 151 percent and 66 percent respectively at the end of 2011 compared with June 2007. Second, it changes structure of balance sheets, resulting in an increase in long-term securities assets and credit to commercial institutions and a decline in short-term securities assets and deposits by financial institutions and the government. For example, the Fed's balance sheet at the end of 2011 nearly doubled from the size in 2006, and 53 percent of the assets were new financial instruments, compared with a 90 percent share of Treasury bonds in 2006.

While balance sheet expansion and unconventional monetary policies played a positive role in addressing financial crisis and maintaining financial stability, it made balance sheet management more difficult. many central banks control the risk exposures by managing assets and liabilities in a flexible manner, including capital increases and risk provisioning in ECB, the special entities set up by Bank of England to insulate its balance sheet from credit risks, and foreign reserve sterilization operations and transfer of exchange rate risks to the government in central banks of Netherland and South Africa, which reduces central banks' exposures to exchange rate risks. In this regard, while enhancing central banks' mandate in financial stability, it is important to explore ways to prevent finance risks in central banks and strengthen central banks' finance position, and to study the establishment of a government compensation mechanism.

IV. Credit Environment

In 2011, China made strong progress in developing the social credit reporting system, pressed ahead with the development of credit information market, sector-specific and regional credit systems, improved public awareness of credit records, and further optimized credit environment.

1. Steady progress was made in developing the credit information and social credit reporting system, contributing to an increasingly favorable credit environment

New progress was achieved in developing relevant regulations and standards. The *Regulation on Credit Information Management (Draft)* was completed after consulting the public, local governments, other government agencies, academic institutions, financial institutions and credit reporting institutions. The enterprise credit code program was launched on a pilot basis to improve the enterprise credit code system, the policy of real-name registration for opening bank accounts was implemented to improve financial services, and information sharing among government agencies was enhanced.

The building of the social credit system was advanced. Sector-specific credit reporting systems were strengthened as preliminary punishment mechanisms were built up and more sectors were included in the credit information sharing system. Joint efforts were made to build a uniform financial credit information platform, preliminarily realizing information exchanges and sharing between the PBC's individual and enterprise credit information and the CBRC and the CSRC's credit information. Positive progress was made in development of regional credit information systems as local governments consolidated credit information from different government departments and encouraged credit information sharing. The establishment of credit information systems for SMEs and in rural areas was continued, easing financing difficulties facing SMEs and rural households. As of the end of 2011, credit records have been established for 143 million rural households, 93.6 million of which were identified as creditworthy and nearly 81.85 million of which received a total of RMB 1.52 trillion yuan of bank lending. Credit information of 2 265 400 SMEs that had yet to receive bank loans was added to the credit information system, of which 363 600 SMEs now secured lending agreement from banks and 216 600 SMEs received RMB 4.28 trillion yuan of bank lending.

The credit information market continued to grow, playing a stronger role in preventing credit risks. The coverage of the PBC individual and enterprise credit information system were expanded, playing an important role in preventing credit risks for commercial banks. As of the end of 2011, the individual and enterprise credit information system had set up credit files for 805 million individuals and 18.09 million enterprises, and opened 198 000 and 126 000 enquiry accounts respectively, the accumulative number of enquiry reached 241 million and 69 million throughout the year. The Movable Assets Financing Public Registry System serving SMEs operated smoothly, with a significant rise in numbers of registrations and enquiries, and playing a more and more important role in receivables financing and financial leasing services. As of the end of 2011, the receivables financing system and financial leasing system had 501 800 and 47 200 registrations respectively and the accumulative number of enquiry reached 640 000 and 12 700 respectively. After an upgrade and the coverage expansion, the CSRC credit database now includes credit information of nearly 8 500 institutions and 14 000 individuals with nearly 100 daily enquiries on average in 2011. The capabilities of credit rating agencies were strengthened, and their influence in the capital and loan markets was enhanced. The number of credit ratings services in the interbank bond market and loan market reached 49 200 in 2011, up 14.97 percent y-o-y.

Supervision was further strengthened. Quality management of data in the credit information system was enhanced, supported by examination on data reporting, enquiry, security management, handling of complaints, use of lending registration cards and institutional arrangements of commercial banks. Commercial banks were urged to improve credit information system and comply with policies that require ex-ante registration with supervisors. Management of credit rating service was strengthened to regulate practices of credit rating agencies, and the testing system on credit rating default ratio was improved as a technological approach to assess credit rating risks. Market self-discipline was enhanced as efforts were made to guide the establishment of the joint conference of executives of credit rating agencies in the credit market and the experts committee for reviewing credit rating reports.

2. Outlook

Efforts will be made to develop a comprehensive plan for developing credit information legislation, enhancing credit information regulation, supporting credit information market development, improving public literacy and developing the credit reference cultural system and social credit reporting systems, so as to build a better creditworthy environment and strengthen the foundation of financial stability. Development of the credit regulations system will be accelerated by promoting the promulgation of the *Regulation on Credit Information Management*, developing the *measures to protect personal credit information*, and encouraging the adoption of enterprise credit codes. The social credit reporting systems will be enhanced, including improving credit files, expanding credit information sharing among government agencies and promoting the establishment of a uniform financial credit information platform, and launching the set-up of credit reporting systems for SMEs and in rural areas on a pilot basis. Measures will be taken to build a credit management system that focuses on market entry and exit of credit reporting institutions and services, personnel management, on-site examination and off-site surveillance, and combines government administration and industry's self-discipline. Development of credit information market will be launched, including supporting the development of credit rating services by encouraging the adoption of advanced rating techniques and methodologies and supporting the development of the brand rating agencies with strong reputation and market recognition. Public education on credit information will be enhanced.

Box 21 Properly Understanding the Role of Credit Rating Agencies

Credit rating agencies are intermediary institutions that serve the capital markets by helping investors address information asymmetry against issuers through professional information gathering and analysis. Originated in the U.S. in late 19th century and early 20th century, the international credit rating service is now dominated by three leading rating agencies: the Moody's, Standard & Poor's and Fitch.

Credit rating has been under wide criticism since the global financial crisis broke out. First, pro-cyclicality, continual rating upgrades in times of rising economy fuel bubbles, while sharp downgrades in recession to intensify market panic and lead to financial instability in some degree. Second, conflict of interests, rating agencies rely heavily on the *issuer-pay* business model and therefore bring conflicts between commercial operation and independence of rating agencies that could give ratings in favor of the issuers. Third, lack of competition, credit rating industry is highly monopolized, therefore the self-discipline mechanism of *reputation capital* is ineffective. Fourth, lack of transparency, rating agencies do not fully disclose and explain the underlying assumptions for ratings and data sources, which could mislead investors in risk judgment in some extent.

To address above weaknesses, international community developed a range of reform measures and proposals on credit ratings based on the reflections on resources and lessons of the financial crisis. The International Organization of Securities Commissions (IOSCO) revised the *Code of Conduct Fundamentals for Credit Rating Agencies* in 2008, while the G20 called for stronger supervision on rating agencies in the *Declaration on Strengthening Financial System* at its London summit. The U.S. and EU also developed reform plans to step up supervision on rating agencies, the major measures included higher requirements on information disclosure, enhanced requirements to avoid conflict of interests, less reference of credit ratings in regulatory rules, clear responsibilities of rating agencies to investors and issuers, and rating information sharing mechanisms on structured financial products.

Credit rating industry in China has played its role in risk disclosure and risk pricing in recent years. Nevertheless, given its short time of development, there are a number of problems it needs to address: First, the development of the industry still remains in relatively low level and competitiveness is rather weak, the second is misconduct and weak governance of rating agencies and the rating techniques are yet to be enhanced, the third is inadequate institutional arrangements that give only limited protection for investors' interests, and the fourth is unreasonable business model that undermines the fairness of rating results. To promote the development of credit rating industry in China, measures need to be taken as follows: First, guide investors, particularly large financial institutions to develop internal rating system as a cross-check to external ratings so as to reduce reliance on credit rating agencies. Second, streamline institutional arrangements and relationships of interested parties, explore the investor-pay model, and improve rating techniques and transparency. Third, explore the application of a dual rating system as part of the efforts to promote credit rating's positive role in supporting current macroeconomic management and reform, foster stronger domestic rating agencies. Fourth, improve practical standards and enhance market competition to better protect investors' interests.

V. Anti-money Laundering

With the development of the money laundering risk prevention mechanism, improved AML investigations and deepened international cooperation, AML work was pushed forward in 2011, playing an important role in building and improving the national money laundering risk prevention system and safeguarding economic and financial order.

1. Working mechanism and arrangements for AML was further improved

AML regulation and supervision was improved, as reflected in the optimized allocation of regulatory resources, a combined use of both on-site examination and off-site surveillance, studies on building a system for assessing money laundering risk in financial institutions, and developing objectives for on-site examination by drawing on results of off-site assessments. AML supervision on specific non-financial sectors was launched as the draft *Administrative Measures on Anti-money Laundering and Counter-terrorist Financing in Payment Institutions* was completed.

The effectiveness of AML investigations was enhanced further. Actions were taken to strengthen management of case reporting, limit co-investigations of cases to a strictly defined scope, and urge financial institutions to improve identification and analysis of suspicious transactions. As of the end of 2011, the PBC AML system has reported 595 cases to investigation agencies, of which 8 cases were convicted as money laundering crimes by judicial authorities. The PBC also enhanced risk alerts against financial crimes to financial institutions by issuing *Key AML Cases Bulletin* and conducting researches on new criminal activities including illegal financing, cashing out of credit cards, and cross-border telecom frauds.

International cooperation on AML was deepened. The *Follow-up Report to the Mutual Evaluation Report of China* was completed, and the *Report on Progress in Follow-up Evaluation* was discussed and adopted by the Financial Action Task Force (FATF) at its plenary in June 2011, which highly acknowledged the progress China has made in AML, particularly in preventive measures in the financial sector, and supported China's efforts to further improve counter-terrorist financing (CTF) policies. The PBC actively participated in the preparation of the fourth round of FATF mutual evaluation and developed proposals on improving AML work in China. As approved by the State Council, the PBC, on behalf of China, signed the *Agreement of the Eurasian Group on Combating Money laundering and Financing of Terrorism* in June 2011. As the rotating presidency-designate of the Asia/Pacific Group on Money Laundering (APG), China joined the steering group at the 14th APG annual meeting, which further enhanced China's standing in regional AML organizations.

Assessment of money laundering risks in financial institutions was launched. The PBC launched the assessment of money laundering risks in financial institutions, rated money laundering risks of financial institutions according to their compliance with AML regulations and internal control performance and explored to allocate AML resources in line with risk profiles, with intensified AML measures to financial institutions with high money laundering risks and streamlined AML measures to those with low risks, and calibrating its risk management strategies in line with risk profiles of financial institutions.

2. Outlook

The PBC will focus on the development of AML regulations, including developing regulations on freezing terrorism related assets and building necessary mechanisms to facilitate its implementation. Regulatory and supervisory framework and approaches will be improved. The supervision should be focused on institutions with legal person status, the supervisory archives and database should be set up by fully using information technologies, and differentiated supervisory approaches based on different risk profiles of financial institutions should be adopted. Measures should be taken to encourage financial institutions to develop internal standards for suspicious transactions, improve customer risk classification and assessment, and build a client-centered risk management system, refine the procedures for transferring of clues on suspicious transactions and AML investigation, enhance coordination and cooperation with the financial intelligence unit on AML investigation, and improve the quality of suspicious transactions clues and the proportion of clues leading to AML actions. The international information exchanges and cooperation will be strengthened within the FATF framework and China's voice in international anti-money laundering will be enhanced.

Chapter Ⅷ

Macro-prudential Regulation

In 2011, International organizations continued to promote the research and formulation of international standards and rules on macro-prudential regulation, financial regulatory reforms of major economies were advanced and macro-prudential regulation was strengthened. China continuously enhanced and improved the macro-prudential framework, made proactive progress in financial statistics and monitoring and assessment of systemic risk, countercyclical macro adjustment mechanism, policy measures on systemically important financial institutions and crisis management and risk resolution regime, effectively maintaining the soundness of financial system.

I. International Progress on Enhancing Macro-prudential Regulation

In 2011, international community has made positive progress on supervision of Systemically Important Financial Institutions (SIFIs), set-up of countercyclical macro adjustment mechanism, supervision of shadow banking system and enhancement of OTC derivatives infrastructure. Many initiatives have become consensus at global level, some policy tools have been implemented at national level.

1. Strengthening Supervision on SIFIs

In 2011, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and other international organizations continued to strengthen the supervision on SIFIs through developing assessment methodologies, enhancing loss absorbency capacity, improving resolution regime and intensifying supervision effectiveness, relevant measures have been released successively.

The assessment methodologies and loss absorbency capacity was improved. In November 2011, the BCBS released *Global Systemically Important Banks: assessment methodologies and the additional loss absorbency requirement*, setting out policy framework for G-SIBs including assessment methodologies for systemic importance, additional loss absorbency requirements and instruments to meet additional loss absorbency requirements. Firstly, the assessment methodologies were based on an quantitative indicator approach, supplemented by qualitative supervisory judgment, 12 quantitative indicators on systemic importance fall into five categories: size, cross-jurisdictional activity, interconnectedness, substitutability /financial institution infrastructure and complexity (Table 8.1). Based on the indicators, relevant authorities adjusted the systemic importance according to the quantitative and qualitative information and come out with the assessment results. In 2011, the BCBS released the preliminary list of 29 G-SIBs including Bank of China. The bank scores and list of G-SIBs will be updated periodically by the BCBS. Secondly, different additional loss absorbency requirements should be imposed on different buckets of banks. The BCBS divided G-SIBs into 4 buckets according to their systemic importance, and set an empty bucket above all, different additional loss absorbency requirements apply to banks in different buckets (Table 8.2).

Table 8.1 Assessment Indicators for Systemic Importance of G-SIBs

Category(and weighting)	Individual indicators	Weighting (%)
Cross-jurisdictional activity（20%）	Cross-jurisdictional claims	10
	Cross-jurisdictional liabilities	10
Size（20%）	Total exposures as defined for use in the Basel III leverage ratio	20
Interconnectedness（20%）	Intra-financial system assets	6.67
	Intra-financial system liabilities	6.67
	Wholesale funding ratio	6.67
Substitutability/financial institution infrastructure（20%）	Assets under custody	6.67
	Payments cleared and settled through payment systems	6.67
	Values of underwritten transactions in debt and equity markets	6.67
Complexity（20%）	OTC derivatives notional value	6.67
	Level 3 assets	6.67
	Held for trading and available for sale value	6.67

Source: The BCBS, "*Global Systemically Important Banks: Assessment Methodologies and the Additional Loss Absorbency Requirement*", November 2011.

Table 8.2 Magnitude of Additional Loss Absorbency

Bucket	Score Range	Minimum additional loss absorbency(%)
5（Empty）	D-	3.5
4	C-D	2.5
3	B-C	2
2	A-B	1.5
1	Cut-off Point-A	1

Source: The BCBS, "*Global Systemically Important Banks: Assessment Methodologies and the Additional Loss Absorbency Requirement*", November 2011.

Effective resolution regime was established. In November 2011, the FSB released *Key Attributes of Effective Resolution Regimes for Financial Institutions*, setting out key elements of effective resolution regimes from 12 dimensions including scope, resolution authority, resolution powers, disposal of client assets, safeguards, funding of firms in resolution, legal framework conditions for cross-border cooperation, crisis management groups(CMGs), institution-specific cross-border cooperation agreements, resolvability assessments, recovery and resolution planning, access to information and information sharing. The report stated that jurisdictions should resolve SIFIs in an orderly manner, set up privately-financed deposit insurance or resolution funds, with decreasing the reliance on public ownership or bail-out funds. Home and key host jurisdictions of all G-SIFIs should establish CMGs comprising the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes, and undertake resolvability assessment, recovery and resolution planning and formulating of institution-specific cooperation agreements, etc. In the next stage, the FSB will review periodically the progress of effective resolution regime for G-SIFIs, and *Key Attributes of Effective Resolution Regimes for Financial Institutions* will be integrated into the FSAP/ROSC assessment framework.

The intensity and effectiveness of SIFIs supervision was enhanced. In 2011, the FSB reviewed the progress on implementing the recommendations proposed in *Intensity and Effectiveness of SIFI Supervision*, and released the progress report setting out a series of recommendations for making the supervision of financial institutions more intense, effective and reliable including improving data aggregation capabilities of financial institutions, ensuring the adequacy of resources at supervisory agencies for the supervision of SIFIs, reinforcing risk governance practices of financial institutions, encouraging global accounting firms to improve auditing quality, and facilitating more meaningful dialogue between supervisors and audit firms, particularly of SIFIs.

2. Further improving the Countercyclical Measures

The procyclicality of accounting standards was mitigated. In January 2011, the International Accounting Standards Board (IASB) and the US Federal Accounting Standards Board (FASB) jointly issued *Supplement Financial Instruments: Impairment* for consultations, aiming to improve current financial reporting system, developing an expected loss provisioning approach to reduce the procyclicality of current accounting standards. The report proposed to divide financial assets into 2 buckets to reflect the general pattern of deterioration in assets quality. The provisioning for relatively high-quality assets shall be measured as a portion of remaining lifetime expected losses and the provisioning for relatively low-quality assets shall be measured as the remaining lifetime expected losses. The report also set the minimum provisioning to ensure that provisioning is adequate to cover credit losses in the near future. Moreover, the IASB and FASB are researching the measurement of the loan loss provisioning, particularly the choice of the portion for the provisioning of assets in bucket 1 and the criteria for transferring assets between buckets.

The procyclicality of hair-cuts and margin requirements were reduced. The Committee on Global Financial System (CGFS) has proposed a series of policies to mitigate the procyclicality of hair-cut and margin requirements, including through-the-cycle hair-cuts requirements based on two parts, one part is relatively stable across the cycle which should be calculated based on market volatility and liquidity, another part is countercyclical add-on which supervisory authorities could use as a discretionary tool when authorities judge that markets are underestimating collateral risks in periods of rising financial leverage and asset prices. Decoupling margin requirements with credit rating, all counterparties should be subject to frequently varying margin payments when the mark-to-market losses on derivatives trades exceeds moderate threshold amounts, so as to reduce cyclicality of margin requirements.

3. Strengthening Supervision on Shadow Banking

In April and October 2012, the FSB released respectively *Shadow Banking: Scoping the Issues and Shadow Banking: Strengthening Oversight and Regulation*, setting out recommendations for strengthening supervision on shadow banking. The FSB proposed a two-step approach: the first step, authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all areas where shadow banking-related risks to the financial system might potentially arise. The second step, authorities should narrow the focus to the subset of nonbank credit intermediation where systemic risk or regulatory arbitrage may arise. Based on above approach, the FSB proposed a standardized process for monitoring the shadow banking system: Firstly, authorities conduct a macro-mapping exercise based on the Flow of Funds data to scan and map the scale as well as the key trends in non-bank credit intermediation broadly. Secondly, authorities identify the aspects of the shadow banking system posing systemic risk or regulatory arbitrage concerns by focusing on non-bank credit intermediation that involves (i) maturity transformation, (ii) liquidity transformation, (iii) credit risk transfer, and/or (iv) leverage. Thirdly, authorities will assess the degree of potential impact that the severe distress or failure of certain shadow banking entities/activities would pose to the system. The FSB also proposed some regulatory measures to address concerns related to shadow banking system, including strengthening regulation of banks' interactions with shadow banking entities, promoting regulatory reform of money market funds, strengthening regulation of other shadow banking entities, securitization, securities lending and repos etc.

4. Enhancing OTC Derivatives Infrastructure

In March 2011, the Committee on Payment

and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) jointly issued *Principles for financial market infrastructures -Consultative report*. The report set out a unified set of standards and principles for systemically important payment system (CPSIPS), central securities depositories (CSDs), securities settlement systems (RSSS), central counterparties (CCPs) and trade repositories (TRs), provided 24 principles from the following aspects: general organization, credit and liquidity risk management, settlement, CSDs and exchange-of-value settlement systems, default management, general business and operational risk management, access, efficiency and transparency and defined the responsibilities of central banks, market regulators, and other relevant authorities for financial market infrastructures. Furthermore, relevant international organizations have conducted research on central banks' liquidity support to CCPs, margin requirements on non-centralized settled OTC derivatives trades, supervision on securitization and relaunch of securitization etc.

II. Major jurisdictions' Progress in Strengthening Macro-prudential Regulation

1. United States

Financial Stability Oversight Council (FSOC) performed macro-prudent mandate. In July 2011, the FSOC published the first annual report. It analyzed the macroeconomic environments, developments of financial sector, regulatory reforms, assessed potential risks threatening to financial stability of the United States, and provided relevant policy measures. In October 2011, the FSOC published *Guidance for Nonbank Financial Company Determinations*, stating that the nonbank financial companies should be supervised by the FSOC if the FSOC determines them could pose a threat to the financial stability of the United States. Besides, the FSOC released a report regarding study and recommendations on implementing Volcker Rules, made 10 recommendations including regulatory review on proprietary trading, disclosure requirements on banks' risk exposures to hedge funds and private equities.

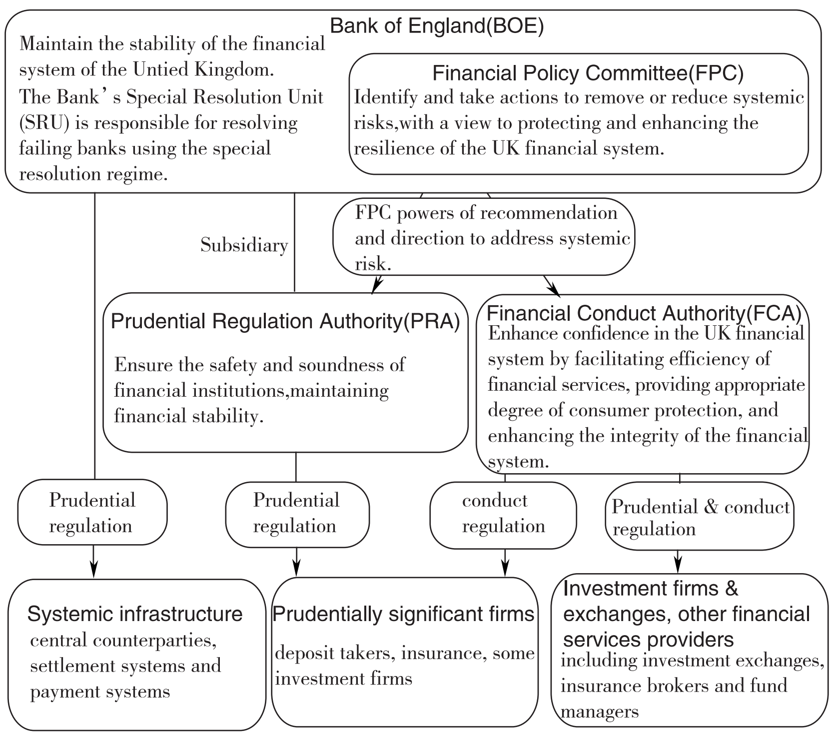
Regulation and supervision on SIFIs were strengthened. In December 2011, the Federal Reserve Board released a series of new banking supervisory rules, proposing a package of measures on capital, liquidity, credit exposure limit, stress tests, risk management and early remediation requirements etc, set out higher regulatory standards and requirements on large bank holding companies and systemically important nonbank financial firms.

Resolution regime was improved and final rule on resolution plans was issued. In October 2011, the Federal Deposit Insurance Company (FDIC) and the Federal Reserve Board jointly issued a final rule to implement the requirements regarding large and complex financial institutions' resolution plan (living will), requiring large and complex financial institutions to provide descriptions on core business lines, organization structures, interconnectedness, risk exposures to major counterparties, applicable regulation regime and submit the orderly resolution plan and risk mitigation measures, urging them to strengthen corporate governance and internal management. The final rule also specified the regulatory powers of the Federal Reserve Board and FDIC respectively.

2. United Kingdom

Financial regulatory reform scheme was improved further. In February 2011, the UK government published *A new approach to financial regulation: building a stronger system* for consultation, which proposed the creation of Financial Conduct Authority (FCA) responsible for financial consumer protection and regulation of conduct of business in financial services. The report made it clearer the roles of Financial Policy Committee (FPC), Prudential Regulation Authority (PRA) and FCA. The interim FPC was created at the Bank of England, and began to undertake macro-prudential mandate by identifying and monitoring systemic risks, maintaining and enhancing the soundness of UK's financial system. In June 2011, the UK government published the White Paper "*A new approach to financial regulation: the blueprint for reform*", pushing reforms into legislation phase by proposing a draft Financial Service Bill. In January 2012, the draft Bill completed pre-legislative scrutiny and entered into the legislation process.

