

# Part IV

## ***Financial Sector and Financial Stability***

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China's financial institutions are composed mainly of banking institutions, securities and insurance companies. The health of the financial institution has a direct impact on China's financial stability.

Since the beginning of economic reform, China has been fostering and improving its financial institutions. By the end of 2004, financial institutions in China consisted of:

- Banking: 3 policy banks, 4 SOCBs, 12 JSCBs, 112 city commercial banks, 681 UCCs, 32,854 RCCs, 8 rural cooperative banks, 7 rural commercial banks, 211 operating branches of foreign banks, 220 representative offices of foreign banks, 4 financial asset management corporations, 59 TICs, 74 finance companies, 12 finance leasing corporations, 3 auto finance companies, and postal saving agencies ubiquitous in urban and rural China.
- Securities: 131 securities companies, 43 fund management companies, 187 futures brokerage companies and 111 securities investment and consultancy agencies.
- Insurance: 6 insurance groups and holding companies, 69 insurance companies, 4 insurance asset management companies, 1,317 specialized insurance intermediaries and over 110,000 part-time insurance intermediaries.

Based on statistics from the PBC, the total value of assets in China's financial sector by the end of 2004 was RMB41.28 trillion yuan.

China has intensified its efforts on risk management and restructuring of the financial institutions in recent years, and the financial sector as a whole has progressed prudently.

The banking reform has made breakthroughs, particularly in the shareholding reform of SOCBs. The pilot shareholding reform of BOC and CCB has been progressing fast and has produced some preliminary results. ICBC has also started the reform. The pilot programme of RCCs reform now includes 29 provinces (including autonomous regions and municipalities), reform of the rural financial system is happening all over the country. In addition, reform is progressing steadily in JSCBs, city commercial banks, RCCs, TICs and other institutions.

The result of the reform and development of the insurance sector is also very obvious. State-owned insurance companies have completed the reorganization and restructuring process. The successful overseas listing of PICC P&C, China Life and Ping An Insurance (Group) have effectively promoted better corporate governance of insurance institutions.

China's securities sector is temporarily at a difficult time. However, the risks have been exposed fully, and the reform approach and framework have largely been identified. Since the beginning of 2005, the risk management and restructuring of securities companies have been successful, and we expect the overall situation to improve.

Looking ahead, China is likely to act upon the principles of improving the socialist market

economic system in its financial sector, intensify financial enterprise reform, clarify ownership, improve corporate governance, change the operation mode, improve internal management and reform the commercial banks, securities companies and insurance companies to institutions with adequate capital, rigorous internal control, operational safety, satisfactory services and good economic returns. We should improve the innovation capability of the financial sector, make financial institutions more capable of pricing their products, promote the development of intermediary services in banking, tap the agency business of securities companies, speed up the adjustment of the insurance product mix, cultivate a sustainable way of making profits, and improve the competitiveness of financial institutions. We plan to optimise the country's financing structure, raise the ratio of direct financing, expand investment channels for its citizens and effectively manage financial risks. China will also require more prudential monitoring and regulation, to promote the healthy development of the financial sector.

## Banking Sector

China's banking institutions include SOCBs, policy banks, JSCBs, city commercial banks, UCCs, RCCs, rural cooperative banks, rural commercial banks, financial assets management corporations, TICs, finance companies and finance leasing corporations. In general,

China's banking institutions are sound and prudent, with the total assets, deposits and outstanding loans growing steadily, consistently improving business performance and risk management capability, and effectively turning savings into investment, which is important in the allocation of resources. However, there are still some adverse factors inhibiting the progress of China's banking institutions, which is the rationale behind China's decision to reorganize and reform its banking institutions by market principles, optimise the shareholding structure, improve corporate governance and develop them into modern financial enterprises. In the past two years, banking reform has been focused on the shareholding reform of the SOCBs and further reform of the RCCs, with the restructuring proceeding in parallel with other banking institutions, such as JSCBs, city commercial banks and policy banks. Up to now, the reform has produced remarkable results. China will continue to intensify its efforts on reorganization and reform to ensure the continuation of prudent business performance and improve competitiveness.

## Current Development

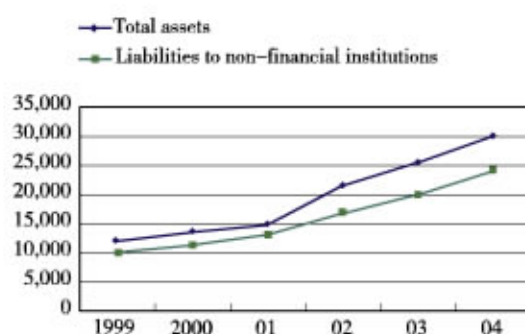
*Total assets, deposits and outstanding loans are growing steadily.* By the end of 2004, total assets of domestic banking institutions in China reached RMB31.02 trillion yuan, up 13.46% over 2003. The total outstanding loans (in both domestic and foreign currencies) were RMB18.65 trillion yuan, up by 11.04%; and the total deposits (in both do-



mestic and foreign currencies) were RMB24.81 trillion yuan, up by 15.5%. Statistics of deposit money banks in China, including SOCBs, JSCBs, city commercial banks, UCCs, RCCs, rural commercial banks, rural cooperative banks, finance companies of enterprise groups and Agricultural Development Bank of China, indicate the trend of growth in both assets and liabilities in China's banking institutions (Figure 4.1). To meet the CAR set by the regulators, China's banks have strengthened their risk control in lending in recent years, which has resulted in a slowdown of total banking asset growth.

**Figure 4.1 Deposit Money Banks' Total Assets and Liabilities to Non-financial Institutions**

(billions of RMB yuan)



Note: Liabilities to non-financial institutions include demand deposits, time deposits, deposit savings, other savings and foreign currency savings.

Source: *Almanac of China's Finance and Banking 1999-2002*, the PBC Annual Report 2002-04.

*More prudent operation and better profitability.*

In 2004, total profits of banking institutions in China reached RMB101.119 billion yuan, RMB70.422 billion yuan more than in 2003. The fast growth in profitability has provided a solid financial position in solving historical legacy problems.

*Gradual improvement of asset quality and the "double decline" of total NPLs and NPL ratio.*

According to the five-category classification, by the end of 2004, China's major commercial banks (including 4 SOCBs and 12 JSCBs) had a total NPLs balance of RMB1.7176 trillion yuan, declined by RMB394.6 billion yuan from the end of 2003. The NPLs ratio in 2004 was 13.2%, down by 4.6 percentage points. That was the "double decline" of NPLs China experienced for the third consecutive year. The main reasons include: (1) these banks have widely adopted the separation of loan authorization from customer services, thus have strengthened the credit management; (2) they have intensified management over credit line authorization and loan inspection to prevent new NPLs; (3) they have used economic and legal means to recover more NPLs, pool resources to dispose of all types of NPLs and effectively strengthened efforts to write off bad loans; and (4) they have made greater efforts to dispose of non-credit assets, improve risk management systems and tighten internal controls.

*Rapid rise of CAR and better protection against risks.*

In 2004, the gap of loan loss provision of 16 major commercial banks dropped by RMB123.9 billion yuan, while their CAR in-

creased by 2.87 percentage points. In particular, the SOCBs that have carried out shareholding reform and listed commercial banks are basically fully provided with risk provision, and their capacity for risk control has significantly improved. By the end of 2003, among China's major commercial banks and all city commercial banks, only eight met the new CAR criteria set by CBRC. That number rose to 30 by the end of 2004. The total assets of those banks that met the CAR requirement accounted for only 0.56% of total assets in China's entire banking institutions in 2003, but increased rapidly to 47.53% by the end of 2004.

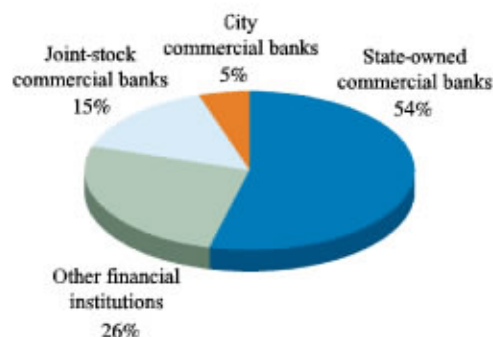
*Appropriate liquidity in the banking system.* By the end of 2004, the liquidity ratio of China's banking institutions was 47.05%, the reserve ratio for bank deposits was 11.89%, the ratio of medium- to long-term foreign currency loans was 34.06%, and the loan-to-deposit ratios for RMB and foreign currencies were 70.26% and 76.07%, respectively. All these ratios meet the statutory requirement of the banking authorities, suggesting the good liquidity conditions of China's commercial banks.

## Banking Reform Achievement

### *Remarkable Results in the Shareholding Reform of SOCBs*

The four SOCBs accounted for over 50% market share in both deposits and loans of all China's banking institutions (Figure 4.2). Chinese government attaches great importance to their reform after the 1997 Asian Financial

Figure 4.2 The Market Structure of China's Banking Institutions in 2004



Note:

1. Market share in the banking institutions is calculated based on the total assets of these institutions.
2. OFIs include policy banks, rural commercial banks, foreign financial institutions, UCCs, RCCs, finance companies, TICs, leasing companies and postal savings and remittance agencies.

Source: <http://www.cbrc.gov.cn>.

Crisis, Chinese government formulated strategic arrangements for the reform and development of the four SOCBs and took a series of significant measures to promote a comprehensive reform. In 1998, the government issued RMB270 billion yuan special-purpose treasury bonds to recapitalize the four SOCBs. In 1999, the four AMCAs were set up to remove RMB1.4 trillion yuan NPLs from the SOCBs. Starting from 2002, China introduced the five-category classification for loans and adopted prudent financial accounting standard. These banks have taken positive measures to reform their operational and management structure and improve risk management and internal



control. These reform measures have substantiated their capital adequacy and improved their internal control. As a result, the profitability of the SOCBs has increased significantly.