Figure 8.1 The Roles of the Bodies in the New Regulatory Architecture



Source: HM Treasury, *A new approach to financial regulation: building a stronger system*, 2011.

Reforms in banking sector were promoted. In September 2011, the UK Independent Commission on Banking (ICB) published the report on UK's banking reform, providing a package of recommendations to reform UK's Banking system: Firstly, separate retail banking and wholesale and investment banking by creation of separate entities for individuals and small and medium-sized enterprises banking activities within a bank, cutting off risk transfer within bank. Secondly, set higher regulatory standards and requirements on systemically important banks and retail banks to enhance their loss absorbing capacity. Thirdly, deepen structural reforms on banking and incorporating competitiveness into financial supervision to promote vigorousness and competitiveness of financial market.

Box22 Bank of England: Research on Macro-prudential Instruments

In December 2011, the interim FPC under Bank of England issued *Instruments of Macroprudential Policy: a discussion paper*. The paper proposed monitoring indicators based on the analysis of sources of systemic risk, and set out a range of potential macro-prudential instruments.

The paper distinguished two distinct manifestations of systemic risk: (i) the amount of risk that the financial system takes at a point in time relative to its capital and liquidity resources ('time-varying' or 'cyclical' risk); and (ii) for a given amount of time-varying risk, structural features of the financial system, such as the connections and distribution of risk across different participants, which create or exacerbate vulnerabilities ('cross-sectional' or 'structural' risk). Underlying these manifestations of risk are various amplifiers in the financial system, such as mispriced lending terms and excessive leverage, maturity mismatch, interconnectedness, concentration, complexity and opacity.

The paper outlined some potential indicators of systemic risk regarding to above sources of risk, including quantity-based indicators, such as credit-to-GDP gaps, leverage ratio; price-based indicators, such as equities, corporate bonds and property prices, real interest rates etc.; composite and model-based indicators, such as the European Central Bank's Systemic Risk Diagnostic (SRD), the Bank of England's Risk Assessment Model for Systemic Institutions (RAMSI) and stress testing. Market and supervisory intelligence is also helpful for identification of systemic risk.

The paper presented a set of macro-prudential tools to tackle different sources of systemic risk (Table 8.3): (i) those that affect the balance sheets of financial institutions, including maximum leverage ratios, countercyclical capital buffers, time-varying liquidity buffers, time-varying provisioning practices and restrictions on distributions; (ii) those that affect the terms and conditions of loans and other financial transactions; including loan to value and loan to income restrictions, margining requirements; and (iii) those that influence market structures, including use of central counterparties, design and use of organized trading platforms.

Table8.3 Overview of Macro-prudential Tools

Instruments	Key pros	Key cons
Countercyclical capital buffers	Direct effect on loss-absorbing capacity; Simplicity eases communication	Cannot focus on particular sector-may even encourage risking up; May be ineffective if risk weights are miscalibrated
Sectoral capital requirements (variable risk weights)	Targeted approach to nipping problems in the bud; May provide sharper incentives than countercyclical capital buffer; Adjusting risk weights on flow of lending relative to its stock could restrain lending in booms or encourage lending in downturns	May displace risk to other parts of the system- a 'water bed' effect①; Implementation challenges to ensure consistent application across balance sheet; Data needs greater than with aggregate tools
Maximum leverage ratios	Less susceptible to arbitrage and mis-measuring risk than risk-based tools	No penalty for risk, so may create perverse incentives to 'risk up'
Time-varying provisioning practices	Ensure early provisioning against prospective credit losses	Overlaps with countercyclical capital buffers and variable risk tools
Restriction on distributions	Limits risk of disruption to credit supply-useful in downturns	Uniform cap would penalize healthy banks; Cap linked to capital ratio may cause deleveraging
Time-varying liquidity buffers	Direct effect on banks' liquid assets holdings and maturity mismatch, increasing resilience; May also help to moderate the credit cycle	Limited international experience with liquidity requirements; Microprudential standards still development
Loan to value and loan to income restrictions	Directly limits risky lending, enhancing resilience to risks from real estate; May be less prone to foreign branches leakage	Difficult to calibrate the trade-off between financial stability benefits, economic activity and societal preferences for home ownership

① Water bed is designed by utilizing water buoyancy, water bed effect means something increasing and others decreasing just like a water bed.

concluded

Instruments	Key pros	Key cons
Margining requirements	May reduce the risk of margin calls precipitating liquidity hoarding and asset fire sales; Enhances resilience of funding markets	May prone to leakage/arbitrage across borders, market segments, and from unsecured lending; Capital and liquidity requirements could be used to deliver similar effects in terms of bank resilience
Use of central counterparties	Simplifies network interconnectedness and reduces the potential for contagion; Centralizes risk management; Provides greater transparency	Increases systemic importance of infrastructure; Capital and liquidity requirements could be used to deliver similar effect in terms of bank resilience
Design and use of trading venues	May help prevent sharp falls in liquidity and reduce extreme price volatility	May discourage participation, reducing liquidity; Avoidance risk (e.g. move activity overseas)
Disclosure requirements	Reduce likelihood of information contagion; Enhances market discipline	Liquidity disclosure risks ‘spooking’ the market or making buffers less usable

Sources: Bank of England, *Instruments of Macroprudential Policy: a discussion paper,* December 2011.

3. European Union

European Systemic Risk Board (ESRB) performed macro-prudential mandate. In September 2011, ESRB published *Decision the provision and collection of information for the macro-prudential oversight of the financial system within the Union*, requiring European Central Bank (ECB), European Banking Authority (EBA), European Securities Markets Authority (ESMA) and Insurance and Occupational Pensions Authority (EIOPA) provide regularly information necessary to ESRB for monitoring and assessment of systemic risk. ESRB released *recommendations* to EU, member states and three supervisory authorities and national supervisory authorities, providing policy measures on lending in foreign currencies, US dollar denominated funding of credit institutions and macro-prudential mandate of national authorities, calling upon member to designate an authority to conduct macro-prudential policy in their legislation, with the aim of safeguarding financial stability, and highlighting central bank’s leading role in macro-prudential policy.

Stress testing on banking sector was conducted. Since March 2011, EBA, ESRB and ESB conducted the third EU-wide banking stress test exercise. The exercise was conducted in a constrained bottom-up fashion, selecting 90 banks across 21 member states, assessing the changes in market risk, sovereign risk, and funding cost of a large sample of banks against an adverse scenario when main macroeconomic variables(such as GDP, unemployment and house prices) deteriorates. EBA required 8 banks whose Core Tier 1 Ratio falls below the 5% threshold under the adverse scenario in the stress test exercise to promptly remedy this capital shortfall by the end of 2011,16 banks whose Core Tier 1 Ratio falls between 5% and 6% to improve their capital position and remedy capital by April 2012.

Soundness standards of European banking sector was enhanced. In October 2011, EU summit approved a package of measures to restore confidence in the banking sector, including starting term funding guarantee scheme to meet banks' medium-term funding needs, strengthening banks' capital position by requiring banks' Core Tier 1 capital ratio reach 9% by the end of June 2012 and build up a temporary capital buffer against sovereign debt exposures. In December, EBA published *Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence*, specifying the instruments to build up capital buffers and the methodologies of calculating capital target, requiring national supervisory authorities should ensure banks to establish capital buffer by the end of June 2012 and reach 9% Core Tier 1 capital ratio.

4. Korea and Japan

In September 2011, the new Bank of Korea Act came into force. The Act further strengthened macro-prudential mandate of the Bank of Korea (BOK) by expanding its powers and responsibilities, improving macro-prudential instruments. Firstly, enhance the central bank's access to information and reinforce its on-site examination power. The range of financial institutions required to submit materials to the BOK was expanded to those institutions as setting out in the Act on Structural Improvement of the Financial Industry, examination mandate was enhanced. Secondly, improve emergency liquidity support facilities and ease the requirements for liquidity support by the BOK. The BOK could provide emergency liquidity support to financial institutions when their liquidity deteriorates due to mismatch between funding and use of funds. The conditions of BOK credit extension to profit-seeking enterprises was eased, the BOK could extend credit to those enterprises when severe impediments to obtaining funds from financial institutions occur or when there is a strong likelihood of their occurrence. The range of securities eligible as collateral for loans extended by the BOK was expanded and the securities lending facility was incorporated into open market operation instruments. Thirdly, enrich the BOK's policy instruments to responding to shocks, increasing central bank's discretionary power in reserve requirement regime.

In October 2011,the Bank of Japan (BOJ) published *The Bank of Japan's Initiatives on the Macroprudential Front*, stocktaking the macro-prudential practices conducted by the BOJ as follows: on-site examination on financial institutions in accordance with the mandate stipulated in the Bank of Japan Act, integrating macro-prudential regulation with on-site examination and off-site monitoring; regularly release of *Financial system report*, assessing financial stability; necessary liquidity support as the lender of last resort; conducting monetary policy from macro-prudential perspective; improving payment and settlement systems to enhance the safety and efficiency of the systems.

III. China's Progress on Strengthening Macro-prudential Regulation

The 12th Five-Year Plan clearly put forward to set up a countercyclical financial macro-prudential framework. In 2011, China explored actively in enhancing macro-prudential regulation, continuously improving and strengthening financial statistics and risk monitoring and assessment, refining the countercyclical macro adjustment mechanism centering upon dynamic adjustment of differentiated reserve requirement, strengthening supervision on SIFIs, setting up crisis management and risk resolution framework. In the next stage, the macro-prudential policy framework should be further improved and tailored to China's domestic circumstances by drawing on lessons from the global crisis and international sound practices. A mechanism to coordinate macro-prudential regulation and micro-prudential supervision should be put in place to enhance capacity of systemic risk prevention and increase sustainability of financial support to economic growth.

1. Strengthening financial statistics and risk monitoring and warning system

In 2011, the PBC started to publicize total financing to the real economy, comprehensively reflecting the total amount of funds provided to real economy by financial sector. The statistics of aggregate financing of the economy covers banking, securities and insurance institutions, involving credit market, bond market, stock market, insurance market and intermediaries, better measuring the financing condition and liquidity of entire society, reflecting risk transfer across various financial institutions and various markets. Meanwhile, financial statistics standardization has been promoted actively, measurement methodologies and classification standards on financial institutions, financial instruments and financial products were consolidated. Financial stability monitoring and assessment framework has been improved, risk monitoring, assessment and warning on wealth management products, financial holding companies and industrial-financial conglomerates has been strengthened, cross-sector, cross-market and cross-border financial risks have been prevented effectively. The risk monitoring system on private financing, micro-credit companies, pawnshops, guarantee companies and other non-financial institutions providing financing services has been established. Review of resilience of financial institutions as well as the ways and features of systemic risk transferring across financial institutions was conducted by using comprehensively various analysis instruments including stress testing and model analysis to make monitoring more scientific, systemic and forward-looking. China Banking Regulation Commission (CBRC) paid highly attention to potential systemic risks including industrial structures, industry policies and movements in assets price, built up actively prudential supervision framework for banking sector, continuously reinforced warning and alerting on systemic risks.

In the next stage, efforts should be made to accelerate the establishment of a comprehensive financial statistical system with full coverage, uniform standards and information sharing; build up a statistical system covering banking, securities and insurance sectors as well as domestic and overseas business; expand coverage of financial statistics and promote financial statistics standardization. Measures should be taken to improve systemic risk monitoring and warning system, strengthen monitoring and assessment on inter-linkages of financial system, linkage between macro economy and financial system and cross-border economic and financial interconnectedness, enhance quantitative analysis capacity on monitoring and warning of systemic risk. Risk monitoring in key areas and crucial links should be ensured, various potential risks should be keenly perceived, timely reported and properly tackled.

Box23 Analysis on Financial Network Stability

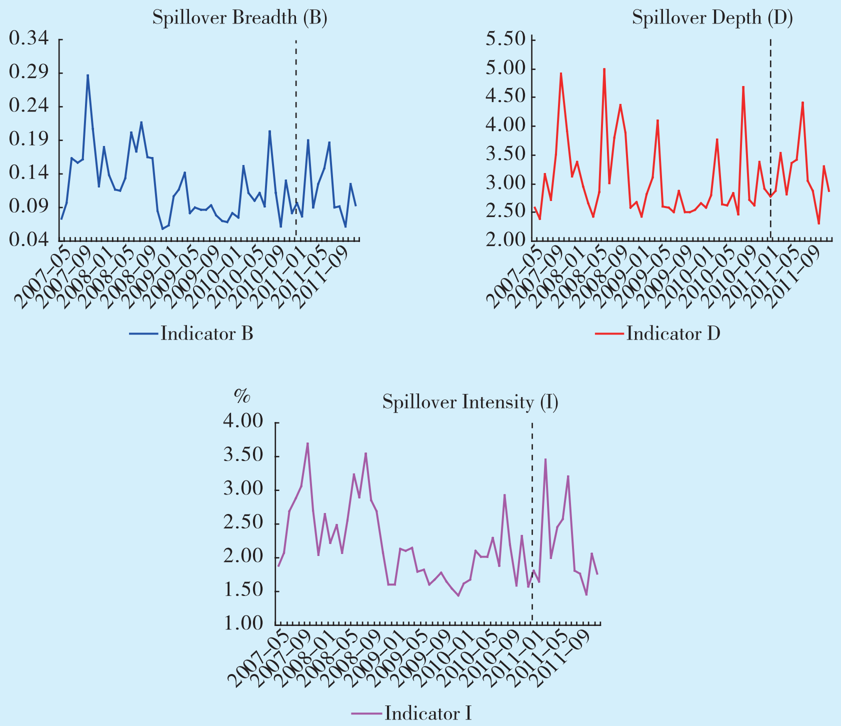
Monitoring accurately systemic risk in various dimensions, analyzing comprehensively effects of macro-prudential policy instruments laid the foundation of macro-prudential policy. Based on financial network model①, we make a further dynamic mapping and update on overall stability and structure of the entire financial network by using data from inter-bank payment and settlement system from 2007 to 2011.

From the movements of major indicators on financial network stability of China from May 2007 to December 2011, breadth (*B*), depth (*D*) and intensity (I)② experienced downward movements with volatility, with average range of fluctuation increased. Compared to historical trend, financial stability indicators experienced upward movements in some specific periods, such as March and July (Figure 8.2).

① Refer to explanation regarding to financial network model based on data from payment and settlement system of Box 19 in *China Financial Stability Report* 2010.

② Breadth (*B*), Depth (*D*) and Intensity (*I*) indicators refer to institutions affected, round of impacts and funds affected. The higher indicators, the weaker network stability and the higher systemic risks and vice versa.

Figure8.2 Movement of Financial Network Stability Indicators (2007–2011)



Source: The PBC.

We select June 2011 as the time point for updated analysis on structural characteristics and movements of payment network composed by large commercial banks[①], policy banks[②], joint stock banks and foreign banks, the results are as follows:

When there are liquidity shocks coming from large commercial banks respectively, on average around 36 banks would be affected more or less. The spillover would last for 5 rounds on average, and the proportion of affected fund exceeds 14% on average. If all of large commercial banks are regarded as a whole, the spillover would last 6 rounds, and most of institutions would be affected. Compared to June 2010, large commercial banks still have strong impact on the network.

When there are liquidity shocks coming from policy banks, on average 24 institutions would be affected, the

① In this Box, large commercial banks refer to four banks, ICBC, ABC, BOC and CCB. BOCOM is included in joint stock commercial banks.

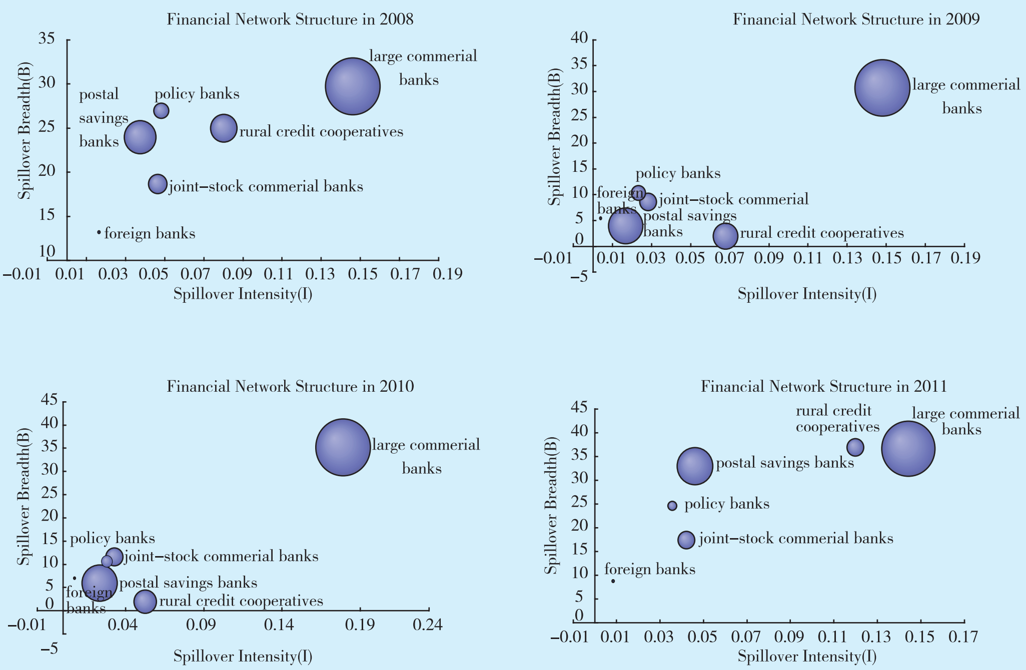
② In this Box, policy banks refer to three banks, CDB, EXIM and ADBC.

spillover could last up to 9 rounds, and the proportion of affected fund rises to 4% on average. Except for foreign banks, the affected institutions also include some joint stock banks. In general, both scope and intensity of impact of policy banks get obvious enhancement.

When there are liquidity shocks coming from joint-stock commercial banks respectively, on average 17 institutions would be affected, the spillover would last 4 rounds and the proportion of affected fund would be 4%. It shows that the impact of joint stock banks on the network has been strengthened compared to June 2010, but still is lower than that of large commercial banks.

The role of foreign banks in the network is relatively stable. When there are liquidity shocks coming from individual foreign banks, on average 8 institutions would be affected, the spillover would last nearly 3 rounds and affecting 1% of transaction volume. This shows the impact of foreign banks is still relatively weak. However, the empirical study shows due to large number and changing activities, foreign banks are also major elements affecting network structure.

Figure8.3 Comparison of Financial Network Structures in 2008 and 2011①



Source: The PBC.

① Figure shows network stability indicators of major net nodes in 2008-2011, the area of the spheres represents average position of institutions of various types.

2. Setting up the Countercyclical Macro-adjustment Mechanism

In 2011, the PBC further improved dynamic adjustment of differentiated reserve requirement, integrating adjustment of aggregate credit and liquidity with the macro-prudential conception, associating credit extension with capital position required by macro-prudential regulation, taking into account systemic importance and soundness of financial institutions, as well as the phase in the economic cycle, guiding and incentivizing the sound operation and countercyclical credit extension of financial institutions. Dynamic adjustment of differentiated reserve requirement, coordinating with interest rates, open market operations, reserve requirement and other traditional monetary policy instruments, has achieved positive results, credit increased steadily, credit extension returned to the normal level, the soundness of financial institutions was enhanced, and the capital adequacy remained high. In Q4 of 2011, by adjusting relevant parameter, dynamic adjustment of differentiated reserve requirement played a positive role in preconditioning and fine-tuning of policies. The CBRC continuously improved supervisory instruments, introducing dynamic provisioning and leverage indicators.

In the next stage, actions should be taken to continuously give full play to countercyclical adjustment function of dynamic adjustment of differentiated reserve requirement, improve and adjust timely parameters, lead credit increase in a moderate manner, enhance resilience of financial institutions. Efforts should be made to enrich and supplement other policy instruments and measures, set up countercyclical capital buffer and forward-looking provisioning tailored to China's banking sector, improve management system on liquidity and leverage indicators, strengthen coordination and cooperation among various instruments, enhance flexibility of policy implementation.

3. Policy Measures to Strengthen Supervision on SIFIs in China

In recent years, with gradual growth of size, complexity of structural organization and business lines, as well as increasing interconnectedness, some large commercial banks and non-bank financial institutions have been fledged with characteristics of systemically important financial institutions (SIFIs). In order to prevent potential risk, in 2011, while deeply participated in SIFIs initiatives at international organizations, the PBC together with relevant authorities, researched policy measures to prevent and reduce risks of SIFIs in China based on domestic circumstances. Firstly, assessment methodology of SIFIs in China has been under development. Adhering to the overall principle of strengthening resilience of SIFIs, reducing moral hazards, preventing risk spillover and contagion, maintaining financial system stability, combining quantitative indicators with qualitative judgment, taking into account size, interconnectedness, sustainability and complexity, as well as institutions' risk profile and the potential impact of institutions' resolution. Secondly, research was made on strengthening macro-prudential regulation on SIFIs in China. Policy measures on SIFIs were enhanced by using dynamic differentiated reserve requirement, countercyclical capital buffer, and capital surcharge. Research has been conducted on building a risk resolution and liquidation arrangements for SIFIs in China.

As the request of enhancing supervision on SIFIs and integrated financial services, developing identification standards and assessment framework of SIFIs, setting higher regulatory requirements and strengthening market disciplines, made by Premier WEN Jiabao at the National Financial Work Conference, in the next stage, efforts should be made to develop regulation on financial holding company, clarify responsibility for supervision of financial holding company, enhance capital adequacy requirements and regulate affiliated transactions. Private equities with assets under management (or consolidated assets of the invested firm) exceeding a certain amount or simultaneously investing in financial and real sector should be incorporated into supervision. Risk resolution and liquidation arrangements with clear structure and well-defined responsibilities should be in place, with strengthening accountability of firms, creditors and shareholders, to make sure that SIFIs could be orderly resolved.

4. Improving the Framework for Crisis Management and Systemic Risk Resolution

In recent years, China has continuously strengthened crisis management and systemic risk resolution regime, promoted actively long-term effective mechanism for preventing systemic risks. The central bank's function of lender of last resort has been strengthened, insolvent financial institutions have been properly tackled by providing specific loan to local governments, emergency loan and risk resolution loan, the central bank has demonstrated an important role in maintaining financial stability. Establishment of deposit insurance scheme has been promoted by drawing on international experiences on risk resolution with an aim to set up a market-oriented exit mechanism of financial institutions. The deposit insurance designing proposal has been improved for several times, currently, the time for introducing deposit insurance scheme has been ripe Resolution regime for financial institutions in China has been reviewed with reference to the latest developments of resolution regime made by international organizations, measures to improve systemic risk resolution framework has been researched.

In the next stage, the lender of last resort function of central banks should be improved with more clarified mandate and function and enriched policy instruments and measures. Efforts should be made to maintain the soundness and flexibility of central banks' balance sheets, and endow central banks with discretionary power in the abnormal time and make sure they could expand scope of assistance and use new resolution instruments when necessary. Systemic risk resolution regime should be improved, and a well-designed, operating effectively deposit insurance scheme with powers commensurate with responsibilities should be set up as soon as possible at the request of the National Financial Work Conference. The cost sharing mechanism in financial risk resolution should be improved with strengthened coordination among relevant authorities and policy instruments.

Box24 Financial Stability Board Conducted Thematic Review on Deposit Insurance

In June 2009, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) jointly issued *Core Principles for Effective Deposit Insurance Systems (Core Principles)*, which set out 18 core principles from 10 aspects including setting objectives, mandates and powers, governance, cross-border cooperation, coverage, funding, failure resolution, reimbursing depositors and recoveries. In December 2010, BCBS and IADI issued a methodology to enable assessments of compliance with these core principles, the IMF and the World Bank have also planned to assess compliance with this standard under their Reports on Observance of Standards and Codes (ROSC) program. In order to take stock of member jurisdictions' deposit insurance systems and of any planned changes using the Core Principles as a benchmark, the FSB conducted a peer review of deposit insurance systems in April 2011, the final report was published in early 2012, the main findings of the report are as follows:

The Majority of FSB member jurisdictions have uniform deposit insurance system in place. Of 24 FSB members, only South Africa, Saudi Arabia and China haven't established explicit deposit insurance yet, in particular, South Africa has planned to introduce a deposit insurance system operated by the central bank in 2012. The majority of the 21 FSB members with explicit deposit insurance system have uniform system; very few jurisdictions have multiple systems for various types of deposit-taking financial institutions. The assessment concludes the existence of multiple DISs presents organizational complexities that could lead to inefficiencies in addition to potential competitive concerns. There could be benefits on the efficiency of financial safety net from consolidating the various systems.