In September 2003, the State Council decided to establish a steering group for the pilot shareholding reform of the four SOCBs. The reform was aimed at turning them into modern commercial banks with adequate capital, rigorous internal control, safe operation, satisfactory services, good profitability and international competitiveness. Actions taken include financial restructuring, internal reform and strict external supervision, such that they could genuinely establish a modern financial enterprises system, improve corporate governance, change operation model, increase internal management and achieve sustained development.

China has conducted the pilot reform on the basis of its own experience of economic and financial restructuring and international best practices regarding the reduction of financial risks. The four SOCBs have adopted a number of measures, such as financial restructuring, disposal of non-performing assets, establishment of joint-stock companies and public listing. During the implementation stage, the approach is "one bank one policy". For financial restructuring, the State Council approved the establishment of China SAFE Investments Ltd. (referred as China SAFE below) on December 16, 2003, which was authorized by the State Council to conduct financial restructuring in key financial institutions, as well as performing the role of shareholder of the major

financial institutions on behalf of the state. To tackle the problem of non-performing assets, the policy is allowed to write off asset losses and dispose of non-performing assets through the market, such as public tendering, in accordance with the law and policies of the state to improve the efficiency in non-performing assets reduction. For the establishment of joint-stock companies, the policy is to introduce sweeping restructuring and institute guidelines for corporate governance and internal control. There are also supporting policies for other related issues such as finance and taxation, labour and wages, social security, operation and management of state-owned land, human resource management, business registration and financial regulation.

The pilot reform officially started on December 30, 2003, when the State Council injected USD22.5 billion each in BOC and CCB through China SAFE. In April 2005, ICBC started its shareholding reform with a USD15 billion injection from China SAFE. The three banks started reforms on financial structure and corporate governance etc immediately after their recapitalization.

As far as BOC and CCB are concerned, the pilot reform has progressed fast and reached the goals for the current phase, thanks to the good overall plan, clearly defined tasks for different phases, disciplined execution by the two banks and timely supporting policies from related government agencies. As a result, the two banks have become stronger financially. After the recapitalization, non-performing assets writing-off and disposal (through the

market) and risk provisions increase, the financial indicators of both banks are now approaching that of major international commercial banks. By the end of 2004, both BOC and CCB raised their CAR to 8.62% and 11.95% respectively. Their assets were of much better quality, as their NPL ratios were reduced to 5.12% and 3.70% respectively. Both banks became much more profitable, as their pre-provision profits were RMB58.5 billion yuan and RMB60.85 billion yuan respectively in 2004, up 16% and 14% from 2003. All types of risk provisions were replenished, with the total provisions reaching RMB78.3 billion yuan for BOC and RMB58.3 billion yuan for CCB by the end of 2004, which gave them greater capacity to fend off risks. In the process of financial restructuring, both banks invited authoritative international intermediaries for finance auditing, asset evaluation, and legal due diligence. The relevant information has been disclosed in accordance with international standards.

The modern corporate governance structure has begun to play its role in both BOC and CCB. As the major shareholder of both banks, China SAFE has assigned directors and supervisors to BOC and CCB, and has thus solved the long-standing problem of absence of accountable ownership in SOCBs. While carrying out financial restructuring and equity transformation, both BOC and CCB have accelerated internal reform and improved corporate governance in accordance with the principle of equal emphasis on reform and management. BOC and CCB were established on August 26, and September 21, 2004 respective-

ly. The shareholders' meetings, boards of directors, boards of supervisors and new management of both banks have started normal operations. In each bank, the board of directors, special committees and board of supervisors have been making important decisions as prescribed, and the management is gradually changing the old way of doing business. Maximizing shareholder value is now the two banks' key objective. Both banks are now improving their internal control and risk management, reforming the organizational structure and human resources management, consolidating the operation procedures and reinforcing a flat organization structure and business oriented management alignment.

Both BOC and CCB strive to attract strategic investors. CCB was the first among the Big Four Banks to reach agreements with overseas strategic investors. On June 17, 2005, CCB signed the final agreement on strategic investment and cooperation with the Bank of America (BOA), which will invest in CCB through different phases until the BOA's holdings reach 19.9%, and also provide strategic assistance in a wide range of areas. On July 1, 2005, CCB also signed a formal agreement on strategic investment cooperation with Singapore's Temasek Holdings, which became CCB's second international strategic investor. BOC's program to attract overseas strategic investors is also progressing well. On August 18, BOC signed an agreement on strategic investment and cooperation with the Royal Bank of Scotland Group, which will invest a total of USD3.1 billion in BOC in exchange for a 10% stake. On August 31, BOC also signed a strategic



investment agreement with Temasek.

ICBC's shareholding reform has also started. After recapitalization, disposal of non-performing assets through the market and other financial restructuring measures, ICBC's financial indicators, including the CAR, asset quality, risk provisions and profitability have all risen significantly. The MOF and China SAFE have begun to play a substantial role in ICBC's corporate governance, ex-

ercising their rights and fulfilling their obligations as shareholders to turn ICBC into a large joint-stock commercial bank with international competitiveness.