The mandates of deposit insurance system in FSB member jurisdictions have been expanded. The mandates of deposit insurance systems in FSB member jurisdictions are broadly classified into four categories: the first one is "paybox" mandate, narrow mandate systems that are only responsible for the reimbursement of insured deposits; the second one is "paybox plus" mandate, where the deposit insurer has additional responsibilities such as resolution functions; the third one is "loss minimizer" mandate, where the insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies; the fourth one is "risk minimizer" mandate, where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities. Deposit insurer in large-sized jurisdictions such as the United States and Japan are mainly "loss minimizer" or "risk minimizer", while deposit insurer in medium or small- sized jurisdictions or jurisdictions where a large-scale financial risks haven't occurred in a long term such as Singapore, Holland are mainly "paybox" or "paybox plus". The mandates of deposit insurance system in FSB member jurisdictions have been expanded following the recent crisis; some member jurisdictions intensified the role of deposit insurance system in resolution of financial institutions. The report suggests the expansion in mandates will likely continue in the future.

Deposit insurance systems with ex-ante funding and risk-based premium are prevailing. The assessment shows most of all member jurisdictions choose ex-ante funding mechanism. The FSB propose that it's more necessary for jurisdictions with large-sized banking sector and high market concentration to build up ex-ante funds. And besides, back-up funding arrangements should be considered particularly. More than half of the deposit insurance systems collecting premiums ex-ante utilize risk-based premium system that may help to mitigate moral hazard but is also more procyclical, which could be mitigated by institutional design.

The report concludes that member jurisdictions' deposit insurance systems are broadly consistent with the *Core Principles*, but further assessments and improvements are still in need. The jurisdictions without deposit insurance system should expedite establishing one.

Special Topic Ⅰ

The Banking Sector Stress Test

I. The Snapshot of the Stress Test

At the end of 2011, aimed at establishing and improving the systemic risk prevention and early-warning system , as well as identifying and assessing potential risks in the financial system,the PBC established the Financial Stability Stress Testing Team (hereafter referred to as "PBC Stress Testing Team") and organized commercial banks to conduct the Financial Stability Stress Test. The test, which mainly targeted on credit risk of commercial banks, was composed of "Sensitivity Stress Test for Aggregate Credit Risk and Credit Risk in Key Areas" (hereafter referred to as "Sensitivity Stress Test") and "Macroeconomic Scenario Stress Test" (hereafter referred to as "Scenario Stress Test").The test, based on the end of 2011 balance sheet data of 17 commercial banks, was to assess the soundness of commercial banks amid negative shocks in 2012.

Scope. The test covered 17 large commercial banks and JSCBs. Large commercial banks included ICBC, ABC, BOC, CCB, and BOCOM; and JSCBs included China Merchants Bank, Shanghai Pudong Development Bank, China CITIC Bank, Industrial Bank, China Minsheng Banking Corporation, Everbright Bank, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, Evergrowing Bank, China Zheshang Bank, and Bohai Bank. As of the end of 2011, total assets of the 17 commercial banks, which were highly representative, accounted for around 65 percent of the total assets of the overall banking institutions.

Approaches and Methodologies. The Sensitivity Stress Test and the Scenario Stress Test followed both top-down approach and bottom-up approach. The PBC Stress Test Team conducted the top-down approach after aggregating financials from the 17 participating commercial banks with predetermined templates. The bottom-up approach designed to evaluate the risk profile of individual or various groups of commercial banks was carried out discretionarily by participating banks, then the test results were compiled and analyzed by the PBC Stress Testing Team. The Sensitivity Stress Test directly assessed the impact of exposure quality deterioration; the Scenario Stress Test applied econometric models to evaluate the changes of overall NPL ratio and CAR in banking system during periods of macroeconomic downturn.

Stress Scenarios① . Tailored to the characteristics of credit structure in China's banking system, and in alignment with domestic and global economic and financial conditions, the Sensitivity Stress Test has evaluated credit risks in 9 key areas besides the aggregate credit risk, so as to gauge the picture of potential risks in key areas and enhance broadness

① It should be noted that the stress scenarios were set based on the results of questionnaires to external economic experts, and should not be assumed to represent PBC's judgments on macroeconomic condition.

and depth of risk monitoring. The key areas included customer concentration, loans to LGFPs, loans to overcapacity industries, loans to road industry, loans to export industries, loans to industries greatly affected by oil price, wealth management products, assets exposures to EU and real estate loans. The stress indicators selected in the Scenario Stress Test were GDP growth rate, M_2 growth rate and CPI annual rise, which generally characterized the overall economic conditions. The severity of the shocks to stress indicators was determined based on financial experts' forecasts. The stress scenarios of the Sensitivity Stress Test and the Scenario Stress Test were as follows (Table 1).

Table1 Scenarios for the Financial Stability Stress Test

<table>
<tr><th>Types of Testing</th><th>Stress Target</th><th>Stress Scenarios</th></tr>
<tr><td rowspan="9">Sensitivity Stress Test</td><td>Aggregate credit assets</td><td>• Mild: NPL ratio up 100 percent[1]
• Medium: NPL ratio up 250 percent
• Severe: NPL ratio up 400 percent</td></tr>
<tr><td>Customer concentration</td><td>• Mild: default of the first largest group (legal entity) customer
• Medium: default of the first 2 largest group (legal entities) customers
• Severe: default of the first 3 largest group (legal entities) customers</td></tr>
<tr><td>Loans to LGFPs</td><td rowspan="5">• Mild: NPL ratio up 5 percentage points[2]
• Medium: NPL ratio up 10 percentage points
• Severe: NPL ratio up 15 percentage points</td></tr>
<tr><td>Loans to overcapacity industries</td></tr>
<tr><td>Loans to road industry</td></tr>
<tr><td>Loans to export industries</td></tr>
<tr><td>Loans to industries greatly affected by oil price</td></tr>
<tr><td>Exposures to off-balance sheet wealth management products[3]</td><td>• Mild: 10 percent loss of off-balance sheet wealth management products
• Medium: 20 percent loss of off-balance sheet wealth management products
• Severe: 30 percent loss of off-balance sheet wealth management products</td></tr>
<tr><td>Assets exposures to EU [4]</td><td>• Mild: 20 percent loss of asset exposures to EU
• Medium: 30 percent loss of asset exposures to EU
• Severe: 40 percent loss of asset exposures to EU</td></tr>
</table>

concluded

Types of Testing	Stress Target	Stress Scenarios
	Real estate loans	• Mild: NPL ratios of personal mortgage loans and real estate development loans (including land reserve loans) up 3 and 5 percentage points respectively • Medium: NPL ratios of personal mortgage loans and real estate development loans (including land reserve loans) up 4.5 and 10 percentage points respectively • Severe: NPL ratios of personal mortgage loans and real estate development loans (including land reserve loans) up 7.5 and 15 percentage points respectively
Sensitivity Stress Test	Aggregate credit assets	• Mild: GDP growth rate down to 8 percent • Medium: GDP growth rate down to 6 percent • Severe: GDP growth rate down to 4 percent (M_2 growth rate and CPI annual rise were comprehensively set according to experts' opinions)

Notes：1. Assuming that the initial NPL ratio is X percent, up n percent means the NPL ratio becomes X%（1+n percent）.

2. Assuming that the initial NPL ratio is X percent, up n percentage points means the NPL ratio becomes (X+n) percent.

3. In terms of the investment orientations of wealth management products, the exposure tested in this stress test was credit wealth management products, exclusive of products invested in bonds and deposits, capital market trust or overseas wealth management products, etc.

4. Asset exposures to EU refer to exposures of commercial banks (including overseas subsidiaries) to EU sovereign debts and corporate loans, on-balance sheet trade financing, bonds, interbank financing and derivatives.

II. Summary Results of the Stress Test

The banking system showed strong resilience to shocks. The results of the Sensitivity Stress Test and the Scenario Stress test indicated satisfactory asset quality and capital adequacy of China's commercial banks. The banking system represented by the 17 commercial banks remained resilient to macroeconomic shocks and achieved stable performance.

The result of the Sensitivity Stress Test indicated that under the severe shock when the overall NPL ratio rose up 400 percent, the CAR of the banking system would decrease from 12.33 percent to 10.89 percent (Figure1). In particular, the CAR of the large commercial banks decreased by 1.63 percentage points while CAR of the JSCBs decreased by 0.92 percentage point. Under the mild, medium and severe shocks to credit risk exposures in 9 key areas, the overall CAR of the banking system maintained a high level. Even under the severe shock, the CAR was no lower than 11.15 percent (Figure2).

Figure1　The Sensitivity Stress Test for Aggregate Credit Asset: Overall

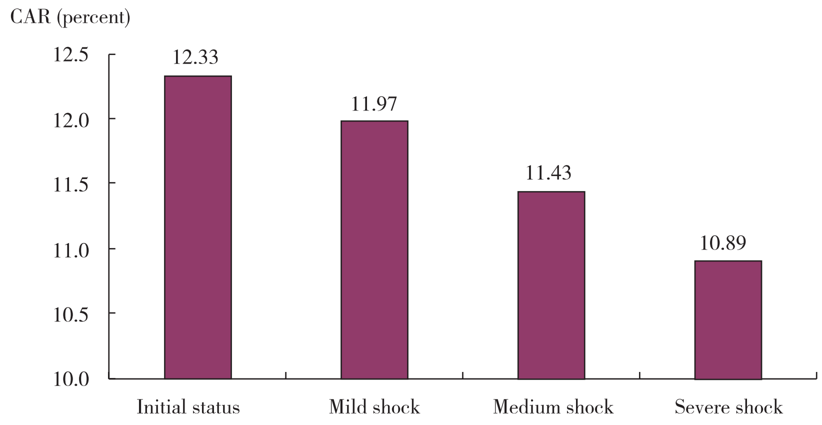
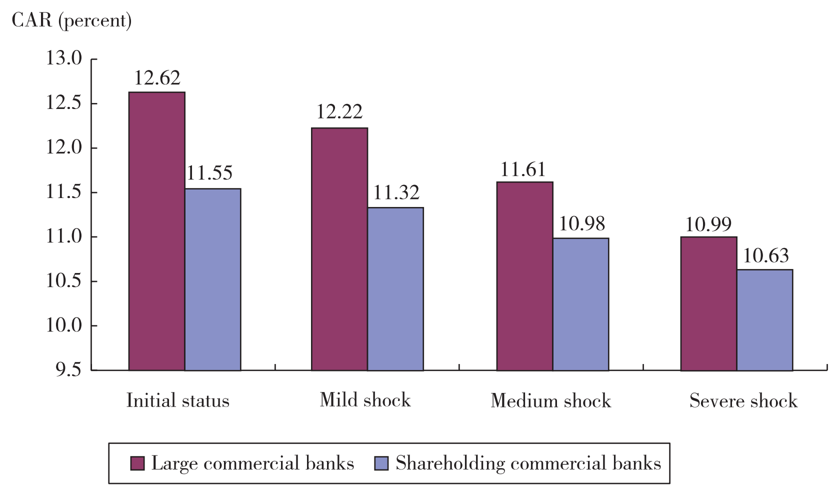


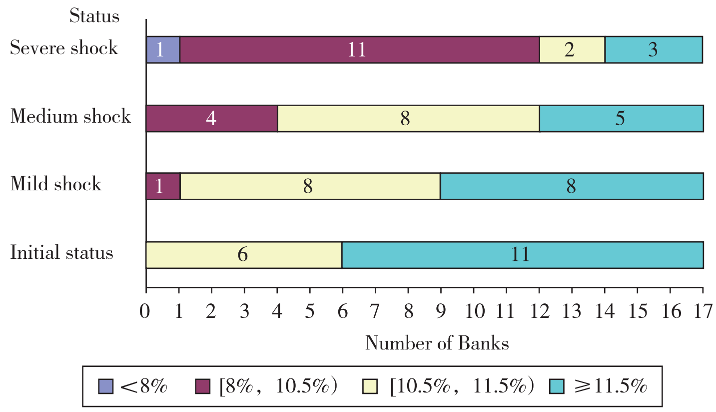
Figure2　The Sensitivity Stress Test for Aggregate Credit Asset: by Group



Source: 17 commercial banks, calculation of the PBC Stress Testing Team.

The result of the Scenario Stress Test indicated that, under mild, medium and severe shocks, the overall CAR of the banking system would decrease by 0.42, 0.86 and 1.68 percentage point(s) respectively. In particular, medium and severe shocks would have significant impact on the banking system, but the high CAR under such shocks indicated China's banking system's strong resilience to macroeconomic shocks and stable performance. Under the status quo, 11 of the 17 commercial banks had CAR higher than 11.5 percent, while under the mild, medium and severe shocks, the number would decrease to 8, 5 and 3 respectively (Figure3).

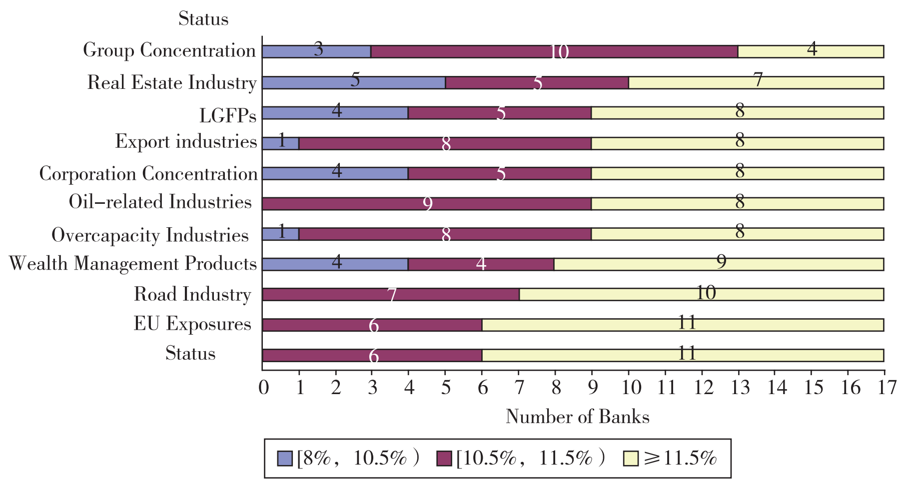
Figure3 Distribution of Bank's CAR: the Scenario Stress Test



Source: 17 commercial banks, calculation of PBC Stress Testing Team.

Soundness condition in a number of areas warrants concern. According to the results of stress testing for exposures to 9 key areas, risk profiles in areas such as real estate, LGFPs, and off-balance sheet wealth management products, as well as customer concentration risk warrant concerns (Figure4).In terms of the institutional distribution, due to the differences in capital adequacies, risk exposures and asset qualities, there were varieties among commercial banks in risk-resistance capacity.

Figure4 Distribution of Bank's CAR: the Sensitivity Stress Test (Severe Shock)



Source: 17 commercial banks, calculated by PBC Stress Testing Team.

Special Topic II

China Initial Financial Sector Assessment Program was Completed Successfully

The International Monetary Fund (IMF) and World Bank jointly developed Financial Sector Assessment Program (FSAP) in May 1999 with an aim to strengthen assessment and monitoring on financial vulnerability of IMF member countries (jurisdictions), so as to reduce the possibility of financial crisis and promote financial reforms and development in member countries (jurisdictions). With ongoing development and improvement, the FSAP has become an internationally accepted framework for financial stability assessment.

In February 2008, Chinese Premier Wen Jiabao announced in a meeting with the then IMF President that China would participate in the FSAP. In November 2008, President Hu Jingtao together with the G20 leaders committed unanimously to undertake FSAPs in their own jurisdictions at the Washington Summit. In order to fulfill the commitment and review Chinese financial system stability from an international perspective, China formally initiated it's first FSAP assessment[①] by IMF and the World Bank in August 2009. In the next two years, the relevant Chinese government agencies cooperated closely according to the plan and the assessment completed successfully.

I. An overview of China FSAP

In order to facilitate the process of FSAP assessment, the People's Bank of China (PBC), together with other agencies including the Ministry of Foreign Affairs (MFA), National Development and Reform Commission (NDRC), Ministry of Finance (MOF), Ministry of Human Resources and Social Security (MHRSS), Ministry of Commerce (MOC), National Bureau of Statistics (NBS), Legislative Affair Office of the State Council, China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC) and State Administration of Foreign Exchange (SAFE), set up working mechanism and principles, and established FSAP Cross-agency Leading Group and Cross-agency Working Group respectively. China FSAP assessment progressed positively.

The initial preparation was made actively. Since China FSAP was initiated, the PBC together with other Cross-agency Working Group members actively made preparations for each work stream to facilitate the assessment. First, organized and coordinated IMF/World Bank technical mission to visit China to make consultations on FSAP scope and hold training on the FSAP Pre-mission Questionnaires, Data, and Information requests (henceforth, FSAP QDI). Second, signed *China FSAP: Memorandum on the Scope of Work* with IMF/World Bank scoping mission, which

① For developing and emerging market countries, FSAP assessments are conducted by IMF and Word Bank jointly, and that are conducted by IMF alone for developed countries. According to IMF requirements, being one of the systemically important countries, China will undertake FSAP updates every five years.

served as a working guideline for China FSAP assessment. Third, the completion of FSAP QDI with high quality and efficiency provided a sound data and information support to FSAP assessment. Fourth, *China FSAP: Implementation Framework of Stress Testing* was formulated to conduct an overall stress testing on 17 major commercial banks and make quantitative analysis on the resilience and soundness of the banking system.

The on-site assessments were carried out thoroughly. In order to get a full understanding of Chinese financial system, since 2010, China FSAP team, comprising officials from IMF/World Bank and national experts on finance, central banks, commercial banks, securities and insurance, etc., conducted two on-site FSAP missions in China. And some of the FSAP mission members also conducted specific assessment and follow-up assessment in China. The FSAP mission held about 400 meetings with relevant authorities, some local governments, big financial institutions and intermediaries. Information exchange and detailed assessment involved six areas including Chinese macro-financial risk and financial system vulnerabilities, institutional regulatory and supervisory framework, systemic liquidity framework and financial stability, financial market infrastructure, financial development issues and access to financial service, contingency planning and crisis resolution arrangements. Through the on-site meetings, FSAP mission has achieved a deep and objective recognition and understanding of Chinese financial system, which laid a sound foundation for systematically assessing Chinese financial system stability.

The FSAP reports were published smoothly. Based on responses to FSAP QDI and on-site assessment, the FSAP team drafted a series assessment reports, including *China: Financial System Stability Assessment* (FSSA), *China: Financial Sector Assessment* (FSA)[①], China FSAP: *Detailed Assessments Reports on Observance of Financial Standards and Codes* (DARs) and a number of technical notes and background notes. The PBC, together with relevant agencies, consulted and exchanged views repeatedly with FSAP team and prompted the latter to revise the incorrect judgments in the reports to reach an objective evaluation of Chinese financial system. The FSSA, FSA and DARs of China FSAP was published on IMF and World Bank websites, demonstrating the financial reform and development achievements and the image of a stable and sound financial system of China, deepening the rest of the world's understanding of Chinese financial sector.

II. The conclusions of China FSAP are positive and constructive

In overall, the FSAP reports evaluated Chinese financial system from an international

① FSSA and FSA are the comprehensive FSAP reports covering the main findings and conclusion. FSSA was drafted by IMF focusing on financial stability analysis, while FSA was drafted by the World Bank focusing on financial development analysis.

perspective, fully recognized the remarkable achievements in recent financial reforms and development, conducted system-wide analysis on the impact of potential risks on the macro financial stability and made conducive recommendations which are of relevance to enhancing the soundness of Chinese financial system.

1. China's financial system reform efforts have had remarkable results and the overall system is stable

It is noted in the reports that China has made remarkable progress in the areas of commercialization, strengthening financial soundness, among other things, which is due to that the Chinese government promoted and completed a series of profound financial reforms and the effective supervision of the central bank and regulatory agencies. An overall stable financial system, smoothly progressed financial reforms, more resilient financial institutions and a growing diversification of financial service and products have strongly supported China's economic growth. Meanwhile, there still remain issues such as structural financing imbalances and insufficient commercialization of the financial system, inadequate inclusiveness of financial products and services, and the need for further improvement in the pension system and financial infrastructure.

The main near-term domestic risks to the financial system 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 of lending outside of the formal banking sector; (iii) the relatively high level of real estate prices; and (iv) the increase in imbalances due to the current economic growth pattern.

Jointly conducted stress tests of the largest 17 commercial banks indicate that thanks to the shareholding reforms, China's banks have continuously improved internal control and asset quality, with adequate capital and sufficient liquidity. They managed risk prudently and could be relatively resilient to varied shocks, which helps to maintain stable performance of the whole banking system.

2. Chinese regulatory and supervisory framework shows a high degree of adherence to international standards

The five DARs with an overall assessment of China's adherence to relevant international standards and codes in banking, securities, insurance, payment system and securities settlement respectively concluded that Chinese financial regulatory and supervisory framework showed a high degree of adherence to international standards, however, further improvement is needed. The DARs also pointed out the inadequate resources of regulatory agencies of banking, securities and insurance sectors, and more resource should be equipped to ensure effective supervision.

With banking sector's compliance to *Basel Core Principles for Effective Banking Supervision*, regulation and supervision of China's banking system has made impressive progress in improving regulatory framework and enforcing prudential supervision, and significant improvements in risk measurement and management were achieved. However, there are still needs to improve the implementation of laws and guidance, enhance risk vigilance and risk management so as to meet the challenges of further opening up and innovation.

With securities sector's implementation of *IOSCO Objectives and Principles of Securities Regulation*, the regulatory agency actively conducted supervision on the securities market and made remarkable progress in infrastructure construction and fostering healthy development of the markets. But the market discipline needs to be further strengthened and the supervision rules should be uniformed. Actions against market manipulation and illegal investment should be strengthened.

With insurance sector's observance to *IAIS Insurance Core Principles*, the regulatory agency has implemented a comprehensive supervision framework. Remarkable progress has been made in disclosure and consumer protection and risk management in insurance companies. But the insolvency supervision needs to be further strengthened and the insolvent companies should be restricted to writing new business. With payment system's observance to *CPSS Core Principles for Systemically Important Payment Systems*, the PBC has carried out landmark reforms of its National Advanced Payment System in recent years, which provides fast, efficient, secure, and reliable settlement services to market participants. But improvement needs to be made in legal foundation, risk management and system management.

With securities settlement systems' observance to *CPSS-IOSCO Recommendations for Securities Settlement Systems and Central Counterparties*, the trading volume of Chinese securities markets grew steadily in the past two decades with the securities settlement systems playing a key role. But improvement still needs to be made in settlement risk management, governance and transparency, oversight and regulation, cross-border risk management etc..

3. Further progress in financial reforms is required to maintain financial stability

The FSAP reports recommend that further financial reforms are required with an aim to promote further healthy and stable development of Chinese financial system and effectively address financial risks.

The commercialization of the financial system needs deepening. Systemic liquidity management needs to be improved and measures should be taken to absorb the significant liquidity overhang. A liberalized and flexible foreign exchange market is necessary. Authorities should rely more on indirect monetary policy instruments and market-based interest rates should become the primary instrument for managing credit expansion. The roles and functioning of policy financial institutions from commercial financial institutions should be clearly delineated. The use of commercial bank credit for policy goals should be replaced by other mechanisms such as direct fiscal expenditures, direct lending by policy banks, government-sponsored credit programs for developmental credit. In addition, transforming Asset Management Companies (AMCs) into commercial entities is recommended.

The framework for financial stability and crisis management should be upgraded. The latest financial crisis showed that separated regulation and supervision regime lacked managing systemic risk from macro-prudential perspective. China should draw the lessons and upgrade its financial stability framework and regime. Regarding monitoring and managing systemic risk from a systemic linkage perspective the oversight of Systemically Important Financial Institutions (SIFIs) should be strengthened, the regulation and supervision of financial holding companies should be clarified, and an early warning system should be explored. With respect to crisis management, a deposit insurance scheme needs to be introduced to expand resolution toolkit and make orderly wind-down of financial institutions a practical option.

The financial regulation and supervision needs to be further strengthened. An assessment of the regulatory and supervisory framework reveals a high degree of adherence to international standards, but its efficiency and responsiveness need to be increased to meet the need of financial innovation and development. There is a need for an expansion of the regulatory and supervisory perimeter, combined with robust systemic oversight. Regulatory policies applying to shadow banking and their interconnections needs to be clarified and made transparent. A framework for regulation and supervision of financial holding companies should be developed. The central bank and supervisory commissions should coordinate closely to improve information sharing and coordination arrangements. In the banking sector, the commercialization reform of banks should be progressed further. Banks' risk management techniques and practices need to be upgraded and the strong dependence on collateral need to be addressed and a forward-looking valuation practices need to be built. In the securities sector, the legal and regulatory system needs improvement. The threshold for action with failed intermediaries should be lowered to allow for early intervention. The monitoring on the stock exchanges should be strengthened and regular comprehensive on-site inspections need to be conducted. In the insurance sector, the insolvency supervision needs to be reinforced and market exit mechanism should be improved. The off-site monitoring should be strengthened and the direct intervention on the products, allocation and investment strategy of insurance companies should be reduced gradually.

Financial infrastructure and relevant legal systems need to be further upgraded. The payment and securities settlements systems need to be improved. The authorities should ensure that the legal framework gives full protection to payments, derivatives, and securities settlement finality. The coverage and quality of the Credit Reference Center need to be improved. The improvement of financial laws and regulations need to be strengthened. A clear legal process for dealing with troubled financial institutions should be defined and market exit should be improved. The accounting and information disclosure should be enhanced. The financial literacy program should be strengthened to enhance to risk-bearing awareness of financial consumers. The anti-money laundering and combating the financing of terrorism law needs to be further improved and preventive measures to non-financial activities and sectors should be taken accordingly.

Financial markets and services need to be broadened. The development of fixed income markets should be further deepened, including taking more proactive strategy for government bond issuance, developing a diversified domestic institutional investor base, proportionately increasing different types of financial instruments and enhancing the interconnection across markets. Based on the multi-pillar pension system, the long-term investment strategy of pension funds should be improved to expand allocations to equity and long-term bonds gradually. The development of personal pension plans should be fostered by designing personal income tax incentives for the contributions or matching fund contributions for low income individuals to channel part of precautionary savings into retirement savings. The policy and strategy for promoting inclusive finance should be strengthened to improve access to finance and broaden the coverage of financial service.

The FSAP reports noted that sequencing financial reforms at an appropriate pace will be a challenge, but essential to China's sustained growth. A rational prioritization of reforms is crucial to maintain a balance between development and financial stability while minimizing risks.

In summary, the FSAP is a comprehensive and system-wide assessment of Chinese financial system by the international organizations for the first time. It helped the financial regulatory authorities of China to conduct a stock-taking of the financial system and institutional framework and made a number of useful recommendations. It will help to further promote China's financial reform and development.

Special Topic III

Actively and Prudently Advance the Pilot Program of Integrated Financial Services

The 11th Five-Year Plan issued in March 2006 explicitly set out the objective of "prudently advancing the pilot program of integrated financial services". Under the leadership of the Communist Party of China (CPC) Central Committee and the State Council, the pilot program has made good progress in the past six years, with much improved business structure and profitability. The global financial crisis has proven once again that integrated financial services remains the major development trend of the international financial sector. In March 2011, the 12th Five-Year Plan darified again the objective "to prudently advance the pilot program of integrated financial services". Drawing on the experiences and lessons at home and abroad, and taking into account the reality of the financial sector development in China, efforts are being made to clarify the policy orientation, strengthen regulation, and effectively mitigate systemic risks, in order to prudently advance the pilot program.

I. International Experiences

Integrated financial services can be found in all the major economies nowadays, in such forms as financial institutions making cross-sector investment, financial holdings companies involved in integrated financial services at the group level whereas the subsidiaries specialized in banking, insurance or securities sector, and financial institutions conducting cross-sector operation; therefore, the corresponding financial regulatory system varies from one form to another.

The U.S. The Great Depression in the 1930s led to the enactment of the *Glass-Steagall Act*, which established the separation of commercial banking from investment banking. Since the 1980s, the U.S. has been faced with tremendous competition pressures from the U.K., Germany and Japan. In order to make American financial institutions more competitive, the *Financial Services Modernization Act* was signed into force in 1999, which allowed bank holding companies and qualified foreign banks performing well and in strong financial positions to conduct cross-sector operation as "financial holding companies". The holding companies, in addition to controlling deposit-taking institutions, could conduct securities underwriting and securities trading, insurance agency, futures brokerage and other non-financial activities closely related to their core businesses upon approval by the Federal Reserve. As of the end of 2011, there were 494 financial holding companies in the U.S. including Citi Bank, Bank of America, Morgan Stanley, Goldman Sachs, JP Morgan Chase, Bank of New York Mellon and all the other major group companies. With respect to regulation and supervision, an umbrella regulatory system was set up in which the financial holding companies were supervised by the Federal Reserve, whereas their affiliations subject to segregated regulation for banking, insurance and securities. In July 2010, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* was signed into force, which gave the Federal Reserve more regulatory power over financial holding companies and other systemically important financial institutions.

The U.K. There are no strict stipulations about segregated or integrated financial services in the UK. As the financial sector developed, financial institutions spontaneously separated banking from securities according to their respectively development strategies and available resources. UK's balance of payments started to deteriorate from 1978, and with increasing capital internationalization and financial securitization, the separated operation model was increasingly ill-aligned with the economic development. In order to turn around the weakening financial sector, the UK implemented a "Big Bang" reform in 1986 when commercial banks merged with or acquired securities companies and other financial institutions into financial groups covering diversified business services such as banking, securities, insurance and trust. The typical ones among them included Lloyd, Barclays, HSBC, Standard Chartered and other cross-border banking groups. With respect to supervision and regulation, the *Bank of England Act* in 1998 took away Bank of England's supervisory mandate and gave it to the Financial Services Authority (FSA). Drawing on the lessons from the global financial crisis, the new government decided to abolish FSA, and set up a prudential regulatory agency under the Bank of England, so as to give the Bank of England the power to conduct both micro and macro prudential regulation.

Germany. Most continental European countries such as Germany adopt the universal banking system, where banks get directly involved in diversified financial services, and don't need to set up affiliations for different business lines. The *German Banking Law* stipulates that banks are allowed to conduct such businesses as deposit-taking, lending, transfer and settlement, note discount, investment fund, securities underwriting, proprietary and brokerage of securities, asset management, and trust fund. In the late 1980s, Germany's universal banks expanded their scope of business through combining life insurance with conventional banking. In recent years, a few large universal banks in Germany have also set up subsidiaries to operate some financial businesses; therefore, they start to carry characteristics of financial holding companies. In terms of supervision and regulation, the *Law on Harmonizing Financial Services Regulation* became effective in May 2002, requiring the banking, securities and insurance supervisory authorities to be merged into the Federal Financial Supervisory Authority (BAFin) that maintains close cooperation with the Deutsche Bundesbank.

Japan. After the Second World War, in imitation of the *Glass-Steagall Act*, Japan separated banking sector from securities, long-term finance from the short-term one, and banks from trust companies as well as set up the specialized foreign exchange banks. The "Big Bang" financial reform in the UK in the 1980s gave Japan a big nudge, and affected by the U.S. move to shift away from separated operation, Japan started to turn to the integrated financial services model. In 1992, financial institutions were allowed to conduct banking, securities and insurance businesses through their subsidiaries. In 1997, financial holding companies were allowed to be established. In 1998, financial institutions were given the green light to conduct various cross-sector financial businesses. After the integrated financial services system was set up, massive M&A swept over the financial sector, and internationally competitive financial groups came into being, including Mizuho, Sumitomo Mitsui, UFJ Holdings, and Mitsubishi Tokyo Financial Group. With regard to supervision and regulation, the Japan Financial Services Authority was set up in 2000, which supervised various types of financial institutions and financial markets, and worked closely with the Bank of Japan.

Chinese Taiwan. From the 1980s, Chinese Taiwan relaxed financial supervision in order to liberalize, modernize and internationalize the financial sector. In 2000, Taiwan revised the *Banking Act*, expanding the scope of business for banks, allowing commercial banks to invest in other financial sectors. In 2001, in order to relieve the pressures from international competition after Taiwan's accession to the World Trade Organization (WTO), and drawing on the experiences of the U.S. and Japan, Taiwan passed a series of financial laws such as the *Act on Financial Holding Companies*, and encouraged financial institutions to set up financial holding companies through equity transfer or equity conversion, in order to make shares holding more concentrated, size bigger and business structure more diversified. At present, there are 15 financial holding companies in Taiwan, including Cathay, Fubon, Megabank and etc.. The *Act on Financial Holding Companies* in Taiwan stipulates that financial holding companies are only confined to equity investment and management, and they themselves cannot conduct specific financial businesses. Their investment scope can cover both financial business such as banking, trust, securities, futures and insurance and non-financial businesses. However, the total investment in non-financial businesses cannot exceed 15% of the equity of the financial holding companies, and moreover, share holding in any of the non-financial businesses cannot exceed 5% of equity of the target company. After that, Taiwan stipulated regulations on capital adequacy and corporate governance for financial holding companies. With respect to supervision and regulation, Taiwan set up the Financial Regulatory Commission under the Executive yuan in 2003 to carry out umbrella oversight on financial holdings companies.

II. Overview of Pilot Program of Integrated Financial Services in China

Integrated financial services in China have undergone a tortuous path. The financial sector started the experimental initiative of cross-sector operation at the beginning of the reform and opening up. In 1993, in light of the disordered financial environment and grave risks in the financial system, the CPC Central Committee and the State Council ordained segregated operation along the lines of insurance, securities, trust, and banking. Since 2003, with the deepening of the economic and financial reform and opening up, the desire and impetus for integrated financial services have been building up. In particular, with the advancement in various financial reforms including the reform of the major commercial banks, solid foundation for integrated financial services has been laid. Both the 11th Five-Year Plan and the National Financial Work Conference in 2007 proposed to prudently advance the pilot program of integrated financial services. The 12th Five-Year Plan darified once again the objective of "prudently advancing the pilot program of integrated financial services".

1. Steady progress has been made in the pilot program of integrated financial services

Financial institutions accelerated the pace in cross-sector investment. Since the State Council permitted commercial banks to invest in and set up securities investment fund management companies, the pace of financial institutions' cross-sector investment has been accelerated. As of the end of 2011, in the banking sector, 8 commercial banks had established fund management companies, 6 commercial banks invested in insurance firms, 10 commercial banks set up or invested in financial leasing companies, 3 commercial banks invested in 3 trust companies, 3 commercial banks set up 3 consumer finance companies, and 4 asset management companies held controlling shares in the banking, securities and insurance institutions. In the securities sector, 3 securities companies made equity investment in 3 commercial banks, 1 securities company invested in an investment trust company. In the insurance industry, 4 insurance groups held controlling shares in commercial banks, trust companies, securities and fund management companies.

Financial holding companies came into shape. Financial holding companies control subsidiaries from at least two financial sectors such as banking, insurance and securities, whereas the holding companies themselves do not conduct any specific financial business. The State Council approved the establishment of Galaxy Financial Holding Company and Everbright Financial Holding Company respectively in 2006 and 2008. CITIC Group, Everbright Group and Ping An Group became *de facto* financial holding companies after years of development. Shanghai International Group, Tianjin Taida Group and other group companies managing local state-owned financial assets were set up, which also carried characteristics of financial holding companies.

Cross-sector financial products mainly in the form of wealth management products have developed rapidly. Driven by market competition and customers' diversified demands, cross-sector cooperation has been strengthened, such as bank-trust cooperation, bank-securities cooperation, bank-insurance cooperation and securities-insurance cooperation, the cross-sector financial products mainly in the form of wealth management products have developed rapidly. As of the end of 2011, commercial banks' outstanding volume of wealth management products on and off the balance sheet posted RMB 4 trillion yuan, while off-the-balance-sheet wealth management products boomed to RMB 2.7 trillion yuan. Some funds raised from the wealth management products was directly or indirectly loaned out, thus substituting bank loans to some extent. Since 2005, the pilot program of credit asset securitization has advanced steadily.

There have been more groups integrating industrial and financial entities. International experiences indicate that under socialized mass production conditions, industries naturally combine with finance when they develop to a certain level. In recent years, the integration of industrial and financial entities has accelerated notably, some industrial groups, mainly the central government-led enterprises, are getting involved in the financial sector with respect to investment, business operation and personnel appointment through setting up financial institutions, M&A and equity investment. At present, some central government-led enterprises have invested in or controlled some financial subsidiaries, such as commercial banks, finance companies, trust companies, financial leasing companies, securities brokerage, insurance companies, pawn companies and guarantee companies. Other central government-led group companies set up affiliations within the groups to manage the financial assets of the group, and have become truly financial holding companies.

2. Progress has been made in the pilot program of integrated financial services

Synergy effect in financial institutions has emerged tentatively. Financial institutions could leverage on advantages of subsidiaries from different sectors and share customer resources through integrated financial services such as cross sales and cooperative marketing, so the synergy effect has been achieved to some extent and the overall operational costs has been reduced. For example, Industrial and Commercial Bank of China (ICBC) Credit Suisse Asset Management Co., Ltd. and the China Construction Bank (CCB) Principal Asset Management Co. Ltd. set up respectively by the ICBC and the CCB conduct 90% of their business through bank outlets. After acquiring and reorganizing Shenzhen Commercial Bank into Ping An Bank, Ping An Group has consolidated the business, tightened risk control, centralized back-end business, and expanded the depth and breadth of cross sales until the cross sales had covered all the business lines in 2010. Cinda, Orient, Huarong and other asset management companies have diversified ways to dispose non-performing assets through integrated financial services.

The business structure of commercial banks has been improved in some degree. Commercial banks have improved their business structure through integrated financial services, as profits from one sector can make up losses from another. Excessive reliance on interest rate spread has been reduced somewhat, and therefore resilience of commercial banks through the whole economy cycle has been enhanced. For example, in 2010, the ICBC's revenue from such new business as M&A, asset transfer and trading, and housekeeping banking for equity investment funds have grown rapidly, with the net commission revenue amounting to RMB 72.84 billion yuan, up by 32.1% y-o-y, accounting for 19.13% of the operating revenue, up 1.31 percentage points from last year. Revenue from the wealth management business grew by 31.96% percent y-o-y to RMB 21.774 billion yuan, accounting for 27.91% of the revenue from financial intermediation, which indicated the income structure was improved further. The pilot program of integrated financial services also helps deepen cooperation with the related financial sectors, promote the development of the invested financial institutions.

The integration of industrial and financial entities has to some extent promoted the development of the core business of the industrial groups, and boosted the capital strength of the financial sector. Industrial groups have improved capital utilization and tapped low-cost financing channels through investing in the financial sector, and allocating capital in a centralized manner among different businesses. The core business of the industrial groups also grows because well-trained affiliated financial institutions can provide high-quality financial services specifically to the core business. By entering into the financial sector, these industrial groups have extended the industrial chains, found new revenue-generating businesses, and reduced the impact of cyclical fluctuations from one single industry. Since the outbreak of the global financial crisis in 2008 and in the context of significantly declining profits from the core business, some industrial groups however have made up for the losses of their core business with the earnings from financial investments. Meanwhile, industrial groups' engagement in the financial sector has diversified the shareholders of financial institutions, and helped the financial sector to introduce high-quality capital; therefore, it has played a positive role in reinforcing capital strength, improving capital quality, enhancing the loss-absorbing capacity and improving the capital structure of the financial institutions concerned.

Integrated financial services regulation has taken initial shape. While steadily advancing the pilot program of integrated financial services, the People's Bank of China (PBC), the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC), the Ministry of Finance (MOF) and other government authorities concerned have improved regulations and rules to strengthen integrated financial services regulation. Working jointly with the CBRC and the CSRC, the PBC subsequently issued the *Administrative Measures on Commercial Banks Setting up Fund Management Companies* and the *Administrative Measures on Credit Asset Securitization*, improving rules making and strengthening coordination to steadily advance the pilot program of integrated financial services. The CBRC promulgated the *Guidelines on Banks' Consolidated Balance Sheet (Tentative)* and other regulations, and in 2008, it signed the *Memorandum of Understanding on Strengthening In-depth Cooperation and Cross-Sector Regulatory Cooperation between the Banking and the Insurance Sectors* with the CIRC. The CSRC put forward the idea of integrated financial services on a pilot basis. The CIRC issued such documents as the *Administrative Measures on Insurance Group Companies (Tentative)*. The MOF issued the *Measures on Financial Management of Financial Shareholding Companies*.

III. Challenges Ahead

Some financial institutions need to strengthen overall planning of cross-sector investment. The characteristics of different financial sectors have posed challenges for the overall planning, risk management, and integration of information systems for financial institutions in the pilot program. Some financial institutions are impulsive to become big and comprehensive, some just content with equity investment or business licenses-granted, whereas ignoring the thorough integration of businesses and sufficient coordination between core and side businesses. Due to similar strategic objectives, large commercial banks have faced fierce homogeneity competition, while motivations of seizing resources and pursuing size expansion have intensified capital shortage.

Integrated financial services in various financial sectors need to be more balanced. Banks enjoy advantages in capital strength, outlets network and market recognition, whereas securities and insurance institutions appear weaker. In particular, as brokerage and underwriting dominate the business line, the securities sector suffers from homogeneity competition, insufficient capability of product innovation and resources allocation, and the room for development is thus squeezed. At the same time, regulatory requirements on shareholders' qualification and cross-sector investment vary from one sector to another, which, to some extent, has contributed to the imbalance of integrated financial services among different sectors.

There is a regulatory vacuum over financial holding companies. Financial holding companies' diversified businesses, complex organizational structure and hardly detectable affiliated transactions have blurred the boundary between various financial sectors. Therefore, a holistic perspective is required in order to identify, assess and mitigate risks. However, due to the absence of a regulator explicitly charged to oversee financial holding companies as well as regulatory disparity among separated regulators, there might be regulatory blind spots and inconsistence on the cross-sector businesses and inside the entire group, which might lead to multiple calculations and abuses of capital, capital arbitrage, high leverage, improper affiliated transactions, excessive concentration of risks and etc. Meanwhile, due to lack of effective regulation on licensing and operation of financial holding companies, regulatory vacuum exists to some extent, the Delong Group Risk happened in 2004 gave a profound lesson in this regard.

Oversight over cross-sector financial products needs to be strengthened. Commercial banks' advantages in size and customer resources heavily impact the wealth management business of trust companies, securities companies, fund management companies and insurance companies. The different regulatory standards in terms of product approval, minimum issuance volumes, shares, marketing and promotion and information disclosure are likely to trigger regulatory arbitrage. Some wealth management products have such problems as exaggerating expected earnings, ill-developed information disclosure mechanisms, and deliberately downplaying or hiding investment risks. As a result, consumers' rights and interests are not adequately protected.

The policy orientation on the integration of industrial and financial entities needs to be further clarified. Industrial groups' engagement in the financial sectors has some potential risks. On one hand, neglecting the development of the core business, excessive pursuit of high returns on financial investment, and magnifying financial capital through equity connections and financial leverage might lead to hollow-out of the industrial groups so some extent. Once the financial business suffers from losses, the industrial business will suffer too. On the other hand, in the absence of an effective risk management mechanism, industrial groups can turn their financial subsidiaries into "automatic teller machine" (ATM) by materially controlling the financial subsidiaries or affiliated transactions. Overly pumping liquidity from such "ATM" might transfer the risks from industries to financial sectors. In particular, in those groups integrating industrial and financial entities whose management ability is weak and that don't set up an independent internal institution specialized in financial assets management, an effective risk separation mechanism cannot be established, and therefore the possibility of risk contagion is heightened. At present, the policy orientation on industrial groups' investment to financial sectors is not clearly pronounced, and there is no effective umbrella regulation over the financial businesses of such groups. All of these are not conducive to effective ring-fencing between financial and industrial risks.

The regulatory responsibilities for preventing integrated financial services risks need to be reinforced. With the advancement of the integrated financial services in China, different financial sectors and financial markets are more closely connected with one another, and financial products are getting more complex, financial risks have characterized by cross-sector, cross-market and cross-border. At the current juncture, financial regulation in China aims to mitigate risks of the given sector and individual financial institutions, and oversight on cross-sector and cross-market risks rising from interconnectedness of financial sector is inadequate. Therefore, it's necessary to have one umbrella regulator endowed with macro-prudential mandate, incorporate financial institutions involved in integrated financial services into supervision from a holistic rather than a narrow sector perspective. The umbrella regulator should accurately identify and assess potential systemic risks on the basis of consolidation and effective utilization of comprehensive data information of the entire financial sectors, make better targeted and more rigorous regulatory policies and criteria, research and set higher and more pertinent regulatory policies and standards, apply risk-correction measures in a timely manner, set up a clearly-layered risk resolution and liquidation arrangements with clarified responsibilities, in order to effectively reduce the probability of systemic risks and the impact on financial stability.

IV. Actively and Prudently Advance the Pilot Program of Integrated Financial Services

Experiences and lessons from home and abroad have proven that integrated financial services are a logic outcome when the financial market develops to a higher stage, and it has already existed in China's financial sectors. Going forward, efforts will be made to draw on past experiences, set up proper institutional arrangements, and strengthen regulation and mitigate risks, in order to actively and prudently advance the pilot program of integrated financial services.

1. Integrated financial services is the development trend and a necessity of the financial sectors

Integrated financial services remain the development trend of the global financial sectors after the crisis. Since the outbreak of the global financial crisis, there have emerged various views on integrated financial services in the international community. Some people hold the view that it has made the financial activities more complex and increased the difficulty to identify and mitigate financial risks; therefore, it's one of the roots of the crisis, and the size and business scope of financial institutions should be limited. However, practice has shown that financial institutions involved in integrated financial services are more resilient during the crisis, and those suffering from huge losses are mainly small and medium-sized institutions with simple business structure. Nowadays the international community has achieved the consensus that it is the excessive risk taking, over-high leverage, super complex and opaque financial innovation, and regulatory weaknesses that have triggered the financial crisis, rather than integrated financial services. Integrated financial services remain the main development trend, and some of major banks have conducted integrated financial services to a greater extent after the crisis. Meanwhile, the post-crisis financial regulatory reform has not changed this trend, but instead has emphasized the importance of umbrella regulation over financial groups. The Volker Rule put forward by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* does not aim to prohibit integrated financial services, but rather to put the risks of the banking system under control by preventing excessive risk-taking activities in commercial banks. The *Principles for the Supervision of Financial Conglomerates (Consultative Document)* was issued in December 2011 by the Joint Forum established under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

It highlights the importance of regulatory improvement over financial groups that centers around avoiding multiple uses of capital, mitigating overall risks of the group, preventing regulatory arbitrage, and focusing on unregulated holding companies and institutions within financial groups.

Integrated financial services are vital for China's financial sectors development. In recent years, integrated financial services in China have made great progress and taken initial shape. However, there are still different views on its necessity, the major concern is that at the start of the financial sector reform in the late 1980s and early 1990s, financial institutions generally conducted cross-sector businesses and financial disorders appeared. In a historical perspective, given the specific financial environment, the outbreak of financial disorders have various reasons such as legislation falling behind financial market development, inadequate regulation and supervision, unsound internal control mechanisms, ill-developed accounting standards, and lack of human resources. It's not directly linked with cross-sector operation of financial institutions. In order to recover the financial order, separated operation and regulation system for banking, insurance and securities is adopted, which, though has to some extent helped to prevent risk contagion, has revealed such problems as lack of competitiveness and low efficiency in resources allocation in financial sectors. Against the background of increasing financial opening-up, it is a necessary choice for Chinese financial institutions to switch to integrated financial services, through which financial institutions can exert their outlets and customer resources advantages to promote synergy among different businesses, develop diversified businesses, improve profitability, and satisfy various financial demands, enhance competitiveness in the international arena and become truly big and strong. Meanwhile, after developments in the 11th Five-Year Plan period, integrated financial services have made great progress and taken initial shape, which has become a notable phenomenon in domestic financial sectors.