The ABC has also made efforts in improving operational structure, deepening internal reform, strengthening risk control and increasing profitability. It has laid a good foundation for the upcoming shareholding reform.

### Box 6 Strengthening Internal Control within Commercial Banks

Internal control is the dynamic process and mechanism through which commercial banks identify, evaluate, control, monitor and rectify risks by formulating and implementing systematic policies, procedures and programmes in order to achieve business and management objectives. It is composed of five inter-related and interacting processes: internal control environment, risk identification and evaluation, internal control measures, supervision assessment and correction, information exchanges and feedback.

Internal control institutionalisation is considered one of the key elements for corporate governance by all countries in the world. In 2002, the US passed the *SOA* to systematically and legally demand listed companies to disclose their corporate governance and internal control systems. *Article 404* of the *SOA* (referred as *SOA 404* below) set more stringent standards on strengthening internal control. This article includes internal control procedures for financial report-

ing, responsibilities of the management on internal control, and evaluation and certification by external auditors on a company's internal control. *SOA 404* regulates only companies listed in the US. However, China's banks can use it as an important reference to strengthen internal control. For example, *SOA 404* requires explicit internal control targets and matching elements. It also requires an internal control system that includes board of directors, management, internal auditors, external auditors and other relevant compliance functions.

For quite some time in the past, China's commercial banks lacked internal control. They did not have a systematic internal control structure, nor did they have an active risk identification and evaluation mechanism. Their integrated data computing and system development was slow, supervision and examination inadequate, and internal control measures piecemeal at best. Therefore they were unable to form a comprehensive system, and internal



control outcomes were unstable. In addition, the banks lacked motivation to continuously improve internal control. As a result, there was no long-term mechanism for risk management.

Given the aforementioned problems, China's SOCBs now put top priority on internal control and risk management while carrying out shareholding reform and improving corporate governance. A series of measures has been put in place on internal control management structure, branch agency management and business process reengineering, including an internal control structure that covers and supervises all types of

business and management activities. It is a long-term task to build a proper internal control structure, which is the key to the success of the shareholding reform of China's SOCBs and their long-term sustainable development. In the shareholding reform of SOCB, one of the major goals for financial restructuring, setting up joint-stock companies and future IPOs, is to build a functioning corporate governance mechanism and cultivate better internal control. SOCBs must learn from international best practices and take feasible measures to improve the risk management and internal control structure to genuinely improve internal control.

### *Smooth Progress of RCCs Reform and Major Headway in Rural Financial Restructuring*

RCCs were among the first financial institutions in China after the founding of the People's Republic of China. For many years, RCCs have been implementing the state's financial services policy to serve the agriculture business, rural areas and farmers. By constantly improving their services and increasing subsidies for agriculture, RCCs have done a great deal to promote agriculture and rural economy and help farmers to increase productivity and income. In recent years, RCCs have been promoting micro credit and mutually guaranteed loan for rural households, thus easing the difficulties peasants and rural self-employed economic entities encountered in getting loans.

In terms of the management structure of RCCs, before 1996, ABC was authorized to supervise the business of RCCs. In 1996, the PBC began to assume that function and contribute many resources to intensify the RCC reform in accordance with cooperative principles. Since 2003, the regulation of RCCs has been the responsibility of CBRC.

RCCs have a reasonably long history in China, and thus having accumulated a lot of historical legacy problems like ownership structure, management systems, roles and responsibilities, corporate governance, historical burden and asset quality. In order to resolve RCCs' problems once and for all and improve the rural financial system, on June 27, 2003, the State Council issued the *Pilot Plan on Further Reform of RCCs*, which set forth explicitly the principles of "clear ownership, tighter

discipline, better services, moderate state support and local government responsible". In 2003, after getting approval from the State Council, eight provinces and municipalities, namely Jilin, Shandong, Jiangxi, Zhejiang, Jiangsu, Shaanxi, Guizhou and Chongqing, began the pilot reform programme. The central government provides support in finance, taxation and funding for those regions' RCCs reform programmes. For example, the PBC has issued central bank special-purpose bills and arranged for special loans to them. The central bank special-purpose bills are to cover the loss from half of the actual "negative equity" of RCCs by the end of 2002<sup>1</sup>. The funding support by the PBC to RCCs reform is conducive to improving rural financial services, helping farmers increase production and income, and promoting agricultural development and rural economic growth.

Judging from the experiences in the eight participating provinces and municipalities, the pilot reform programmes have produced significant effects. First, the CAR of the RCCs increased rapidly, improving their capacity to protect themselves against risks. From 2003 to 2004, the equity of these RCCs increased by RMB36.7 billion yuan, and their net equity reached RMB60.4 billion yuan by the end of 2004, with the CAR reaching 8.7%. Second, the historical burdens have been gradually alleviated. By the end of 2004, the NPLs of the RCCs there dropped by RMB39.1 billion yuan from the end of 2002, including the amount

replaced by central bank bills injection (the actual decline was RMB8.3 billion yuan, if the central bank bills were excluded), and the NPL ratio was lowered by 13.3 percentage points. Third, the financial status improved remarkably. In 2004, all the RCCs there were profitable, making a total profit of RMB6.88 billion yuan, accounting for 66.9% of profits of all RCCs in China. Fourth, their financial strength to support agriculture has grown. In 2004, the loan and deposit growth of these RCCs much faster than the national average. The credit they provided to support agriculture also grew substantially. Fifth, some county and city-level RCCs have done useful work in exploring the reform of ownership structure, organizational pattern and operational mechanism and strengthening internal control. Their business concepts have changed, and they are now more active in providing services to support agriculture.