2. Policy recommendations for advancing the pilot program of integrated financial services

Advance the pilot program in an orderly manner while keep risks manageable. In order to avoid the herd behavior of financial institutions, the pilot program should be pushed forward in a prudent and orderly manner, with the precondition of keeping risk manageable. Those institutions with adequate capital, good corporate governance, internal control and risk management capability, and professional staff should be selected firstly to conduct integrated financial services. The relevant qualification criteria and preconditions for commercial banks should be tightened, and those with strong risk management capacity should be prioritized to conduct integrated financial services. Businesses closely related to traditional commercial banking should be carried out first. Financial institutions should judge whether integrated financial services can improve core business competitiveness, and carry out an objective self-assessment, avoiding of irrational behavior regardless of its own conditions.

Choose a proper pattern of integrated financial services in line with the China's situation. Various patterns of integrated financial services are on the menu. In light of the condition of China's financial sectors, financial holding companies taking the pattern of "parent company as holding company, and subsidiaries operating separated financial business" enjoy advantages in asset allocation, risk management, customer information and resources sharing and etc., and can effectively prevent financial risks from spreading cross sectors. Therefore, this pattern is well aligned with the current financial regulatory system, and can become an important pattern for integrated financial services. Moreover, some capable large-sized financial institutions have possessed abilities of capital operation, risk control, cross sales and business integration, of which qualified ones can conduct integrated financial services by investing financial institutions in other sectors.

Improve supervision and regulation over financial institutions' cross-sector investment. Continuous efforts should be made to enhance corporate governance, standardize the decision-making procedure, and strengthen internal control. Capital adequacy regulation should be strengthened and on a consolidated basis. In this regard, a holistic view is needed regarding supervision and regulation over the entire financial groups, so as to make sure that business expansion keeps commensurate with the capital size. Stricter control and information disclosure requirements should be exercised on high-leveraged and large capital consuming businesses. Efforts should also be made to regulate intra-group trading, comply with the fair value pricing principle and the transparency principle, mitigate risk transfer and improper transportation of benefits, and create synergy through compliant internal transactions. Exposure of different subsidiaries to one single customer should be limited, and risk dispersion measures in line with the risk caps should be adopted.

Specialized and holistic supervision and regulation is needed for financial holding companies. Financial holding companies, generally big in size and complicated in structure, are not subject to specialized and holistic supervision, so there are such problems as multiple uses of capital, excessive risk concentration and regulatory arbitrage. Overall planning is thus required to combine institution-based supervision and function-based supervision. The responsibilities for supervising financial holding companies should be well defined in order to eliminate regulatory blind spots as well as prevent and mitigate systemic risks, whereas the subsidiaries are regulated along the lines of their businesses, and the relevant authority should be responsible for the financial management of state-controlling financial holding companies. Efforts should be made to accelerate the formulation of supervisory rules over financial holding companies, strengthen capital adequacy requirements, avoid multiple calculations of capital and capital arbitrage, and reduce leverage. Affiliated transaction should be well regulated in line with the fair value pricing principle and the transparency principle to reduce the possibility of cross-sector risk contagion. Moreover, regulation on risk concentration should be strengthened; qualification criteria for shareholders and companies' management should be reinforced, in order to prevent the controlling shareholders from abusing the power to infringe on the legitimate rights and interests of small shareholders and clients.

Improve regulatory rules over cross-sector financial products, and strengthen customer protection. Long and medium-term wealth management products are conducive to promote direct financing. At present, the priority should be given to containing the risks associated with short-term wealth management products, to improving statistics collection and monitoring, and to preventing commercial banks from making use of wealth management products to circumvent the macroeconomic management requirements and the loan-to-deposit ratio requirement. The off-balance-sheet businesses should be well regulated, through building the fire wall between off and on- balance-sheet businesses, and rectifying illegal conduct in wealth management products. The regulatory requirements on various types of wealth management products shall be harmonized, and information sharing and policy coordination should be improved in order to prevent regulatory arbitrage. Financial institutions should carefully assess the risk appetite, risk recognition and risk affordability of their consumers, so as to "sell the right products to the right person". Meanwhile, the information disclosure obligation and investor education should be strengthened in order to put consumers in a better position to assess the profitability and potential risks of the products they purchase.

Qualified industrial groups should be allowed to conduct industrial and financial combined services, and encouraged to set up financial holding companies strengthening the risk separation between industrial and financial sectors. The industrial and financial integration can help financial institutions to introduce high-quality capital, consolidate capital strength, improve capital structure and strengthen shareholders' responsibilities. In that case, some qualified industrial groups should be allowed to invest in financial institutions in the principle of serving their core business. Prudential licensing threshold should be set up in order to prevent improper affiliated transactions. Industrial groups should be encouraged to set up financial holding companies specializing in financial businesses management, so as to realize the risk separation within the group. Meanwhile, efforts should be made to clarify the regulatory mandate over financial holding companies within groups and enhance overall risk-monitoring. Relevant government agencies take the responsibility of managing state-owned assets, whereas the subsidiaries are subject to segregated supervision according to their business.

Special Topic IV

Financial Services for Small and Micro Enterprises and the Development of Small and Medium-sized Financial Institutions

Small and micro enterprises are an important part of the socialist market economic system. The Central Party Committee (CPC) and the State Council attached considerable importance to their sustainable and healthy development. In recent years, relevant authorities carefully carried out the strategic deployment of the CPC and the State Council, took great efforts to address the outstanding problems of financing difficulties and improve financial services, promoted reforms on small and medium-sized financial institutions and realized significant achievements. At present, financial services to small and micro enterprises still lag behind the social and economic development as well as industry's expectations. Relevant policies should be improved and reforms and innovations should be promoted to enhance financial support to the small and micro enterprises.

I. Significant Developments were achieved in improving financial services to the small and micro enterprises and promoting the development of small and medium-sized financial institutions

Currently, the variety of financial services to small and micro enterprises is increasing and financing channels are becoming more and more diversified. A financing service system featured by multichannel and multilayer is basically established, which covers credit, guarantee, stock, bond, venture investments, financial leasing, insurance and private financing. Supportive measures and differentiated supervision are also improving.

1. A multiple financial service system is basically established and the financial services to small and micro enterprises are further improved

Based on the features of small and micro enterprises and the market conditions, financial institutions further improved business process and enhanced product innovations to meet their financing needs.

First, banking institutions continued to play the major role in financing small and micro enterprises. In recent years, banking institutions steadily improved their service mechanism for small and micro enterprises, and gradually established the credit review and management system tailored to their features. Total credit extended to small and micro enterprises increased and a series of new products were created to meet their financing needs. As of the end of 2011, the outstanding loans of banking institutions to small enterprises registered RMB 10.76 trillion yuan, with a growth rate higher than those of the large and medium enterprises by 14.2 and 12.5 percentage points respectively, which realized the target that the growth rate of loan to small enterprises was higher than that of the total loans and the increment was larger than that of previous year. Besides, specialized financial services were also steadily developed, such as collective funds trusts and financial leasing services for small and medium-sized enterprises (SMEs).

Second, the direct financing system for

small and micro enterprises was basically established. At present, China has basically built a multilayer capital market system including SMEs market, growth enterprises market (GEM) and the stock quoted transfer system. Through the funding function of capital market, more private capital was guided and absorbed into the growth enterprises market in the form of equity investment. New tools for direct financing were invented, including SME collective bonds, SME commercial papers and SME collective notes (SMECNs), etc. A so-called "green channel" was established for SME commercial papers and collective notes. As of the end of 2011, RMB 13.435 billion yuan was raised through direct financing products such as SME commercial papers and SMECNs, etc.

Third, innovations were also conducted in insurance products for small and micro enterprises. As credit insurance was developed for exporters, small and micro enterprises became more confident and competitive. The credit insurance for domestic trades was strongly promoted, which effectively smoothed the financing difficulties and extended the domestic market for small and micro business and trade enterprises. Pilot programs were conducted in several provinces and municipalities on guarantees and insurances for small loans and the financing channels further broadened. Services such as policy loans were encouraged, which improved the insurance service environment for small and micro enterprises and effectively supported the solution of their financing difficulties.

2. Small and medium-sized financial institutions made innovative explorations, solved heritage problems, and continued to improve services for small and micro enterprises

Small and medium-sized financial institutions enjoy an information advantage in providing financial services to small and micro enterprises. In recent years, relevant authorities have actively promoted small and medium-sized financial institutions reforms, with a constant improvement in corporate governance, financing capability and risk management. Their capacity of servicing small and micro enterprises as well as agriculture, rural areas and farmers has been steadily improved.

First, reforms were pushed forward in small and medium-sized commercial banks and their ability to service small and micro enterprises was significantly improved. In recent years, small and medium-sized commercial banks steadily improved shareholding structures and corporate governance. A differentiated and featured operation model was gradually established. Small and medium-sized commercial banks have become a major player in providing financial services to small and micro enterprises. At the end of 2011, among all small and medium-sized financial institutions, there were 144 city commercial banks, whose asset registered RMB 9.98 trillion yuan, up 27.18 percent y-o-y, accounting for 9.19 percent of total assets of banking institutions, up 0.95 percentage point y-o-y. The outstanding loans reached RMB 4.37 trillion yuan, with a y-o-y increase of 21.78 percent.

Second, reform was also pushed forward in RCCs, with their role strengthened in supporting the agricultural sector. There was a huge increase in RCCs' funding capacity and lending to the agricultural sector. In 2011, newly added loans to agriculture and farmers registered RMB 737.4 billion yuan and 309.3 billion yuan respectively, the outstanding loans of the year end correspondingly up 19 percent and 15 percent y-o-y. The outstanding agricultural loans accounted for 68.9 percent of total loans, up 0.5 percentage point y-o-y. Progress was also made in reforms of property right systems for RCCs. As of the end of the year, 1 882 RCCs at the county (city) level, 212 rural commercial banks, 190 rural cooperative banks were established nationwide. Among the loans provided by rural commercial banks at the township level, the proportion of agricultural loans rose from 57.2 percent at the end of 2009 to 67 percent at the end of 2011, and the agricultural loans provided by rural cooperative banks increased from 66.1 percent to 70 percent, indicating a significant increase of financial support to the agriculture sector.

Third, the new-type financial organizational system for serving small and micro enterprises in county and the rural areas was constantly improved. Since 2006, relevant authorities gradually relaxed restrictions on the approval for setting up banking institutions in rural areas. According to the principle of *low criteria for entry and strict ongoing supervision*, the social capital was guided to invest and establish four types of financial institutions, including village and township banks, lending companies, rural mutual cooperatives and small lending companies in areas where there were not adequate financial services. As of the end of 2011, 786 new-type financial institutions were established across the country. Among them, there were 726 village and township banks, 10 lending companies and 50 rural mutual cooperatives, with outstanding loans of RMB 131.042 billion yuan. 4 282 small lending companies were also established and their total outstanding loans registered RMB 391.5 billion yuan. These four types of financial institutions played an active role in guiding private capital to support small and micro enterprises.

3. The supporting system was basically established, which ensured quality financial services for small and micro enterprises

Relevant authorities took efforts to improve the funding environment for small and micro enterprises and strengthened the supporting system. This created a favorable condition for upgrading financial services for small and micro enterprises.

First, policy guidance on financing business for small and micro enterprise was enhanced. In credit financing, the PBC used differentiated monetary policy tools and strengthened credit guidance, took a series of measures, including encouraging financial institutions to strengthen credit support to small and micro enterprises, lowering reserve requirement for small and medium-sized financial institutions with large proportion of loans to small and micro enterprises, providing lending support to these institutions, prioritizing rediscounting to small and micro enterprises and other institutions in the weak link, and asking for more reasonable credit structure and plan of financial institutions. The CBRC established a differentiated supervision framework, loosened the licensing requirement of financial services for small and micro enterprises, carried out differentiated examinations on capital consumption and loan-to-deposit ratio, moderately loosened the differentiated supervision and incentive policies, such as the toleration of NPL ratio of small and micro enterprises. Banks were also encouraged to strengthen financial support to small and micro enterprises. Regarding direct financing, the PBC promoted the establishment of a multiple direct financing system for small and micro enterprises, and strengthened the supportive role of commercial papers, medium-term notes and SMECNs to support the financing of small and micro enterprises. The CSRC promoted the establishment of a multilayer capital market and strengthened market basis by improving SMEs market and GEM, etc, to cater to the need of IT and innovative enterprises to raise capital in the market. With regard to the insurance services, the CIRC promoted innovations in insurance products and institutional arrangements, improved the risk-sharing mechanism and enhanced the financing creditworthiness of small and micro enterprises.

Second, taxation support for small and micro enterprise was gradually strengthened. In recent years, a series of polices on tax reduction and exemption were pushed forward, including raising the threshold of value-added tax and business tax, reducing and exempting revenue tax for small and micro enterprises, exempting stamp tax for lending contracts between financial institutions, delaying the expiration of policy on pre-tax deduction of agricultural loan loss provisions and SME's loan loss provisions, deferring payment of the social security insurance or reducing insurance fees of small enterprises which went under substantial impact of the global financial crisis, providing policy subsidies and business tax exemptions to small enterprises credit guarantee companies, and carrying out pre-tax deduction of required reserves. At the same time, through encouraging and rewarding the growth of agricultural loans by village financial institutions and providing specialized subsidies to rural financial institutions, the financial institutions were guided to strengthen financial support to the agriculture, rural areas and farmers as well as small and micro enterprises. Some local governments established risk compensation funds for small enterprises loans and rewarded banks with faster growth of loans to small enterprises. Other local governments abandoned or lowered fee standards related to small enterprise loans.

Third, the establishment of a long-term financial service mechanism for small and micro enterprises was steadily promoted. In recent years, China actively pushed forward the development of the credit information system of small enterprises. Credit information of small and micro enterprises was collected through multiple channels, and a rating system in line with small and micro enterprises' features was established. The development of credit information system for enterprises and individuals was promoted. Information asymmetry faced by small and micro enterprises in financing was reduced, and a favorable credit environment for small and micro enterprise financing was created. Relevant authorities also actively promoted the structure reform of small and micro enterprises to improve their services and profitability. Local government also played an important role in developing the service program and creating the public service platform for small and micro enterprises. These measures laid the foundation for financial institutions to provide more targeted services to small and micro enterprises.

II. Main Problems are still to be solved in improving services for small and micro enterprises and the development of small and medium-sized financial enterprises

The financing difficulty faced by small and micro enterprises is a world-wide problem. Although China has made significant progress in improving financial services for them, there are still some problems that wait to be addressed.

Inborn shortcomings lowered the financing capability of small and micro enterprises. Small and micro enterprises have inherited financing disadvantages, such as higher business risks and smaller but more frequent funding need. First, some small and micro enterprises are easily eliminated from competitions, since they are less adaptive to adjustment of macro-economic policies and market changes. Thus, financial institutions are less incentivized to provide financing services to them. Second, some small and micro enterprises lack innovation capacity and their low-tech products enjoy little advantage and market competitiveness, which made financial institutions rather prudent when dealing with small and micro enterprises. Third, some small and micro enterprises don't have sufficient business management capacity, accompanied by low profitability and transparency. When providing services to them, financial institutions usually bear higher information costs or even find it impossible to acquire the necessary information. Fourth, some small and micro enterprises have weak credit awareness. They sometimes evade from banks' after-loan managements, change the use of the loan without informing the banks or even refuse to payback.

Direct financing channels for small and micro enterprises are not well established and the support from capital market should be further strengthened. In developed countries, about half of the funding need of small enterprises is satisfied by direct financing. By comparison, Chinese small enterprises are faced with an imbalanced finding structure, whose direct financing lags far behind that of the developed countries. First, a multiple financing system has not been fully established and enterprises' financing rely excessively on banking institutions. Particularly, since large enterprises mainly resort to banks for financing, banks lack the initiative to provide service to small and micro enterprises. Second, the capital market financing channel is narrow and the over-the-counter market for small enterprises is not well developed. Third, some products need to be developed further, such as SME collective bonds, SME commercial papers, SMECNs and SME collective fund trusts.

The structure of the banking system needs to be improved and community financial institutions should be further developed. Currently, there is a mismatch between the financing volume of small and micro enterprises and their social and economic status, and traditional service of commercial banks cannot fully satisfied their growing financing needs. First, business models of banking institutions are similar to each other. Most banking institutions are used to do business with big customers and haven't changed their scale-oriented and extensive business model. A differentiated and featured business model has not been established. Second, the low coverage of financial services cannot satisfy the need of small and micro enterprises. Particularly, small and micro enterprises have a wide distribution, with larger distribution in counties and townships and the mid-western of china. Considering the related costs and risks, financial institutions have less motivation to set up physical branches in these areas. Third, the newly-born village and township banks, lending companies and rural mutual cooperatives are still in their premature phases and cannot play their full role in providing small and micro enterprises with financial support. There are not enough banking financial institutions that provide specialized services to small and micro community enterprises. Fourth, there haven't been sufficient innovations in financial products customized for small and micro enterprises, and in terms of interest flexibility, guarantee requirements, maturity term and payback methods, many products cannot satisfy the need of small and micro enterprises.

Risk sharing system is not fully developed, and the protection function is not fully brought into play. Currently, China's risk sharing system is not fully functioning, which influenced the funding of small and micro enterprise. First, incompliance in operations of financing guarantee companies added to the financing cost of small and micro enterprises. At present, there is a huge number of financing guarantee companies in China, but they are often small-sized with limited capital strength and less compliance in operations. The guarantee capability of guarantee companies funded by government is also limited. Second, the insurance market for small and micro enterprises needs to be further developed. Currently, insurance companies haven't played their full role of servicing small and micro enterprises and promoting risk sharing. Their products are too simplex and they need to do more in developing new products such as credit insurance and loan guarantee insurance that can enhance the creditability and risk sharing of small and micro enterprises. The whole-process risk monitoring and control, as well as underwriting and claim services, cannot meet the financing needs of small and micro enterprises.

More supporting policies should be further developed. At present, there are some deficiencies in related laws and regulations, subsiding taxation policies and credit information system. This prevents financial services to small and micro enterprises from developing further. First, laws and regulations are not complete, lack of supporting administrative rules and supervisory documents for *the Law of the People's Republic of China on Promotion of Small and Medium-sized Enterprises.* Laws and rules supporting small and micro enterprises financing are not reviewed or published, in some of which there are some factors that limit the financing of the small and micro enterprises. Second, subsidizing taxation policies are still to be improved, with an emphasis on making them more targeted and balanced. Third, the current credit information system should be further developed. At present, the credit information of small and micro enterprises scatters among different authorities, such as the PBC, the administration for industry and commerce, taxation and customs authorities. It is hard to collect and share the business information of small and micro enterprises in a uniform and standard way. Fourth, there exist redundant procedures and high costs for collateralizing and guaranteeing.

III. Outlook

China will continue to shift the growth pattern, carry out structural reforms and realize a high quality economic growth while boosting employment. In this process, small and micro enterprises play a unique and irreplaceable role. Therefore, while encouraging banking institutions to further improve their service mechanism for small and micro enterprises, small community financial institutions that can provide services to small and micro enterprises should be developed energetically. A multi-channel financial service system for small and micro enterprises should be established, and innovations should be made in financial products and credit modes specifically for small and micro enterprises. Relevant policies should also be improved, and policies and measures designed for solving small and micro enterprises' financing problems should be firmly implemented.

Develop small community financial institutions. An effective way to solve the financing difficulty is to develop small community financial institutions. With the precondition of establishing deposit insurance system and strengthened supervision, authorities should loosen access restrictions and encourage, guide and regulate private capital to establish small community financial institutions. Small community financial institutions should be encouraged to focus on local and basic business to play the major role in supporting the development of small and micro enterprises and to avoid unreasonable cross-region expansions, so that a financial service system with abundant competition, quality services and controllable risks will be established. On this basis, small community financial institutions and existing financing institutions will become complementary to each other, and a financial service system for small and micro enterprises, combining commercial, cooperative and policy factors will be fostered.

The construction of the direct financing market for small and micro enterprises will be promoted. The venture investment system catering for the needs of small and micro enterprises should be forcefully carried forward. The venture investment enterprises should be encouraged to develop, with the related policy system to be improved and a national venture investment guiding fund to be built up. A venture capital raising mechanism guided by government fund and mainly relying on private capital, and a market-based venture capital operation system will be set up gradually. Debt financing tools of small and micro enterprises such as SMECNs will be steadily developed. The issuance should be extended gradually, and private-financing convertible note as well as high-yield note catering to the growing small enterprises should be explored. Credit enhancement agencies should be encouraged to play their full role in externally enhancing enterprises' credit, so as to solve the financing difficulty of some small and micro enterprises with low credits. Appropriate small enterprises meeting certain requirements will be encouraged to go listed on SME market and GEM. The institutional construction of SME market and GEM should be further improved. Small enterprises with good growth prospect and high technical content will be supported to go listed on the capital market. The stock transfer channel of non-listed enterprises will be further exploited. Besides, private financing market will be guided toward an orderly development and an effective monitoring system of private financing will be built up in order to fully explore the positive role of private financing market in catering to the financial service needs of small and micro enterprises.

The innovation of financial products and credit model will be actively promoted. Financial organizations should be devoted to the innovation of financial products and credit model suitable for small and micro enterprises in line with the market principle, and the innovation of credit products such as trade financing and product chain financing will be further promoted. Private business loans or micro enterprises loans guaranteed with individual unlimited liabilities would be encouraged. Innovations should be made to build a risk-controllable credit financing mechanism for micro enterprises. A series of featured and key products in line with the financing needs of small and micro enterprises will be gradually developed. Business administrative system for small and micro enterprises should be further improved. A credit review and management system consistent with the features of small and micro enterprises should be improved. The lending procedures will be simplified, and review process should be more effective. A dynamic customer access and exit management system should be established. Funding modes, such as financial leasing and trust, will play a more important role in small and micro enterprises financing.

Supporting policies and measures should be improved to create a favorable external financing service environment for small and micro enterprises. Based on current development of small and micro enterprises, the supporting policies and measures should be gradually improved to create a favorable social and market environment for small and micro enterprises financing. A supporting policy system should be established, which could ensure sustainable development and profitability of small and micro enterprises. Industry policy guidance to small and micro enterprises should be strengthened in order to realize differentiated supports, promote competition and achieve industrial upgrades. Multiple monetary policy tools will continue to be applied flexibly, credit examination on small and micro enterprises will be improved, and credit support to small and micro enterprises by banking institutions should be encouraged and guided. Efforts should be made in establishing special fiscal funds to compensate the risks from loans to small and micro enterprises, which will subsidize the lending financial institutions and appropriately compensate for the losses from NPLs. Researches should be made to improve differentiated supervision on small and medium-sized financial institutions. Supervision should be enhanced and the entry to cross-regional market should be strictly limited. Charges will be cleared up and regulated, and a scientific and transparent fee system will be established consistent with financial industry's features to substantially reduce the financing costs of small and micro enterprises.

Appendix Ⅰ

A Quantitative Analysis of the Soundness of the Banking Sector: the Case of 17 Major Commercial Banks

In 2011, China's banking sector continued to maintain sound performance with asset size, profits and risk management steadily improved, banking sector indicators remained favorable. Capital adequacy further enhanced, and strongly supported the sound and rapid development of the real economy. In order to make analysis of the operational condition of the banking sector and identify risk profile as soon as possible, we selected the 17 major commercial banks[①] (hereafter referred to as major commercial banks) with their assets accounting for 63.07 percent of the total assets in banking institutions[②], and conducted a quantitative analysis in terms of profitability, assets, liabilities, capital and liquidity.

I. Profitability Analysis

1. Breakdown Analysis of ROE

In 2011 the ROE of the major commercial banks registered 21.28 percent, up almost 1.06 percentage points than that recorded in 2010. The breakdown analysis showed that the increase of ROE was primarily attributed to the increase of risk-adjusted returns and operational risks (Table B1.1), as well as the decrease of profit margin and leverage ratio. The notable increase of risk-adjusted returns indicates that the risk management of the banking sector has been greatly improved, the decrease of profit margin evidences that the profitability has been weakened to some extent, and the decrease of leverage ratio for two consecutive years demonstrated that the soundness has been continuously enhanced.