In August 2004, the pilot reform was further extended to 21 other provinces, autonomous regions and municipalities, including Beijing, Tianjin and Hebei. At present, the pilot reform is progressing well, with the RCCs there developing services steadily. Their business performance and support to agricultural development continue to improve.

In the past two years, as the reform of RCCs has gathered pace, the rural financial restructuring has also made significant progress. The band of RCCs lending rates has been widened twice, and the interest rate regime for the

1 negative equity = accumulative losses + actual assets losses - owners' equity - NPLs provisions.



transformation of postal savings to bank deposits has been resolved preliminarily, and funding sources for credit support to agriculture, rural areas and farmers have increased. The rural financial situation continues to improve through the overhaul of the rural cooperative foundations. Pilot agricultural insurance programmes have been introduced to regions where conditions are ripe.

### *Rapid Development of JSCBs*

JSCBs are improving their corporate governance and internal control regime by reorganization, recapitalization and the introduction of strategic foreign investors. By the end of 2004, eight of China's twelve JSCBs had a CAR of over 8%, an improvement from only three by the end of 2003. Six of the twelve banks have introduced overseas strategic investors, while the remaining six were making preparations.

The BOCOM has been working diligently to press ahead with the shareholding reform. On June 30, 2004, BOCOM completed its financial restructuring. On August 18, 2004, it completed the share sales to its strategic investor, HSBC. With a 19.9% stake, HSBC became the second-largest shareholder of BOCOM. It sends representatives to sit on the board of directors in BOCOM and participates in senior management. Through restructuring, inviting investors and pursuing various internal reform measures, BOCOM has gradually developed a proper shareholding structure, functioning corporate governance and a basic system of checks and balances by the shareholders' meeting, board of directors,

board of supervisors and senior management. Its major financial indicators are comparable to those of its international peers. In addition, BOCOM has completed the organizational transformation of its headquarters and the branch offices based on a flat organizational structure, and its cooperation with HSBC is intensifying. On June 23, 2005, BOCOM held its successful IPO on the Hong Kong Stock Exchange.

Other JSCBs are also inviting overseas strategic investors and pushing forward reorganization and reform. For example, a combined total of 24.98% of Industrial Bank Corp. Ltd.'s shares are held by three foreign financial institutions, the highest level in China. On September 22, 2004, the American firm—Newbridge Capital Ltd. became the largest shareholder of Shenzhen Development Bank, taking 17.89% of its shares. Citibank has bought a stake in Shanghai Pudong Development Bank, and the two banks have signed an agreement to cooperate on credit cards and other businesses. China Everbright Bank and Guangdong Development Bank are pressing ahead with restructuring and reform as well. We have seen significant improvement in the JSCBs' operation of the board of directors, risk management, market expansion and business performance as a result of the introduction of overseas strategic investors and the acceleration of reform.

### *Strong Momentum of City Commercial Banks*

City commercial banks have managed to maintain strong momentum of development in the dynamic market environment. With structural



advantages such as flexible operations and large networks of branches, city commercial banks have become increasingly competitive by improving corporate governance, attracting overseas strategic investors and increasing transparency under the principles of risk prevention, management, reform and development. Some city commercial banks have piloted standard corporate governance structure and found new ways to attract overseas strategic investors and experienced managers from abroad. Some local governments have also been helping city commercial banks to alleviate historical legacy risks by replacing bad assets with good ones voluntarily. In some city commercial banks, the CAR, the liquidity and other indicators have all reached the required level.

#### *Initial Success in the Overhaul of UCCs*

From 1998, the regulatory authorities have progressively introduced an overhaul of the UCCs. First, county-level UCCs were renamed and restructured as RCCs. Second, some UCCs were merged, reorganized and transformed into joint-stock entities, assuming sole legal entity status. Third, some UCCs were acquired by commercial banks in accordance with market principles or bought back by their original founding commercial banks. Fourth, some UCCs are restructured as city commercial banks. Fifth, a market exit strategy is applied to high-risk UCCs. After six years of restructuring, the total number of UCCs was reduced from 3,290 by the end of 1998 to 681 by the end of 2004.

#### *Steady Performance of Policy Banks*

In 1994, China set up three policy banks—

China Development Bank, Agricultural Development Bank of China and Export-Import Bank of China—which are solely responsible for policy lending. The three banks have been actively implementing China's industrial policies, foreign trade policies and macroeconomic management policies and played an important role in facilitating the strategic adjustment of the economic structure, easing bottlenecks on economic growth, protecting and reinforcing the fundamental status of agriculture, promoting agricultural development and the rural economy, increasing the international competitiveness of China's enterprises and exports and accelerating the development of the open economy. By the end of 2004, the three policy banks had total asset value of RMB2.41 trillion yuan, including outstanding loans of RMB2.22 trillion yuan. Their total liabilities were RMB2.3 trillion yuan, including RMB1.42 trillion yuan in bonds and RMB609.9 billion yuan in central bank loans. In 2004, the total profits of these three banks amounted to RMB13.1 billion yuan.

#### *Positive Role of Financial Asset Management Corporations*

In order to effectively mitigate the risks of banks, promote the structural reform of wholly SOCBs, improve the quality of their assets and promote their competitiveness, China's government set up four AMCs—Cinda, Orient, Great Wall and Hua Rong—to purchase, manage and dispose of non-performing assets worth RMB1.4 trillion yuan that had been carved out from the SOCBs and China Development Bank. Over the past five years, the

four AMC's have employed policies and means granted by the state and disposed of non-performing assets via various methods in a professional fashion, thus played a positive role in mitigating financial risks, promoting banking and SOE reforms, safeguarding social credit order and preserving state-owned assets. The four AMC's handled non-performing assets of China's four SOCBs based on market principles since 2004. They provided important support to shareholding reform. By the end of 2004, the four AMC's had disposed of non-performing assets amounted to RMB675.06 billion yuan, with an asset disposal rate of 53.96%, asset recovery rate of 25.48% and cash recovery rate of 20.29%. In the meantime, the expenses incurred by the AMC's in disposing the assets, including the cash expenses, are decreasing gradually year by year.

#### *Improved Performance of the TICs*

By the end of 2004, there were 59 re-registered TICs across the country. A small number of TICs experienced business risks even after the overhaul, but the industry has improved its performance in general through timely handling of high-risk institutions and intensified control over high-risk services.

Trust and investment services are growing, as are assets under the management of TICs. Capital under trustee agreement, which is the main service in trust and investment, accounts for more than 85% of all assets, while other forms of trusts such as real property trusts, other property trust and social security trusts are all increasing. By the end of 2004, TICs' assets totalled RMB278.4 billion yuan, with

trust under management amounting to RMB204.2 billion yuan, up by RMB63.2 billion yuan y-o-y, or a 45% growth.

The performance of TICs has generally been stable, with growing earnings and an optimised earning structure. In 2004, the turnover of TICs was RMB4.57 billion yuan, including RMB1.2 billion yuan (26% of total turnover) from management fees. The existing trust and investment plans are by and large well managed, and most trust and investment contracts are well executed. Except for a small number of plans such as Jinxin Dairy Trust and Investment Plan, which was severely affected by the Delong incident, all due capital in both stand-alone and collective trust plans by 2004 have been delivered to their beneficiaries safely. TICs' internal management and their employees' risk awareness have both improved, and some risks inherited from the past have been brought under control. In general, the whole industry's liabilities are decreasing, with unsettled liabilities continuing to decrease despite of a slight increase of compliance liabilities.

In 2005, 550 collective trust and investment plans are scheduled to expire, and the principal of funds due to the beneficiaries alone amounts to RMB25.4 billion yuan. It remains a difficult task to manage all types of risk well and keep the trust and investment business running in a steady and sound way.

### **Key Areas to Focus on in Developing the Banking Institutions**

In accordance with the *Core Principles for Ef-*



*fective Banking Supervision* (referred as *Core Principles* below) developed by the Basel Committee on Banking Supervision, banks are faced mainly with the following risks: credit risk, market risk (including interest rate risk), operational risk, liquidity risk, legal risk, reputation risk, sovereign and contagion risk. The *Core Principles* advises that the banking institutions must understand, monitor and control the inherent risks of banking services, improve their corporate governance and risk management capacity through greater CAR and risk provisions, appropriately measure and manage the risks to ensure stable operations. Given the current status of China's banking institutions, we should pay more attention to credit risk, market risk and operational risk and the potential liquidity risk in the RMB loan/deposit maturity mismatch. It is also important to enhance the banking institutions' capacity to fend off risks.

*Credit risk.* Credit risk is the possibility that the borrower's credit rating will deteriorate, or the borrower will default by failing to honour the contract. It exists not only in loans but also in other on-balance sheet and off-balance sheet items (such as guarantees and acceptance). Credit risk is the main type of risks facing China's banking institutions, which appears in two prominent forms —NPLs and risk concentration. At present, more efforts must be made to eliminate factors leading to credit risk in China's banking institutions. (1) Imbalance between direct and indirect financing. The portion of indirect financing is too high, resulting in the concentration of risks in the banking institutions. It will require multiple