① Including the 5 large commercial banks (ICBC, ABC, BOC, CCB, and BOCOM) and 12 JSCBs (China CITIC Bank, Everbright Bank, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Corporation, Evergrowing Bank, China Zheshang Bank, and Bohai Bank).

② Including policy banks, state-owned commercial banks, JSCBs, city commercial banks, rural commercial banks, rural cooperative banks, foreign banks, UCCs, RCCs, non-banking financial institutions (TICs, finance companies, finance leasing companies, auto finance companies and money brokerage companies), and PSBC.

TableB1.1 ROE Breakdown of the 17 Major Commercial Banks

	Profit Margin (percent)		Risk-adjusted Return (percent)		Operational Risk (percent)		Leverage Ratio		ROE (percent)	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
17 Major Commercial Banks	30.28	26.86	6.87	8.51	54.68	56.57	17.77	16.46	20.22	21.28
5 Large Commercial Banks	32.69	31.28	6.75	7.68	53.22	55.04	17.34	16.12	20.37	21.32
12 Joint-stock Commercial Banks	23.65	18.29	7.23	10.76	59.47	61.20	19.36	17.55	19.67	21.15

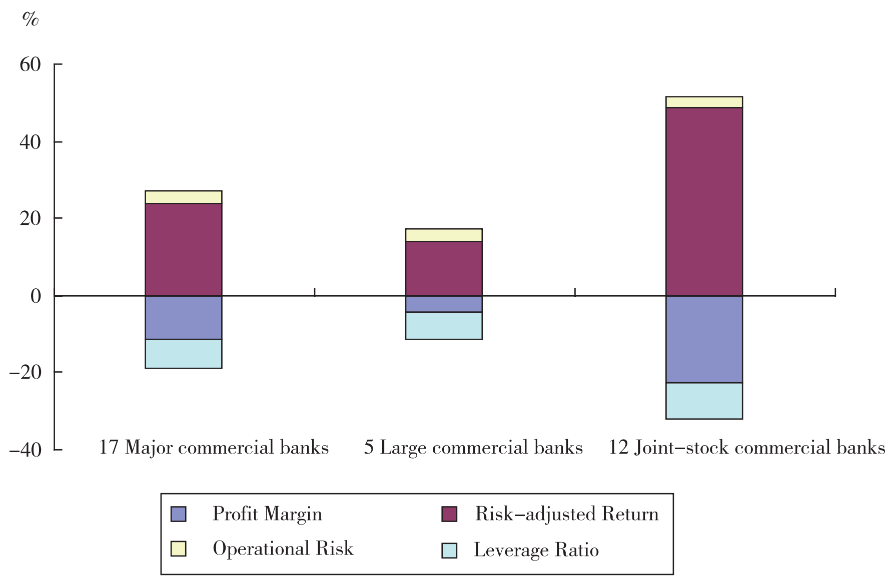
Note: $$\text{ROE}=\frac{\text{Net Profits after Tax}}{\text{Operating Income}}\times\frac{\text{Operating Income}}{\text{Average Risk-weighted Assets}}\times\frac{\text{Average Risk-weighted Assets}}{\text{Average Total Assets}}\times\frac{\text{Average Total Assets}}{\text{Average Owner's Equity}}$$
$$=\text{Profit Margin}\times\text{Risk-adjusted Return}\times\text{Operational Risks}\times\text{Leverage Ratio}$$

Source: The CBRC.

The comparison suggested that the large commercial banks' ROE was slightly higher than that of the JSCBs. In terms of the ROE breakdown analysis, the former had almost 16.5% higher profit margin than that of the latter, but lower risk-adjusted returns, operational risks and leverage ratio. Hence the JSCBs should further enhance their operational efficiency and mitigate financial risk, while large commercial banks should improve risk management and enhance operational soundness.

The risk-adjusted returns of major commercial banks in 2011 was 1.64 percent points above that in 2010, the operational risks was 1.89 percent points higher, whereas the profit margin and leverage ratio was down by 3.42 percent points and 7.4 percent respectively(Figure B1.1). For large banks, the risk-adjusted returns and operational risks was 0.93 and 1.82 percent point higher respectively, while the profit margin and leverage ratio was down by 1.41 percent points and 7% respectively. For the JSCBs, the risk-adjusted return in 2011 was 3.53 percent points higher than that in 2010, whereas the profit margin and leverage ratio was down by 5.36 percent points and 9.3%.

Figure B1.1 Fluctuations in the ROE Breakdown of the 17 Major Commercial Banks



Source: The CBRC.

2. Income Structure Analysis

In 2011, the major commercial banks' net operating income amounted to RMB 2170.707 billion yuan, up 27.96 percent y-o-y. In particular, the net income of large commercial banks increased by 24.9 percent to RMB 1 642.283 billion yuan, while that of the JSCBs increased by 38.5 percent to RMB 528.425 billion yuan (Table B1.2).

TableB1.2 Composition of Net Operating Income of the 17 Major Commercial Banks

Items		17 Major Commercial Banks		5 Large Commercial Banks		12 Joint-Stock Commercial Banks	
		2010	2011	2010	2011	2010	2011
Balance (100 million of RMB yuan)	Net interest income	10 017.40	12 858.24	7 201.52	9 073.20	2 815.88	3 785.04
	Net fee and commission income	2 745.14	3 931.83	2 324.91	3 213.97	420.23	717.86
	Investment income	3 909.40	4 493.10	3 404.40	3 788.20	505.00	704.90
	Other business income	292.60	423.91	218.60	347.45	74.00	76.46
	Net operating income	16 964.54	21 707.07	13 149.43	16 422.83	3 815.11	5 284.25

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Items		17 Major Commercial Banks		5 Large Commercial Banks		12 Joint-Stock Commercial Banks	
		2010	2011	2010	2011	2010	2011
Proportion (percent)	Net interest income	59.05	59.24	54.77	55.25	73.81	71.63
	Net fee and commission income	16.18	18.11	17.68	19.57	11.01	13.58
	Investment income	23.04	20.70	25.89	23.07	13.24	13.34
	Other business income	1.73	1.95	1.66	2.12	1.94	1.45
	Net operating income	100	100	100	100	100	100

Source: The CBRC.

The net interest income remained the major source of operating income. In 2011, the net interest income the major commercial banks increased 28.4 percent, accounting for 59.24 percent of the net operating income, up by 0.19 percentage point y-o-y. In particular, the growth rate of net interest income of the large commercial banks and the JSCBs was 26 percent and 34.4 percent respectively.

The intermediate business income grew at a faster pace. In 2011, the net fee of the major commercial banks increased by 43.2 percent y-o-y. In particular, the growth rate of net fee of the large commercial banks and the JSCBs were 38.2 and 70.8 percent respectively. The proportion of net fee in net operating income of the major commercial banks reached 18.11 percent, up by 1.93 percentage points than that in 2010. In particular, The proportion of net fee in net operating income of the large commercial banks and the JSCBs increased by 1.89 and 2.57 percentage points y-o-y respectively, keeping growing in 5 consecutive years. The proportion of net fee in operating income of the JSCBs was still 5.99 percentage points lower than that of the large commercial banks, but the gap slightly narrowed.

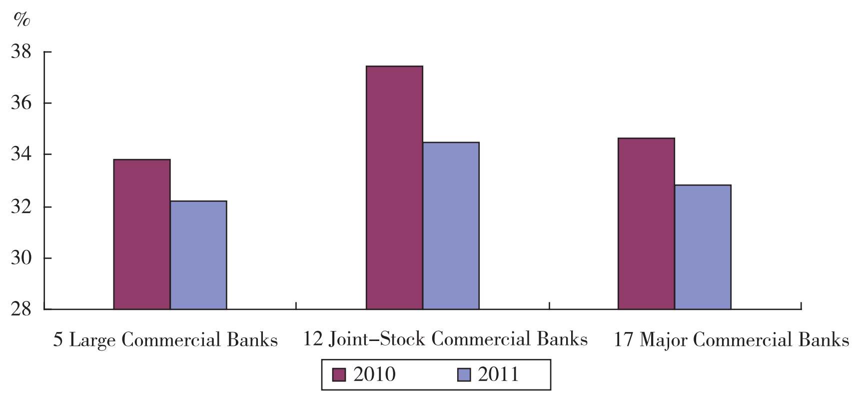
The proportion of investment income in operating income kept declining in 3 consecutive years. In 2011, the inter-bank market remained vigorously. The interest rate in the money market saw a larger fluctuation, while the curve of bond yield abruptly turned downward. While the commercial banks' income from both overseas and domestic investments kept stable, the investment income of the major commercial banks increased by 14.9 percent y-o-y. In particular, the bond investment income and the equity investment income rose by 13.2 and 3.9 percent respectively. The proportion of investment income in operating income of the major commercial banks declined by 2.34 percentage points y-o-y, to 20.7%, declining for the third consecutive year. In particular, that proportion declined by 2.82 percentage points for the large commercial banks, but increased by 0.1 percent point for the JSCBs.

3. Cost Structure Analysis

In 2011, the operating cost① of the major commercial banks amounted to RMB 851.33 billion yuan, increasing by 23.5 percent. In particular, the operating cost of the large commercial banks increased by 21.2 percent to RMB 630.76 billion yuan, and that of the JSCBs rose by 30.6 percent to RMB 220.57 billion yuan.

In 2011, the cost/income ratio② of the major commercial banks was 32.8 percent, down by 1.85 percentage points from the previous year, dropping for the fifth consecutive year (Figure B1.2). In particular, the cost/income ratio of the large commercial banks declined by 1.58 percentage points to 32.3 percent, and that of the JSCBs declined by 2.99 percentage points to 34.5 percent. The net operating income grew faster than the net operating cost. In particular, the growth rates of net operating income of the large commercial banks and the JSCBs were 3.7 and 7.9 percentage points higher than those of the net operating cost of them respectively, indicating an improvement of the profitability commercial banks (Figure B1.3).

FigureB1.2 Cost/Income Ratio of the 17 Major Commercial Banks

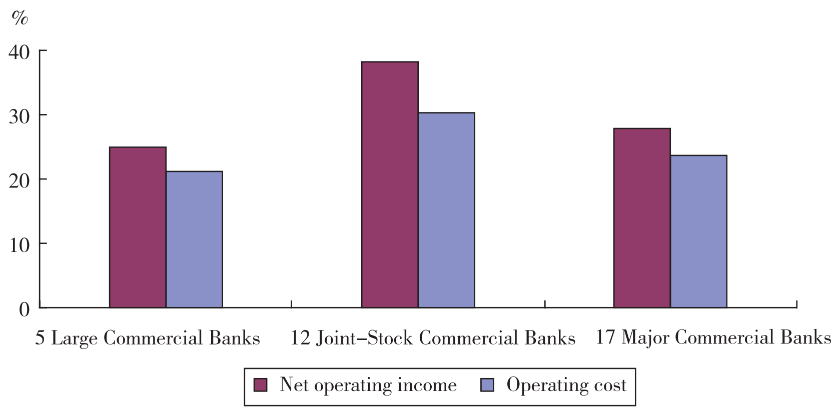


Source:The CBRC.

① Operating cost includes operating expense, business tax and additions, and other operating expenditures.

② Cost/income ratio = (operating cost - business tax and additions) / (net interest income + net fee and commission income +other business income + investment income) × 100%.

FigureB1.3 Growth of Net Operating Income and Operating Cost of the 17 Major Commercial Banks



Source:The CBRC.

II. Asset Analysis

1. The Scale and Structure of Total Assets

In 2011, the total assets of commercial banks maintained a stable growth. As of the end of the year, the total assets of the 17 major commercial banks amounted to RMB 72.01 trillion yuan, increasing by 16.5 percent, accounting for 63.1 percent of the total assets of banking institutions. In particular, the assets of the large commercial banks totaled RMB 52 trillion yuan, increasing by 13.3 percent; the assets of the JSCBs totaled RMB 18.3 trillion yuan, increasing by 23.3 percent.

In terms of the assets structure, loans and investments were still the main constituents, accounting for 67 percent of the total assets. In 2011, the share of deposits in the central bank in total assets of the major commercial banks increased by 1.38 percentage points y-o-y; the share of outstanding loans in total assets decreased by 1.52 percentage points y-o-y; the share of trade finance and interbank deposits increased by 0.69 and 1.17 percentage points y-o-y respectively; the share of assets repurchase and investment declined by 0.63 and 2.34 percentage points y-o-y respectively. For investment, it is the forth consecutive year to decline (Table B1.3).

TableB1.3 Asset Structure of the 17 Major Commercial Banks

	Balance (RMB 100 million yuan)		As a percentage of total assets(percent)	
	2010	2011	2010	2011
Deposit in the central bank	93 423.88	118 791.32	15.12	16.50
Inter-bank deposits	15 819.61	26 890.68	2.56	3.73
Loans	300 073.85	338 717.31	48.56	47.04
Discount	7 686.39	7 115.46	1.24	0.99
Trade finance	16 149.52	23 737.05	2.61	3.30
Inter-bank lending	7 547.67	17 852.76	1.22	2.48
Investment	137 159.99	142 957.27	22.19	19.85
Repurchase of assets	31 572.83	32 265.11	5.11	4.48
Others	8 546.91	11 802.41	1.38	1.64
Total assets	617 980.65	720 129.37	100.00	100.00

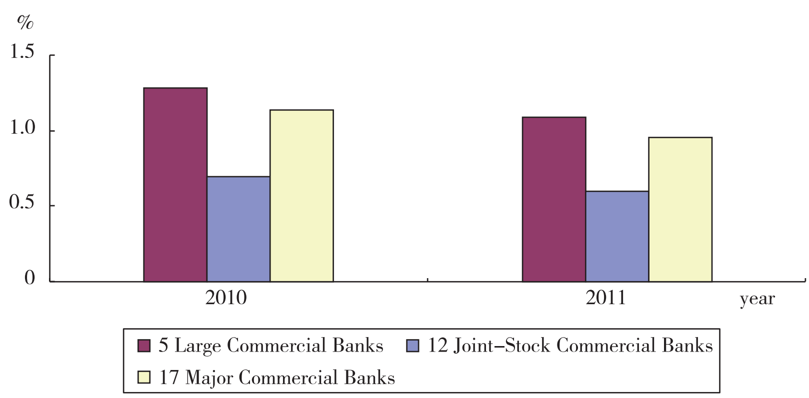
Source: The CBRC.

2. The Size and Quality of Loans

As of the end of 2011, outstanding loans of the major commercial banks reached RMB 35.87 trillion yuan, increased by RMB 4.2 trillion yuan or 13.3 percent y-o-y. In particular, outstanding loans of the large commercial banks rose by 12.6 percent to RMB 26.6 trillion yuan, and that of the JSCBs increased by 15.1 percent to RMB 9.28 trillion yuan.

As of the end of 2011, outstanding NPLs of the major commercial banks amounted to RMB 352.07 billion yuan, decreasing by RMB 12.54 billion yuan y-o-y. The NPL ratio registered 0.98 percent, down 0.17 percentage point y-o-y. In particular, the NPL ratio for the large commercial banks was 1.11 percent, down 0.19 percentage point, and the NPL ratio for the JSCBs was 0.61 percent, down 0.09 percentage points (Figure B1.4).

FigureB1.4 NPL Ratio of the 17 Major Commercial Banks

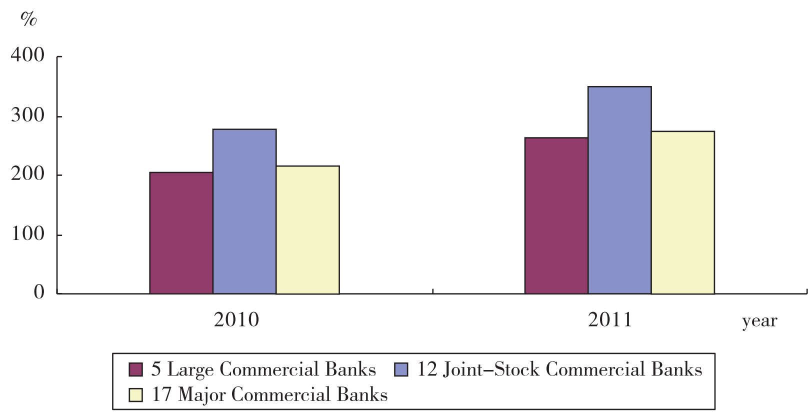


Source: The CBRC.

3. Provision Coverage Ratio[①]

In 2011, the provision coverage ratio of the major commercial banks maintained high level and kept growing. As of the end of 2011, the provision coverage ratio of the major commercial banks reached 275.5 percent, up 57.8 percentage points y-o-y. In particular, the provision coverage ratio of the large commercial banks rose by 54.7 percentage points to 261.5 percent, and that of the JSCBs increased 72.7 percentage points to 350.3 percent (Figure B1.5).

FigureB1.5 Provision Coverage Ratio of the 17 Major Commercial Banks



Source: The CBRC.

III. Liabilities, Capital and Liquidity

1. The Scale and Structure of Liabilities

By the end of 2011, the liabilities of the 17 major commercial banks totaled RMB 67.56 trillion yuan, increasing by 16.2 percent y-o-y, accounting for 63.7 percent of the total liabilities of banking institutions. In particular, the liabilities of the large commercial banks accounted for 47.4 percent, down 1.8 percentage points y-o-y, and that of the JSCBs accounted for 16.3 percent, up 0.6 percentage point y-o-y.

By the end of 2011, deposits of the major commercial banks totaled RMB 56.6 trillion yuan, increasing by 13.2 percentage y-o-y. In particular, corporate deposits rose by

① Provision coverage ratio = loan loss provision / outstanding NPLs × 100%.

9.14 percent, with a drop of 9.92 percentage points in the growth rate; household savings rose by 12.47 percent, with a drop of 1.05 percentage points in the growth rate. With the implementation of prudent monetary policy, the growth rate of deposits declined. Corporate deposits and household savings of the major commercial banks accounted for 78 percent in the total liabilities of the major commercial banks, decreasing by 2 percentage points y-o-y.

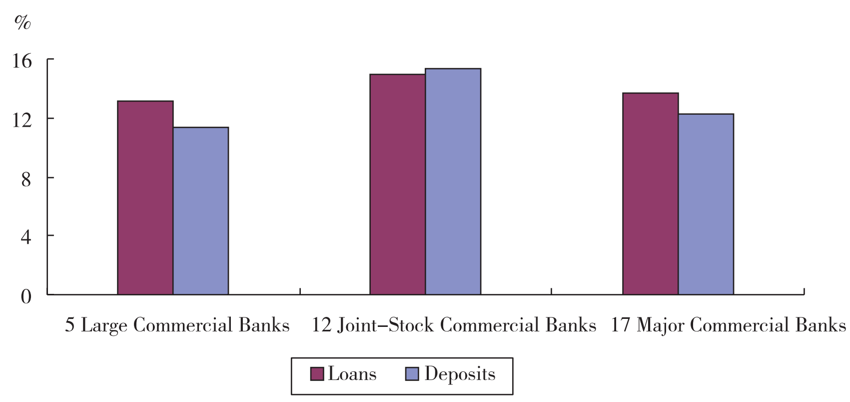
2. Capital and CAR

By the end of 2011, all the 17 major commercial banks had met the CAR requirements of CBRC. The overall CCAR and CAR of the major commercial banks were 9.73 and 12.32 percent respectively, increasing by 0.11 and 0.52 percentage point respectively. As they increased the scale of retained earnings and bond issuance, the major commercial banks' net capital increased substantially by RMB1.02 trillion yuan or 25 percent, to RMB 5.1 trillion yuan.

3. Liquidity

In 2011, loans of both the major commercial banks and the large commercial banks grew faster than their deposits while deposits of the JSCBs grew faster than loans (Figure B1.6). By the end of 2011, the loan/deposit ratio of the major commercial banks recorded 65.26 percent, 0.43 percent point higher that in the end of 2010. The liquidity ratio24 was 41.8 percent, up 0.8 percentage point; RMB excess reserve ratio recorded 2.49 percent, down 0.07 percentage point. The overall liquidity was still sufficient.

FigureB1.6 Growth of Loans and Deposits of the 17 Major Commercial Banks



Source: The CBRC.

Appendix II

Statistics

TableB2.1 Selected Economic Indicators

(Year-end Balance)

Items	2007	2008	2009	2010	2011
Gross Domestic Product (100 million of RMB yuan)	249 530	300 670	335 353	397 983	471 564
Industrial Value Added	107 367.0	129 112.0	134 625.0	160 030.0	188 572.0
Fixed Asset Investment (100 million of RMB yuan)	137 239.0	172 291.0	224 846.0	278 140.0	311 022.0
Retail Sales of Consumer Goods(100 million of RMB yuan)	89 210.0	108 488.0	125 343.0	156 998.0	183 919.0
Urban	60 411.0	73 735.0	85 133.0	136 123.0	159 552.0
County & Below (Rural)	28 799.0	34 753.0	40 210.0	20 875.0	24 367.0
Export & Import (100 million of USD)	21 738.0	25 616.0	22 072.0	29 728.0	36 421.0
Export	12 180.0	14 285.0	12 017.0	15 779.0	18 986.0
Import	9 558.0	11 331.0	10 056.0	13 948.0	17 435.0
Balance	2 622.0	2 955.0	1 961.0	1 831.0	1 551.0
Foreign Direct Investment (100 million of USD)	748.0	924.0	900.0	1 057.0	1 160.0
Foreign Exchange Reserve (100 million of USD)	15 282.5	19 460.3	23 991.5	28 473.4	31 811.0
Consumer Price Index (previous year = 100)	104.8	105.9	99.3	103.3	105.4
Fiscal Revenue(100 million of RMB yuan)	51 304.0	61 316.9	68 476.9	83 080.3	103 740.0
Fiscal Expenditure(100 million of RMB yuan)	49 565.4	62 427.0	75 873.6	89 575.4	108 929.7
Fiscal Balance(100 million of RMB yuan)	1 738.6	-1 110.1	-7 396.7	-6 495.1	-5 189.7
Per Capita Urban Residents Dispensable Income (yuan)	13 786.0	15 781.0	17 175.0	19 109.0	21 810.0
Per Capita Rural Residents Net Income (yuan)	4 140.0	4 761.0	5 153.0	5 919.0	6 977.0
Number of Employed Persons in Urban Area (million)	293.5	302.1	311.2	—	359.1
Registered Unemployment Rate in Urban Area (%)	4.0	4.2	4.3	4.1	4.1
Total Population (million)	1 321.3	1 328.0	1 334.7	1 339.7	1 347.4

Note: Since 2011, the cut-off size of fixed assets investment projects rose from a total planned investment above 500 thousand yuan to 5 million yuan. Since 2010, the new grouping method is adopted by NBS on the Ratail Sales of Consumer Goods: according to the location of outlets, groups "urban" and "county & below" change to "urban" and "rural".

Sources: ① Calculated based on data from "China Statistical Year book", "Statistical Communique of The People's Republic of China on the National Economic and Social Development" and other related materials.

② Data of 2011 was from "Statistical Communique of the People's Republic of China on the 2011 National Economic and Social Development", "Report on the Implementation of the Central and Local Budgets for 2011 and on the Draft of Central and Local Budgets for 2012".

TableB2.2 Selected Financial Indicators (1)

(Year-end Balance)

100 million of RMB yuan

Items	2007	2008	2009	2010	2011
Money & Quasi-money (M_2)	403 442.2	475 166.6	606 225.0	725 851.8	851 590.9
Money (M_1)	152 560.1	166 217.1	220 001.5	266 621.5	289 847.7
Currency in Circulation (M_0)	30 375.2	34 219.0	38 246.0	44 628.2	50 748.5
Total Deposits with Financial Institutions	389 371.2	466 203.3	597 741.1	718 237.9	809 368.3
Urban & Rural Household Deposits	172 534.2	217 885.4	260 771.7	303 302.5	343 635.9
Enterprise Deposits	138 673.7	157 632.2	217 110.0	244 495.6	303 504.3
Total Lending by Financial Institutions	261 690.9	303 394.6	399 684.8	479 195.6	547 946.7

Source: The PBC.