approaches to increase the proportion of direct financing, promote the bond market and the stock market, and ease the problem of risk concentration in the banking institutions. (2) Relations between banks and enterprises must be straightened out. Enterprises are the main borrowers of China's commercial banks. Only when the enterprise reform proceeds well in terms of profitability, overall quality and credibility, will the banks become more capable of repaying the loans, which would then reduce the default rate and lower the probability of new non-performing assets emerging. (3) Accounting and taxation policies must be reformed. For commercial banks, an industry that deals with risks, it is very important to have the capability to digest non-performing assets through provisioning and write-off. From this perspective, provisioning reform is a key component of the banking institutions reform, so is the corresponding taxation system. (4) The market for risk transfer and disposal of non-performing assets does not exist. In order to help banks identify, price and diversify risks through normal transactions, there needs to be a market for risk products. For existing non-performing assets, there must be a special market, which is crucial for the banking institutions to dispose of the remaining NPLs. (5) Intermediary service agencies have not yet fully played their roles. A wide variety of professional intermediaries such as accounting firms, law firms, appraisal offices, rating companies and credit companies have an important role to play in fending off credit risk. The development of these intermediaries must be acknowledged and encouraged.



*Market risk.* Market risk is the possibility of losses on a bank's on-balance sheet and off-balance sheet position due to changes in market prices. Interest rate risk is a significant form of market risk, faced by banks when there are adverse fluctuations in the interest rate. On the one hand, as China further liberalizes its interest rate regime, we need to keep the interest rate risk in mind. Since 2004, China has made major progress in the liberalization of its interest rate regime, lifted restrictions on both the ceiling of the lending interest rate and the floor of deposit interest rate, which have resulted in a broader interest rate band. However, the liberalization of interest rate is still an ongoing reform process. If interest rates were unable to be liberalized and different types of enterprises were given uniform interest rate, it would be very difficult for the banks to make adequate provisions for some more risky loans, or price various charges and deposits at a reasonable level. On the other hand, as interest rate spread is a key driver in China's banking institutions profits, changes in market prices must be monitored closely. The banking institutions must accelerate the transformation of its business model, develop intermediate business and increase the ratio of non-interest income. At the same time, it is essential for them to study the macro economy closely, make timely judgments regarding possible fluctuations in the economy and fend off market risk.

*Operational risk.* Operational risk is the possibility of losses due, for example, to a major failure of the institution's information technology system, disasters, failure of internal con-

trol or corporate governance, or delay in response to unauthorized transactions, fraud and other unethical behaviour. As there are multi-layered agency issues between creditors and shareholders, between shareholders and the management, and between different levels of the management in the banking institutions, operational risk tends to increase when there is no sound corporate governance or internal control system. In recent years, corporate governance in the banking institutions has improved with the implementation of risk control, financial management, salary incentives, business procedures and information technology. However, we believe it remains a long uphill battle for China's banking institutions to improve corporate governance, update operational mechanism and intensify internal control.

*Liquidity risk.* Liquidity risk is the possibility that a bank will not be able to generate enough cash to meet its short-term needs without incurring large costs, which affects the bank's profitability. RMB loan/deposit maturity mismatch is a prominent problem in China's banking institutions. By the end of 2004, the ratio of medium- and long-term outstanding loans to medium- and long-term outstanding deposits (both with remaining maturities of over 1 year) rose to 135.4%, 35.4 percentage points above the prescribed ratio. Excessive short-term deposits are currently used for issuing long- and medium-term loans, and more than half of the working capital loans are used to fund long-term projects. The potential liquidity risk deserves attention.

**Box 7 Commercial Bank Loan/Deposit Maturity Mismatch**

The commercial bank loan/deposit maturity mismatch arises from financing long-term loans with short-term deposits. Maturity mismatch and currency mismatch are ubiquitous problems in emerging market economies. Maturity mismatch may aggravate external shocks faced by emerging market economies and slow down economic recovery. When a bank keeps shortening deposit maturity and lengthening loan maturity, liquidity risk increases, which may in turn lead to payment crisis.

By the end of 2004, loans accounted for 60.1% of China's commercial banks' total assets, while deposits accounted for 89.2% of their total liabilities. Lending and deposit business accounted for the overwhelming majority of the assets and liabilities of commercial banks. Therefore, the loan/deposit maturity mismatch is a basic indicator of commercial banks' asset/liability mismatch.

China's commercial bank maturity mismatch problem has the following aspects.

First, the loan/deposit maturity structure mismatch is very serious, and the hidden risks therein must not be overlooked. Loan/deposit maturity mismatch includes short-term deposit mismatch and long-term loan mismatch. The first category refers to the gap between deposits that must be disbursed in the short term and loans that must be recovered. The improper structure of long-

and short-term loans in China's commercial banks make short-term deposits a major source of funding for long- and medium-term loans. If money supply is retrenched or savings leaving the banking system, commercial banks will face a liquidity risk. The second category refers to the gap between loans that must be recovered in the long- and medium-term and deposits that must be disbursed. China's commercial banks have accumulated a large positive interest rate gap on long- and medium-term assets, where significant interest rate risk and NPLs risk exist. If NPLs problems cannot be effectively addressed, the long-term loan maturity mismatch will probably affect China's financial stability.

Second, given the current financial ecosystem and the SOCBs capacity of attracting deposits, their lending scale, deposit sedimentation ratio and early payment of loans, the possibility for liquidity crisis to occur is small. However, as China's deposits holders become more profit-driven and liquidity risk grows, it is essential to monitor small- and medium-sized commercial banks' liquidity risks.