TableB2.3 Selected Financial Indicators (2)

(Growth Rates)

(percent)

Items	2007	2008	2009	2010	2011
Money & Quasi-money (M_2)	16.74	17.82	27.68	19.73	13.61
Money (M_1)	21.05	9.06	32.35	21.19	7.85
Currency in Circulation (M_0)	12.20	12.65	11.77	16.69	13.76
Total Deposits with Financial Institutions	16.07	19.73	28.21	20.16	13.54
Urban & Rural Household Deposits	6.77	26.29	19.68	16.31	13.78
Enterprise Deposits	22.46	13.67	37.73	12.61	9.23
Total Lending by Financial Institutions	16.10	18.73	31.74	19.89	15.83

Note: Growth rates have been adjusted to reflect recent changes in statistical coverage.

Source: The PBC.

TableB2.4 International Liquidity

(millions of USD)

Items	2006	2007	2008	2009	2010	2011
Total Reserves (minus gold)	1 068 538	1 530 279.2	1 949 260	2 414 131	2 862 276	3 197 107
Special Drawing Rights (SDRs)	1 113	1 191	1 199	12 510	12 345	11 855
Reserve Positions in IMF	1 081	839	2 031	2 469	2 593	4 104
Foreign Exchange	1 066 344	1 528 249	1 946 030	2 399 152	2 847 338	3 181 148
Gold (millions of ounce)	19.29	19.29	19.29	33.89	33.89	33.89
Gold (national valuation)	4 074	4 074	4 074	9 815	9 815	9 815
Foreign Liabilities of Other Depository Companies	531 724	82 676	75 255	88 146	108 406	123 250

Note: Data of "Foreign Liabilities of Other Depository Companies" for 2009 has been adjusted to reflect changes in statistical coverage.

Source: The PBC.

TableB2.5 Gold and Foreign Exchange Reserves

Year	Gold Reserves (10 thousand of ounce)	Foreign Exchange Reserves (100 million of USD)	Change in Foreign Exchange Reserves (percent)
1995	1 267	736.0	42.6
1996	1 267	1 050.3	42.7
1997	1 267	1 398.9	33.2
1998	1 267	1 449.6	3.6
1999	1 267	1 546.8	6.7
2000	1 267	1 655.7	7.0
2001	1 608	2 121.7	28.1
2002	1 929	2 864.1	35.0
2003	1 929	4 032.5	40.8
2004	1 929	6 099.3	51.3
2005	1 929	8 188.7	34.3
2006	1 929	10 663.4	30.2
2007	1 929	15 282.5	43.3
2008	1 929	19 460.3	27.3
2009	3 389	23 991.5	23.3
2010	3 389	28 473.4	18.7
2011	3 389	31 811.5	11.7

Note: PBC made adjustment to data of gold reserves in December 2001, December 2002 and April 2009.

Source: The PBC.

TableB2.6 Assets of China's Financial Sector

(Including foreign currencies)

(December 31, 2011)

(trillions of RMB yuan)

Items	Balance
Financial Sector	148.97
Central Bank	28.10
Banking Financial Institutions	113.29
Securities Financial Institutions	1.57
Insurance Financial Institutions	6.01

Note：Securities Financial Institutions only include securities companies.

Source: Calculated by the Financial Stability Analysis Group of PBC.

TableB2.7 Depository Corporations Survey in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter4
Net Foreign Assets	235 260.6	243 522.6	248 704.1	251 644.5
Domestic Credit	611 055.8	630 497.6	647 552.5	687 971.6
Claims on Governments (net)	31 899.1	26 633.5	27 862.7	42 363.9
Claims on Non-financial Sectors	542 273.6	562 821.9	579 365.7	600 634.5
Claims on other Financial Sectors	36 883.1	41 042.2	40 324.1	44 973.1
Money & Quasi-money	758 131.0	780 821.0	787 406.2	851 590.9
Money	266 255.6	274 662.7	267 193.2	289 847.7
Currency in Circulation	44 845.3	44 477.9	47 145.3	50 748.5
Demand Deposits	221 410.3	230 184.8	220 047.9	239 099.2
Quasi-money	491 875.4	506 158.3	520 213.0	561 743.2
Time Deposits	148 781.1	159 299.8	171 105.4	166 616.0
Savings Deposits	331 308.9	337 570.6	341 792.3	352 797.5
Other Deposits	11 785.4	9 287.9	7 315.3	42 329.7
Deposits not Included in Broad Money	21 189.8	22 774.9	22 757.4	16 809.1
Bonds	64 385.4	69 587.2	72 964.0	75 409.7
Paid-in Capital	26 982.8	27 533.1	28 008.0	28 861.7
Other Items (net)	-24 372.5	-26 695.9	-14 879.1	-33 055.3

Notes: ① PBC began to compile Depository Corporations Survey from 2006. Depository Corporations Survey does not cover Trust Investment Company and Financial Lease Company, compared with former Banking Survey.

② Data of Other Deposits does not include margin deposits of Non-financial Companies since 2006.

Source: The PBC.

TableB2.8 Balance Sheet of Monetary Authority in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	226 277.5	234 697.9	241 200.8	237 898.1
Foreign Exchange	217 476.5	226 386.7	233 853.6	232 388.7
Money Gold	669.8	669.8	669.8	669.8
Other Foreign Assets	8 131.2	7 641.3	6 677.4	4 839.5
Claims on Governments	15 404.8	15 404.8	15 399.7	15 399.7
Of Which: Central Government	15 404.8	15 404.8	15 399.7	15 399.7
Claims on Other Depository Corporations	9 561.5	9 678.0	9 556.6	10 247.5
Claims on Other Financial Corporations	11 318.7	11 253.9	11 244.8	10 644.0
Claims on Non-financial Corporations	25.0	25.0	25.0	25.0
Other Assets	6 230.5	7 018.9	7 485.3	6 763.3
Total Assets	**268 818.0**	**278 078.6**	**284 912.2**	**280 977.6**
Reserve Money	192 565.4	203 469.9	212 204.1	224 641.8
Currency Issuance	49 272.5	48 815.9	52 203.2	55 850.1
Other Depository Corporations	143 292.9	154 654.0	160 000.9	168 791.7
Deposits of Financial Corporations not included in Reserve Money	978.4	802.6	860.6	908.4
Bond Issuance	31 160.3	27 266.1	22 451.0	23 336.7
Foreign Liabilities	4 579.9	4 866.4	4 671.9	2 699.4
Deposits of Government	27 289.0	34 542.1	35 711.8	22 733.7
Own Capital	219.8	219.8	219.8	219.8
Other Liabilities	12 025.2	6 911.7	8 793.1	6 438.0
Total Liabilities	**268 818.0**	**278 078.6**	**284 912.2**	**280 977.6**

Source: The PBC.

TableB2.9 Balance Sheet of Other Depository Corporations in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	20 801.4	21 977.5	20 353.6	24 211.7
Reserve Assets	146 871.3	158 159.9	164 084.2	173 004.1
Deposits with Central Bank	142 444.1	153 821.9	159 026.3	167 902.5
Cash in Vault	4 427.2	4 338.0	5 057.9	5 101.6
Claims on Governments	43 783.3	45 770.8	48 174.7	49 697.8
Of Which: Central Government	43 783.3	45 770.8	48 174.7	49 697.8
Claims on Central Bank	35 632.3	26 612.2	23 719.8	22 324.0
Claims on Other Depository Corporations	154 450.0	166 119.0	161 523.0	179 466.0
Claims on Other Financial Corporations	25 564.4	29 788.2	29 079.3	34 329.2
Claims on Non-financial Corporations	423 349.3	436 947.9	448 125.0	465 395.2
Claims on Other Resident Sectors	118 899.3	125 849.0	131 215.7	135 214.4
Other Assets	47 948.5	50 642.7	51 949.8	54 224.7
Total Assets	**1 017 299.8**	**1 061 867.2**	**1 078 225.2**	**1 137 867.1**
Liabilities to Non-financial Institutions and Households	726 488.7	753 967.7	760 469.3	780 043.9
Deposits Included in Broad Money	701 500.3	727 055.2	732 945.6	758 512.7
Enterprise Demand Deposits	221 410.3	230 184.8	220 047.9	239 099.2
Enterprise Time Deposits	148 781.1	159 299.8	171 105.4	166 616.0
Household Savings Deposits	331 308.9	337 570.6	341 792.3	352 797.5
Deposits not Included in Broad Money	21 189.8	22 774.9	22 757.4	16 809.1
Transferable Deposits	7 542.7	8 005.5	7 020.9	7 118.5
Other Deposits	13 647.1	14 769.3	15 736.5	9 690.6
Other Liabilities	3 798.6	4 137.7	4 766.4	4 722.1
Liabilities to Central Bank	4 915.1	5 263.0	6 081.7	6 763.9
Liabilities to Other Depository Corporations	62 803.9	68 211.9	69 259.0	85 082.0
Liabilities to Other Financial Corporations	40 556.5	41 217.5	40 497.7	52 210.9
Of Which: Deposits Included in Broad Money	11 785.4	9 287.9	7 315.3	42 329.7
Foreign Liabilities	7 238.4	8 286.3	8 178.4	7 765.9
Bond Issuance	64 385.4	69 587.2	72 964.0	75 409.7
Paid-in Capital	26 763.0	27 313.3	27 788.3	28 642.0
Other Liabilities	84 148.8	88 020.3	92 986.7	101 948.9
Total Liabilities	**1 017 299.8**	**1 061 867.2**	**1 078 225.2**	**1 137 867.1**

Source: The PBC.

TableB2.10 Balance Sheet of Chinese–funded Large Banks in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	15 281.24	15 803.52	14 366.83	17 393.45
Reserve Assets	93 259.40	99 021.94	102 720.53	102 283.66
Deposits with Central Bank	90 776.57	96 640.94	99 878.58	99 371.69
Cash in Vault	2 482.83	2 381.00	2 841.95	2 911.96
Claims on Governments	29 660.49	31 011.54	32 664.35	33 518.21
Of Which: Central Government	29 660.49	31 011.54	32 664.35	33 518.21
Claims on Central Bank	32 461.97	23 990.55	21 495.00	19 509.63
Claims on Other Depository Corporations	70 146.48	76 870.78	73 822.20	79 116.87
Claims on Other Financial Corporations	15 411.77	19 152.60	18 404.88	20 576.74
Claims on Non-financial Corporations	246 176.14	252 522.94	258 428.50	266 750.32
Claims on Other Resident Sectors	63 944.31	67 562.25	70 755.09	73 526.67
Other Assets	31 475.48	33 466.80	33 317.46	34 048.26
Total Assets	**597 817.28**	**619 402.90**	**625 974.85**	**646 723.81**
Liabilities to Non-financial Institutions and Households	439 940.88	453 379.95	456 075.05	458 964.23
Deposits Included in Broad Money	422 688.98	435 085.96	437 392.95	445 941.34
Enterprise Demand Deposits	127 393.29	132 607.06	125 737.99	134 650.32
Enterprise Time Deposits	70 306.90	74 708.19	81 606.25	76 394.95
Household Savings Deposits	224 988.79	227 770.70	230 048.71	234 896.07
Deposits not Included in Broad Money	14 062.81	14 953.86	14 841.79	9 357.32
Transferable Deposits	4 279.84	4 529.33	3 833.39	3 636.14
Other Deposits	9 782.97	10 424.53	11 008.41	5 721.18
Other Liabilities	3 189.09	3 340.14	3 840.31	3 665.57
Liabilities to Central Bank	881.91	1 000.85	1 614.52	2 076.57
Liabilities to Other Depository Corporations	19 691.53	22 746.53	24 754.53	27 970.84
Liabilities to Other Financial Corporations	23 368.23	22 687.05	20 927.26	29 337.58
Of Which: Deposits Included in Broad Money	8 117.14	6 403.26	4 891.68	24 374.89
Foreign Liabilities	2 940.64	3 281.30	2 913.85	2 717.53
Bond Issuance	44 948.77	48 243.29	49 943.44	50 956.96
Paid-in Capital	15 835.37	15 884.36	15 915.52	15 904.68
Other Liabilities	50 209.96	52 179.56	53 830.66	58 795.41
Total Liabilities	**597 817.28**	**619 402.90**	**625 974.85**	**646 723.81**

Source: The PBC.

TableB2.11 Balance Sheet of Chinese–funded Medium–sized Banks in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	4 122.28	4 670.42	4 589.16	5 108.48
Reserve Assets	22 508.73	24 674.78	25 195.99	28 353.98
Deposits with Central Bank	22 129.47	24 275.59	24 758.89	27 885.83
Cash in Vault	379.26	399.19	437.11	468.15
Claims on Governments	6 678.62	7 004.49	7 265.00	7 539.97
Of Which: Central Government	6 678.62	7 004.49	7 265.00	7 539.97
Claims on Central Bank	2 189.68	2 005.57	1 640.42	1 956.77
Claims on Other Depository Corporations	37 012.20	38 822.06	37 468.32	44 221.39
Claims on Other Financial Corporations	4 547.57	5 090.80	4 358.14	6 670.20
Claims on Non-financial Corporations	95 328.27	99 256.57	101 305.84	105 724.99
Claims on Other Resident Sectors	20 846.22	22 209.43	23 112.61	24 081.70
Other Assets	5 194.11	5 666.44	6 742.99	7 331.55
Total Assets	**198 427.67**	**209 400.56**	**211 678.46**	**230 989.04**
Liabilities to Non-financial Institutions and Households	119 248.41	124 850.57	125 015.86	130 272.49
Deposits Included in Broad Money	114 766.61	119 893.68	120 014.03	125 649.30
Enterprise Demand Deposits	44 731.47	45 498.71	42 946.01	46 817.74
Enterprise Time Deposits	45 156.54	48 365.15	50 812.98	50 945.02
Household Savings Deposits	24 878.59	26 029.82	26 255.03	27 886.55
Deposits not Included in Broad Money	4 097.32	4 422.84	4 383.85	4 025.07
Transferable Deposits	1 636.71	1 678.36	1 528.66	1 699.00
Other Deposits	2 460.61	2 744.48	2 855.19	2 326.06
Other Liabilities	384.48	534.04	617.98	598.13
Liabilities to Central Bank	2 814.02	2 928.65	2 951.05	3 096.65
Liabilities to Other Depository Corporations	22 692.91	24 399.70	21 912.37	29 889.15
Liabilities to Other Financial Corporations	15 270.30	16 103.67	17 036.50	19 783.85
Of Which: Deposits Included in Broad Money	3 566.27	2 765.63	2 377.30	16 295.14
Foreign Liabilities	736.89	870.06	724.94	725.78
Bond Issuance	18 591.21	20 436.40	22 098.91	23 411.06
Paid-in Capital	2 149.93	2 258.92	2 352.02	2 351.63
Other Liabilities	16 923.99	17 552.59	19 586.83	21 458.43
Total Liabilities	**198 427.67**	**209 400.56**	**211 678.46**	**230 989.04**

Source: The PBC.

TableB2.12 Balance Sheet of Chinese–funded Small Banks in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	137.29	292.85	211.96	317.34
Reserve Assets	17 655.43	19 958.71	20 781.36	24 966.11
Deposits with Central Bank	17 014.97	19 291.68	20 000.48	24 087.11
Cash in Vault	640.46	667.03	780.88	879.01
Claims on Governments	5 628.49	5 752.43	6 023.69	6 234.15
Of Which: Central Government	5 628.49	5 752.43	6 023.69	6 234.15
Claims on Central Bank	820.08	498.67	464.81	715.33
Claims on Other Depository Corporations	26 664.31	29 018.33	28 336.27	34 407.24
Claims on Other Financial Corporations	3 242.36	3 391.82	4 241.57	5 125.51
Claims on Non-financial Corporations	48 581.54	50 822.28	53 018.72	56 894.17
Claims on Other Resident Sectors	13 853.80	14 836.76	15 634.31	16 691.66
Other Assets	5 217.14	5 145.00	5 494.22	6 003.40
Total Assets	**121 800.44**	**129 716.85**	**134 206.92**	**151 354.91**
Liabilities to Non-financial Institutions and Households	91 792.69	97 610.36	99 326.44	109 208.88
Deposits Included in Broad Money	91 027.19	96 656.71	98 288.20	108 395.94
Enterprise Demand Deposits	31 314.26	33 170.56	32 572.25	37 003.33
Enterprise Time Deposits	21 010.17	23 405.57	24 744.21	26 081.65
Household Savings Deposits	38 702.76	40 080.59	40 971.75	45 310.96
Deposits not Included in Broad Money	608.72	766.32	822.69	498.56
Transferable Deposits	242.78	270.22	253.24	263.18
Other Deposits	365.94	496.10	569.45	235.37
Other Liabilities	156.78	187.33	215.56	314.38
Liabilities to Central Bank	320.03	284.89	347.47	418.11
Liabilities to Other Depository Corporations	15 481.27	15 996.73	17 460.75	22 157.42
Liabilities to Other Financial Corporations	1 054.65	1 538.86	1 632.20	2 066.31
Of Which: Deposits Included in Broad Money	101.29	118.41	45.82	1 563.25
Foreign Liabilities	35.08	108.04	125.23	174.37
Bond Issuance	499.19	565.38	582.43	702.98
Paid-in Capital	3 921.99	4 192.29	4 372.60	4 903.42
Other Liabilities	8 695.54	9 420.30	10 359.78	11 723.42
Total Liabilities	**121 800.44**	**129 716.85**	**134 206.92**	**151 354.91**

Source: The PBC.

TableB2.13 Balance Sheet of Foreign–funded Banks in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	1 156.87	1 112.05	1 107.38	1 296.17
Reserve Assets	2 193.15	2 358.68	2 702.64	2 966.48
Deposits with Central Bank	2 183.83	2 346.97	2 692.39	2 955.73
Cash in Vault	9.32	11.71	10.25	10.75
Claims on Governments	857.90	1 084.11	1 308.34	1 541.46
Of Which: Central Government	857.90	1 084.11	1 308.34	1 541.46
Claims on Central Bank	0.00	0.00	0.00	0.00
Claims on Other Depository Corporations	3 896.36	4 542.40	4 861.97	5 041.76
Claims on Other Financial Corporations	311.65	343.41	431.82	493.26
Claims on Non-financial Corporations	8 491.60	8 687.86	8 901.22	8 981.34
Claims on Other Resident Sectors	417.34	420.11	445.07	462.24
Other Assets	2 433.53	2 594.59	2 577.17	2 601.01
Total Assets	**19 758.39**	**21 143.20**	**22 335.61**	**23 383.71**
Liabilities to Non-financial Institutions and Households	9 971.15	10 624.69	11 338.01	12 202.23
Deposits Included in Broad Money	8 029.37	8 506.41	9 147.76	9 787.67
Enterprise Demand Deposits	2 019.92	2 118.63	1 978.08	2 610.72
Enterprise Time Deposits	4 726.03	4 939.40	5 567.97	5 419.74
Household Savings Deposits	1 283.42	1 448.38	1 601.71	1 757.21
Deposits not Included in Broad Money	1 941.78	2 118.28	2 190.25	2 414.56
Transferable Deposits	1 007.80	1 054.12	963.16	1 091.44
Other Deposits	933.98	1 064.16	1 227.10	1 323.11
Other Liabilities	0.00	0.00	0.00	0.00
Liabilities to Central Bank	0.96	0.00	1.90	3.45
Liabilities to Other Depository Corporations	1 150.80	1 236.68	1 368.48	1 617.61
Liabilities to Other Financial Corporations	527.80	515.55	552.55	541.97
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	3 525.73	4 026.90	4 414.31	4 148.17
Bond Issuance	24.66	20.42	11.01	11.07
Paid-in Capital	1 526.94	1 545.09	1 583.49	1 622.54
Other Liabilities	3 030.35	3 173.87	3 065.86	3 236.68
Total Liabilities	**19 758.39**	**21 143.20**	**22 335.61**	**23 383.71**

Source: The PBC.

TableB2.14 Balance Sheet of Urban Credit Cooperatives in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	0.00	0.00	0.00	0.00
Reserve Assets	7.45	7.49	7.96	8.30
Deposits with Central Bank	6.92	6.95	7.30	7.58
Cash in Vault	0.53	0.55	0.66	0.72
Claims on Governments	0.80	0.80	0.80	0.75
Of Which: Central Government	0.80	0.80	0.80	0.75
Claims on Central Bank	0.00	0.00	0.00	0.00
Claims on Other Depository Corporations	4.37	6.69	7.85	8.68
Claims on Other Financial Corporations	0.00	0.00	0.00	0.00
Claims on Non-financial Corporations	16.86	17.35	18.56	19.49
Claims on Other Resident Sectors	16.34	15.88	16.06	17.39
Other Assets	4.08	4.57	6.52	8.81
Total Assets	**49.91**	**52.78**	**57.76**	**63.43**
Liabilities to Non-financial Institutions and Households	44.73	46.77	49.38	55.19
Deposits Included in Broad Money	44.72	46.77	49.38	55.19
Enterprise Demand Deposits	8.69	8.65	9.38	10.20
Enterprise Time Deposits	5.73	7.48	8.10	9.85
Household Savings Deposits	30.31	30.63	31.90	35.14
Deposits not Included in Broad Money	0.00	0.00	0.00	0.00
Transferable Deposits	0.00	0.00	0.00	0.00
Other Deposits	0.00	0.00	0.00	0.00
Other Liabilities	0.00	0.00	0.00	0.00
Liabilities to Central Bank	0.00	0.00	0.00	0.00
Liabilities to Other Depository Corporations	1.80	1.59	1.29	0.86
Liabilities to Other Financial Corporations	0.04	0.00	0.00	0.00
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	0.00	0.00	0.00	0.00
Bond Issuance	0.00	0.00	0.00	0.00
Paid-in Capital	2.31	2.29	5.83	5.83
Other Liabilities	1.03	2.12	1.26	1.55
Total Liabilities	**49.91**	**52.78**	**57.76**	**63.43**

Source: The PBC.

TableB2.15 Balance Sheet of Rural Credit Cooperatives in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	12.06	7.91	7.54	5.84
Reserve Assets	9 433.24	10 045.67	10 527.75	12 399.62
Deposits with Central Bank	8 554.32	9 167.20	9 540.73	11 568.69
Cash in Vault	878.92	878.47	987.02	830.94
Claims on Governments	771.57	733.68	758.29	731.83
Of Which: Central Government	771.57	733.68	758.29	731.83
Claims on Central Bank	158.88	116.24	118.32	140.76
Claims on Other Depository Corporations	11 374.63	11 517.01	11 768.07	10 755.31
Claims on Other Financial Corporations	1 757.44	1 422.99	1 334.22	1 146.73
Claims on Non-financial Corporations	17 376.29	18 035.88	18 497.36	18 528.00
Claims on Other Resident Sectors	19 656.30	20 625.10	21 053.87	20 204.37
Other Assets	3 102.08	3 256.59	3 288.96	3 687.48
Total Assets	**63 642.49**	**65 761.08**	**67 354.37**	**67 599.94**
Liabilities to Non-financial Institutions and Households	53 303.84	54 716.65	55 852.64	55 846.81
Deposits Included in Broad Money	53 223.37	54 627.64	55 744.81	55 702.72
Enterprise Demand Deposits	9 883.03	10 269.37	10 706.73	10 876.68
Enterprise Time Deposits	1 915.48	2 147.98	2 155.23	1 914.72
Household Savings Deposits	41 424.86	42 210.28	42 882.85	42 911.31
Deposits not Included in Broad Money	18.40	19.01	21.30	7.16
Transferable Deposits	4.74	5.04	4.85	0.97
Other Deposits	13.66	13.97	16.45	6.20
Other Liabilities	62.07	70.00	86.52	136.92
Liabilities to Central Bank	889.29	1 042.64	1 134.23	1 107.58
Liabilities to Other Depository Corporations	3 042.35	3 132.96	3 096.90	2 652.93
Liabilities to Other Financial Corporations	308.07	344.62	308.27	412.60
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	44.38
Foreign Liabilities	0.02	0.02	0.02	0.02
Bond Issuance	0.10	0.00	6.78	5.98
Paid-in Capital	2 100.33	2 149.40	2 187.24	2 353.64
Other Liabilities	3 998.48	4 374.80	4 768.30	5 220.38
Total Liabilities	**63 642.49**	**65 761.08**	**67 354.37**	**67 599.94**

Source: The PBC.

TableB2.16 Balance Sheet of Finance Companies in 2011

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	91.70	90.75	70.73	90.46
Reserve Assets	1 813.90	2 092.64	2 147.99	2 025.90
Deposits with Central Bank	1 778.03	2 092.60	2 147.96	2 025.86
Cash in Vault	35.87	0.04	0.03	0.04
Claims on Governments	185.45	183.75	154.26	131.48
Of Which: Central Government	185.45	183.75	154.26	131.48
Claims on Central Bank	1.69	1.14	1.29	1.47
Claims on Other Depository Corporations	5 351.63	5 341.75	5 258.34	5 914.80
Claims on Other Financial Corporations	293.60	386.62	308.66	316.74
Claims on Non-financial Corporations	7 378.58	7 604.97	7 954.76	8 496.88
Claims on Other Resident Sectors	165.02	179.51	198.72	230.33
Other Assets	522.05	508.69	522.44	544.16
Total Assets	**15 803.62**	**16 389.82**	**16 617.18**	**17 752.22**
Liabilities to Non-financial Institutions and Households	12 186.97	12 738.71	12 811.95	13 494.09
Deposits Included in Broad Money	11 720.02	12 238.00	12 308.47	12 980.58
Enterprise Demand Deposits	6 059.60	6 511.79	6 097.45	7 130.26
Enterprise Time Deposits	5 660.24	5 726.00	6 210.69	5 850.10
Household Savings Deposits	0.17	0.21	0.34	0.22
Deposits not Included in Broad Money	460.78	494.54	497.49	506.40
Transferable Deposits	370.85	468.47	437.62	427.75
Other Deposits	89.93	26.07	59.87	78.65
Other Liabilities	6.17	6.17	6.00	7.11
Liabilities to Central Bank	8.90	5.95	32.50	61.50
Liabilities to Other Depository Corporations	743.25	697.65	664.70	793.16
Liabilities to Other Financial Corporations	27.43	27.79	40.96	68.58
Of Which: Deposits Included in Broad Money	0.70	0.59	0.52	52.02
Foreign Liabilities	0.00	0.00	0.00	0.00
Bond Issuance	321.45	321.68	321.46	321.64
Paid-in Capital	1 226.14	1 280.98	1 371.56	1 500.26
Other Liabilities	1 289.49	1 317.06	1 374.05	1 512.99
Total Liabilities	**15 803.62**	**16 389.82**	**16 617.18**	**17 752.22**

Source: The PBC.

TableB2.17 Statistics of Securities Market

Year	2005	2006	2007	2008	2009	2010	2011
Number of Domestic Listed Companies (A share, B share)	1381	1434	1550	1625	1718	2063	2342
Number of Domestic Listed Foreign Companies (B share)	109	109	109	109	108	108	108
Number of Overseas Listed Companies (H share)	122	143	148	153	159	165	171
Number of Shares Issued (100 million of shares)	7 629.51	14 897.57	22 416.85	24 522.85	26 162.85	33 184.35	36 095.52
Of Which: Negotiable Shares (100 million of shares)	2 914.77	5 637.79	10 331.52	12 578.91	19 759.53	25 642.03	28 850.26
Total Market Value of Shares (100 million of RMB yuan)	32 430.28	89 403.90	327 140.89	121 366.44	243 939.12	265 422.59	214 758.09
Of Which:Negotiable Shares (100 million of RMB yuan)	10 630.51	25 003.64	93 064.35	45 213.90	151 258.65	193 110.41	164 921.30
Trade Volume of Shares(100 million of shares)	6 623.73	16 145.22	45 038.71	24 131.38	51 106.99	42 151.99	33 957.55
Turnover of Shares(100 million of RMB yuan)	31 664.78	90 468.91	460 556.20	267 112.64	535 986.74	545 633.54	421 646.74
Shanghai Composite Index (close)	1 161.06	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08	2 199.42
Shenzhen Composite Index (close)	278.75	550.59	1 447.02	553.30	1 201.34	1 290.87	866.65
Number of Investor Accounts (10 thousand)	7 336.07	7 854.00	13 887.02	12 363.89	14 027.88	15 454.03	16 546.90
Average P/E							
Shanghai	16.33	33.38	59.24	14.86	28.73	21.61	13.40
Shenzhen	16.36	33.61	72.11	17.13	46.01	44.69	23.11
Average Turnover Rate (percent)							
Shanghai	274.37	46.31	37.77	392.52	499.41	197.61	124.80
Shenzhen	316.43	55.95	42.35	469.11	793.27	557.46	340.49
Treasury Bonds Issue (100 million of RMB yuan)	7 042.00	8 883.00	23 139.10	8 558.20	17 927.24	19 778.30	17 100.10
Corporate Bonds Issue (100 million of RMB yuan)	2 046.50	3 938.00	5 181.00	8 723.40	16 599.30	16 094.45	21 395.32
Trade Volume of Bonds(10 thousand of units)	283 714.36						
Turnover of Bonds(100 million of RMB yuan)	28 367.85						
Turnover of Outright Treasury Bonds Purchase(100 million of RMB yuan)	2 780.63	1 540.71	1 200.59	2 122.52	2 085.10	1 661.64	1 253.32
Turnover of Treasury Bonds Repo(100 million of RMB yuan)	23 621.17	9 092.77	18 345.08	24 268.65	35 475.87	65 877.79	199 581.50
Number of Securities Investment Funds	218	301	346	439	557	704	915
Number of Shares of Securities Investment Funds(100 million of shares)	4 714.18	6 020.09	22 339.84	19 403.25	26 767.05	25 200.75	21 917.54
Turnover of Securities Investment Funds(100 million of RMB yuan)	773.15	1 909.68	8 620.10	5 831.06	10 249.58	8 996.43	6 365.80
Trading Volume of Futures(10 thousand lots)	32 287.41	272 098.56	71 565.57	136 396.00	215 751.76	313 368.83	105 413.75
Turnover of Futures (100 million of RMB yuan)	134 463.38	209 533.78	400 733.30	719 173.35	1 305 142.92	3 080 592.40	1 375 162.44

Source: The CSRC.

TableB2.18 Ratio of Stock Market Capitalization to GDP

(100 million of RMB yuan unless otherwise noted)

Year	GDP	Market Capitalization	Ratio (percent)	GDP	Negotiable Market Capitalization	Ratio (percent)
1995	60 794	3 474	5.71	60 794	938	1.54
1996	71 177	9 842	13.83	71 177	2 867	4.03
1997	78 973	17 529	22.20	78 973	5 204	6.59
1998	84 402	19 506	23.11	84 402	5 746	6.81
1999	89 677	26 471	29.52	89 677	8 214	9.16
2000	99 215	48 091	48.47	99 215	16 088	16.21
2001	109 655	43 522	39.69	109 655	14 463	13.19
2002	120 333	38 329	31.85	120 333	12 485	10.38
2003	135 823	42 458	31.26	135 823	13 179	9.70
2004	159 878	37 056	23.18	159 878	11 689	7.31
2005	183 868	32 430	17.64	183 868	10 631	5.78
2006	211 923	89 404	42.19	211 923	25 004	11.80
2007	249 530	327 141	131.10	249 530	93 064	37.30
2008	300 670	121 366	40.36	300 670	45 214	15.04
2009	335 353	243 939	72.74	335 353	151 259	45.10
2010	397 983	265 422	66.69	397 983	193 110	48.52
2011	471 564	214 758	45.54	471 564	164 921	34.97

Source: Calculated based on data from the CSRC and the NBS.

TableB2.19 Ratio of Domestic Stock Financing to Bank Loan Increment

(100 million of RMB yuan unless otherwise noted)

Year	Domestic Stock Financing	Loan Increment	Ratio (percent)
1995	118.86	9 339.82	1.27
1996	341.52	10 683.33	3.20
1997	933.82	10 712.47	8.72
1998	803.57	11 490.94	6.99
1999	897.39	10 846.36	8.27
2000	1 541.02	13 346.61	11.55
2001	1 182.13	12 439.41	9.50
2002	779.75	18 979.20	4.11
2003	823.10	27 702.30	2.97
2004	862.67	19 201.60	4.49
2005	338.13	16 492.60	2.05
2006	1 231.89	31 441.30	3.92
2007	8 431.86	36 322.51	23.21
2008	3 308.16	49 854.00	6.64
2009	3 923.52	96 290.18	4.07
2010	9 672.20	79 510.73	12.16
2011	5 518.27	68 751.14	8.03

Note: Domestic stock financing includes financing through A share and B share.

Source: Calculated based on data from the PBC and the CSRC.

TableB2.20 Statistics of Stock Market

Year		2005	2006	2007	2008	2009	2010	2011
Number of Domestic Listed Companies (A share, B share)		1381	1434	1550	1625	1718	2063	2342
Of Which: ST Companies		115			140	142	153	137
Medium/ Small-sized Companies		50	102	202	273	327	531	646
Growth Enterprises Board						36	153	281
Number of Domestic Listed Foreign Companies (B share)		109	109	109	109	108	108	108
Of Which: ST Companies		15			20			
Number of Shares Issued (100 million of shares)		7 629.51	14 897.57	22 416.85	24 522.85	26 162.85	33 184.35	36 095.52
Of Which: Medium/ Small-sized Companies		56.14	143.21	339.64	591.60	794.13	1 366.74	1 943.50
Growth Enterprises Board						34.60	175.06	399.53
Total Market Capitalization of Shares (100 million of RMB yuan)		32 430.28	89 403.90	327 140.89	121 366.44	243 939.12	265 422.59	214 758.10
Of Which: Medium/ Small-sized Companies		481.15	2 015.30	10 646.84	6 269.68	16 872.55	35 364.61	27 429.32
Growth Enterprises Board						1 610.08	7 365.22	7 433.79
Market Capitalization of Negotiable Shares(100 million of RMB yuan)		10 630.51	25 003.64	93 064.35	45 213.90	151 258.65	193 110.41	164 921.30
Of Which: Medium/ Small-sized Companies		185.29	723.63	3 823.66	2 672.68	7 503.57	16 150.32	14 343.52
Growth Enterprises Board						298.97	2 005.64	2 504.08
Volume (100 million of shares)	Total	6 623.73	16 145.22	45 038.71	24 131.38	51 106.99	42 151.99	33 957.55
	Daily Average	27.37	66.99	186.11	98.10	209.45	174.18	139.17
	Medium/ Small-sized	130.30	296.78		1 189.26		4 055.35	3 729.74
	Growth Enterprises Board	—	—	—	—	—	400.53	761.69
Turnover (100 million of RMB yuan)	Total	31 664.78	90 468.91	460 556.22	267 112.64	535 986.74	545 633.54	421 469.72
	Daily Average	130.85	375.39	1 903.12	1 085.82	2 196.67	2 254.68	1 728.07
	Medium/ Small-sized	1 203.92	3 071.55	16 173.66	16 637.28	48 273.52	85 832.42	69 026.46
	Growth Enterprises Board	—	—	—	—	1 828.11	15 717.88	18 879.15

(concluded)

Year		2005	2006	2007	2008	2009	2010	2011
Average Turnover Rate(percent)	Shanghai	274.37	46.31	37.77	392.52	499.41	197.61	124.80
	Shenzhen	316.43	55.95	42.35	469.11	793.27	557.46	340.49
Average P/E	Shanghai	16.33	33.38	59.24	14.86	28.73	21.61	13.40
	Shenzhen	16.36	33.61	72.11	17.13	46.01	44.69	23.11
	Medium/ Small-sized	24.49	42.03	85.07	24.96	51.01	56.93	28.26
	Growth Enterprises Board					105.38	78.53	37.62
Shanghai Composite Index	Open	1 260.78	1 163.88	2 728.19	5 265.00	1 849.02	3 289.75	2 825.33
	Highest	1 328.53	2 698.90	6 124.04	5 522.78	3 478.01	3 306.75	3 067.46
	Date	2005-02-25	2006-12-29	2007-10-16	2008-01-14	2009-08-04	2010-01-11	2011-04-18
	Lowest	998.23	1 161.91	2 617.02	1 664.92	1 844.09	2 319.74	2 134.02
	Date	2005-06-06	2006-01-04	2007-01-05	2008-10-28	2009-01-05	2010-07-02	2011-11-28
	Average	1 153.55	2 302.94	4 797.17	2 707.32	2 969.10	2 810.66	
	Close	1 161.06	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08	2 199.42
Shenzhen Composite Index	Open	313.81	278.99	555.26	1 450.33	560.10	1 207.33	1 298.59
	Highest	333.28	552.93	1 567.74	1 584.40	1 240.64	1 414.64	1 316.19
	Date	2005-03-09	2006-12-29	2007-10-08	2008-01-15	2009-12-04	2010-11-11	2011-01-06
	Lowest	237.18	278.99	547.89	452.33	557.69	890.24	828.83
	Date	2005-07-18	2006-01-04	2007-01-05	2008-11-04	2009-01-05	2010-07-02	2011-12-28
	Average	282.64	483.28	1 252.42	785.83	1 050.25	1 221.15	
	Close	278.75	550.59	1 447.02	553.30	1 201.34	1 290.87	866.65

Source: Shanghai Stock Exchange and Shenzhen Stock Exchange.

TableB2.21 Summary of China's Bond Issuance

(100 million of RMB yuan)

Year	Treasury Bonds			Policy Financial Bonds			Subordinated Bonds			Enterprise Bonds		
	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance
1993	381.31	123.29	1 540.74	—	34.29	108.83	—	—	—	235.84	255.48	802.40
1994	1 137.55	391.89	2 286.40	—	13.54	95.29	—	—	—	161.75	282.04	682.11
1995	1 510.86	496.96	3 300.30	—		1 708.49	—	—	—	300.80	336.30	646.61
1996	1 847.77	786.64	4 361.43	1 055.60	254.50	2 509.59	—	—	—	268.92	317.80	597.73
1997	2 411.79	1 264.29	5 508.93	1 431.50	312.30	3 628.80	—	—	—	255.23	219.81	521.02
1998	3 808.77	2 060.86	7 765.70	1 950.23	320.40	5 121.13	—	—	—	147.89	105.25	676.93
1999	4 015.00	1 238.70	10 542.00	1 800.89	473.20	6 447.48	—	—	—	158.20	56.50	778.63
2000	4 657.00	2 179.00	13 020.00	1 645.00	709.20	7 383.28	—	—	—	83.00	—	861.63
2001	4 884.00	2 286.00	15 618.00	2 590.00	1 438.80	8 534.48	—	—	—	147.00	—	—
2002	5 934.30	2 216.20	19 336.10	3 075.00	1 555.70	10 054.10	—	—	—	325.00	—	—
2003	6 280.10	2 755.80	22 603.60	4 561.40	2 505.30	11 650.00	—	—	—	358.00	—	—
2004	6 923.90	3 749.90	25 777.60	4 148.00	1 778.70	14 019.30	918.80	—	918.80	327.00	—	—
2005	7 042.00	4 045.50	28 774.00	5 851.70	2 053.00	17 818.00	966.30	—	1 885.10	2 046.50	37.00	—
2006	8 883.30	6 208.61	31 448.69	8 980.00	3 790.00	23 008.00	215.00	—	2 100.10	3 938.30	1 672.40	—
2007	23 139.10	5 846.80	48 741.00	11 090.20	4 133.60	29 926.80	376.50	—	2 348.50	5 181.00	2 880.90	7 683.30
2008	8 558.20	7 531.40	49 767.80	10 823.00	4 063.80	36 686.00	724.00		3 072.50	8 723.40	3 277.84	13 250.62
2009	17 927.24	9 745.06	57 949.98	11 678.10	3 745.33	44 818.83	2 746.00	958.20	4 860.30	16 599.30	4 309.12	25 540.80
2010	19 778.30	10 043.38	67 684.90	13 192.70	5 648.37	52 363.16	919.50	469.30	5 310.50	16 094.45	5 099.23	36 318.15
2011	17 100.10	10 958.50	73 826.50	19 972.70	7 317.04	65 018.82	3 168.50	112.00	8 367.00	23 103.21	10 266.67	49 299.69

Notes:① Since 2006, data of Subordinated Bonds included Capital-mixed Bonds issued after Sep. 2006.

② Since 2011, the data of Enterprise Bonds covers Enterprise Bonds(from China Government Securities Depository Trust & Clearing Co. Ltd.), Coporate Bonds, Commercial Paper, Short-term Commercial Paper, Medium-term Notes , Collective note of SMEs and Private Placement Notes.

Source: The PBC.

Table B2.22 Statistics of China's Insurance Development

(100 million of RMB yuan unless otherwise noted)

Items	2005	Increase y-o-y (percent)	2006	Increase y-o-y (percent)	2007	Increase y-o-y (percent)	2008	Increase y-o-y (percent)	2009	Increase y-o-y (percent)	2010	Increase y-o-y (percent)	2011	Increase y-o-y (percent)
Premium Income	4927.34	14.11	5641.44	14.49	7035.76	24.72	9784.10	39.06	11137.30	13.83	14527.97	30.44	14339.25	—
1.Property Insurance	1229.86	12.84	1509.43	22.73	1997.74	32.35	2336.71	16.97	2875.83	23.07	3895.64	35.46	4617.82	18.54
2.Personal Accident Insurance	140.89	20.35	162.47	15.31	190.11	17.01	203.56	7.08	230.05	13.02	275.35	19.69	334.12	—
3.Health Insurance	312.30	20.17	376.90	20.69	384.17	1.93	585.46	52.40	573.98	-1.96	677.47	18.03	691.72	—
4.Life Insurance	3244.28	13.78	3592.64	10.74	4463.75	24.25	6658.37	49.17	7457.44	12.00	9679.51	29.80	8695.59	—
Claim Payment	1129.67	12.47	1438.46	27.33	2265.21	57.47	2971.17	31.16	3125.48	5.19	3200.43	2.40	3929.37	22.78
1.Property Insurance	671.75	18.36	796.29	18.54	1020.47	28.15	1418.33	38.99	1575.78	11.10	1756.03	11.44	2186.93	24.54
2.Personal Accident Insurance	43.51	10.37	51.67	18.75	63.43	22.76	62.57	-1.35	63.92	2.15	71.39	11.69	81.84	14.64
3.Health Insurance	107.92	21.11	125.10	15.92	116.86	-6.58	175.28	49.99	217.03	23.82	264.02	21.65	359.67	36.23
4.Life Insurance	306.50	-0.62	465.41	-0.62	1064.45	51.85	1314.98	23.54	1268.74	-3.52	1108.99	-12.59	1300.93	17.31
Operating Expenses	525.96	20.68	667.06	26.83	947.62	42.06	1079.52	13.92	1234.06	14.32	1538.35	24.66	1882.38	22.36
Bank Deposits	5241.43	5.49	5989.10	14.26	6516.26	8.80	8087.55	24.11	10519.68	30.07	13909.97	32.23	17737.17	27.51
Investment	8894.41	55.72	11796.29	32.63	20205.69	71.29	22465.22	11.18	26897.43	19.73	32136.65	19.48	37736.67	17.43
Of Which:														
Treasury Bonds	3588.29	35.32	3647.01	1.64	3961.12	8.61	4208.26	8.61	4053.82	-3.67	4815.78	18.80	4742.40	-1.52
Securities Investment Funds	1099.21	63.29	912.08	-17.02	2530.46	-17.02	1646.46	177.44	2758.78	67.56	2620.73	-5.00	2915.86	11.26
Total Assets	15225.97	28.45	19731.32	29.59	29003.92	46.99	33418.44	15.22	40634.75	21.59	50481.61	24.23	60138.10	19.13

Notes: ① Since 2011, premium income has been recorded according to *Accounting Standards for Enterprises No.2* circulated by the Ministry of Finance. As a result, data of premium income in 2011 is incomparable with those in previous years.

② Data of premium income, claim payment and operating expenses are data for the year.

③ Data of bank deposits, investment and total assets are data of year-end balance.

Source: Calculated based on data from CIRC website.

TableB2.23 The Structure of Non–life Insurance Premium Income

(100 million of RMB yuan unless otherwise noted)

Insurance Lines	2008	Ratio (percent)	2009	Ratio (percent)	2010	Ratio (percent)	2011	Ratio (percent)
Automobile Insurance	1 702.52	69.60	2 155.61	72.02	3 004.15	74.60	3 504.56	73.33
Enterprise Property Insurance	209.63	8.57	221.43	7.40	271.61	6.74	329.81	6.90
Cargo Transportation Insurance	70.97	2.90	61.27	2.05	78.74	1.96	97.83	2.05
Accident Insurance	72.71	2.97	73.92	2.47	85.53	2.12	105.12	2.20
Liability Insurance	81.75	3.34	92.21	3.08	115.88	2.88	148.01	3.10
Others	308.67	12.62	388.46	12.98	470.98	11.70	593.73	12.42
Total	2 446.25	100.00	2 992.90	100.00	4 026.89	100.00	4 779.06	100.00

Source: The CIRC.

TableB2.24 The Structure of Life Insurance Premium Income

(100 million of RMB yuan unless otherwise noted)

Insurance Lines	2008	Ratio (percent)	2009	Ratio (percent)	2010	Ratio (percent)	2011	Ratio (percent)
Life Insurance	6 658.09	90.74	7 457.22	91.57	9 679.31	92.18	8 695.40	90.96
Of Which: Common Life Insurance	983.66	13.41	961.56	11.81	948.17	9.03	951.20	9.95
Participating Insurance	3 798.87	51.77	5 292.56	64.99	7 454.77	70.99	7 662.54	80.15
Unit-linked Insurance	425.03	5.79	147.90	1.82	152.82	1.46	4.55	0.05
Accident Insurance	130.85	1.78	156.13	1.92	189.83	1.81	229.00	2.40
Health Insurance	548.63	7.48	530.83	6.52	631.74	6.02	635.61	6.65
Total	7 337.57	100.00	8 144.18	100.00	10 500.88	100.00	9 560.00	100.00

Source: The CIRC.

TableB2.25 Insurance Premium Income of China's Different Regions in 2011

(100 million of RMB yuan)

Regions	Insurance Premium Income	Property Insurance	Life Insurance	Accident Insurance	Health Insurance
Total	14 339.25	4 617.82	8 695.59	334.12	691.72
Guangdong	1 219.06	367.74	757.36	28.84	65.12
Jiangsu	1 200.02	379.93	741.09	31.08	47.93
Henan	839.82	163.33	637.16	11.02	28.31
Shandong	890.31	276.28	549.88	19.77	44.38
Beijing	820.91	232.56	505.83	16.20	66.32
Sichuan	778.70	225.09	499.02	20.52	34.07
Hebei	732.89	222.92	470.21	12.89	26.87
Shanghai	753.11	233.39	453.87	19.33	46.51
Zhejiang	730.67	310.32	371.55	20.33	28.46
Hubei	501.82	114.71	353.28	11.24	22.58
Hunan	443.53	123.18	289.70	11.28	19.37
Anhui	432.30	142.82	267.53	6.86	15.09
Shanxi	364.67	113.28	232.87	6.06	12.46
Shaanxi	343.72	101.51	221.97	7.64	12.60
Liaoning	376.26	134.61	214.21	7.40	20.04
Heilongjiang	317.79	84.49	212.43	6.07	14.79
Chongqing	311.81	81.63	206.19	10.30	13.70
Fujian	350.38	116.36	201.78	9.33	22.91
Shenzhen	359.90	139.80	190.53	9.66	19.92
Jiangxi	252.23	85.13	151.99	5.49	9.63
Jilin	223.36	69.00	140.85	3.51	9.99
Tianjin	211.74	75.10	118.62	5.18	12.84
Guangxi	212.65	79.06	116.71	6.80	10.08
Yunnan	241.10	109.17	106.52	9.43	15.98
Xinjiang	203.62	78.51	102.86	6.92	15.32
Inner Mongolia	229.78	116.69	98.12	5.57	9.40
Dalian	148.83	52.17	85.75	3.02	7.89
Gansu	140.93	46.49	84.16	3.43	6.84
Qingdao	145.73	55.98	77.69	3.07	8.99
Ningbo	148.60	77.29	63.42	3.54	4.35
Guizhou	131.81	59.03	63.20	4.78	4.80
Xiamen	82.03	34.69	40.39	2.24	4.71
Hainan	53.75	21.78	28.37	1.38	2.22
Ningxia	55.34	21.88	26.70	1.69	5.07
Qinghai	27.89	13.72	11.86	0.85	1.46
Tibet	7.60	5.73	0.78	0.43	0.66
Group and Head Office Level	54.59	52.43	1.17	0.95	0.05

Note: Data of "Group and Head Office Level" refers to the premium income earned by the group and head office, which is not included in regional data.

Source: The CIRC.

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