Third, as China does not have a well-developed capital market, long- and medium-term funds are allocated mainly by banks, hence the excessive concentration of long-term risks is accumulating in the banking system.



Fourth, it is not conducive to forming a rational yield curve. An irrational yield curve may worsen the banks' maturity mismatch further.

To address the commercial bank loan/deposit maturity mismatch, following measures should be considered by the financial authorities: (1) It should study and come up with measures to curb the excessive expansion of long- and medium-term loans and increase supervision on the banks' asset/liability ratio. (2) In terms of liability, it should allow commercial banks to issue subordinate debt, general financial bonds and use other long-term liability tools to increase sources for long-term funding and improve their capabilities for active lia-

bilities. (3) In terms of assets, it should push forward pilot securitization of long- and medium-term loans to effectively lower the ratio of long- and medium-term loans. For example, China Development Bank has received approval to securitize about RMB10 billion yuan of specific project loans. (4) The government should promote further the long- and medium-term corporate bond market and stock market. The purpose is to gradually improve the asset/liability structure of commercial banks and to steer the financial market to develop further while maintaining right balance between supply and demand, to improve commercial banks' comprehensive asset/liability management.

*Legal risk.* China's financial laws and regulations are yet to be improved. In particular, China's bankruptcy laws are not fit for the development of the socialist market economy and inadequate to protect creditors.

*Stronger capacity to fend off risks.* CAR and risk management capacity are basic tools to enable the banking institutions to fend off risks, according to international best practices. China's banking institutions need to improve its capacity further to fend off risks. On the one hand, some banks in China have a fairly low CAR. The CAR for some commercial banks is far lower than 8% required by the *Basel Capital Accord*. The problem of under-provision still exists, and some banks did not raise their loan-loss reserves to the re-

quired level when their loans increased rapidly. Based on international best practice, the CAR requirement can not only effectively restrain banks from expanding their credit business too rapidly, but also encourage banks to broaden their intermediary business through financial innovation, which does not have a strict capital requirement. China's commercial banks must adopt a scientific approach to development. They have to replenish their capital both from within, such as improving assets quality and profitability, and from external channels, such as attracting strategic investors and public listing. These measures will increase their CAR and make them better positioned in fending off risks. On the other hand, China's commercial banks urgently need to establish and improve a risk valuation

and risk management system. In particular, in a business mode where interest rate spreads are the main source of profits, commercial banks will be able to increase net interest rate spreads and increase earnings if they can fully employ the interest rate leverage, and properly charge differing interest rates according to customers' different levels of risk. Accurate identification, measurement, pricing and control of risks are the fundamental methods for the banking institutions to fend off risks, and they are also the most crucial core competitiveness under market economy conditions. International best practice suggests that, for a financial institution to develop sound risk-valuation capacity, it must put many resources into developing risk-management policies and procedures, and accumulate adequate data and withstand the tests of market fluctuations and economic cycles.

### Reform and Development

This year will prove crucial for China's deepening reform in its financial enterprises. Efforts must be made to mitigate risks properly, strengthen capital discipline, improve corporate governance, transform operational mechanisms and reform business modes to push banking reform to a higher standard, fend off banking institutions risks and promote a healthy development of the banking institutions.

#### *Acceleration of Shareholding Reform of SOCBs*

It is essential to take stock of the successful reform in 2004, and encourage BOC, CCB and ICBC to improve their corporate governance further in accordance with the requirements of modern financial enterprise, and ensure effectiveness of the new system and mechanism. The three banks must continuously improve risk management and internal control structure and step up capital discipline under the central task of transforming their business operations. They must keep improving the quality of their assets and prevent recurrence of non-performing assets. At the same time, they must foster and improve accountability, reinforce investigations into those who are responsible for NPLs and effectively prevent new contraventions. They have to speed up the introduction of strategic investors and experienced managerial talents. They have to enhance human resources development and improve the skills of their employees. They must also prepare for public listing when there is an opportunity, utilize the disciplinary, supervisory and facilitative role of capital markets and achieve a major improvement in the reform of both institutions and operational mechanisms.

The reform of ABC bears on the overall planning of the rural financial reform and must be considered in tandem with it.



### Box 8 Significance of Public Listing of SOCBs

Based on the experience in China's economic reform and financial restructuring, the shareholding reform of SOCBs has adopted such measures as financial restructuring, disposal of non-performing assets, establishing joint-stock companies and public listing in their pilot shareholding reform.

Public listing is an important phase in the reform process. The domestic and overseas IPOs of SOCBs is aimed at taking advantage of the disciplinary, supervisory and facilitative role of capital markets to strengthen information disclosure, improve transparency and public supervision, prompt the banks to optimise their capital structure, improve corporate governance, further transform operation mechanism, and enable SOCBs to become genuine market participants. It is fair to say that, without joint-stock reform, without the external pressure of IPO, without supervision from strategic investors and public investors, and without introduction of independent directors, it would be very hard to push forward reform within SOCBs, and make breakthroughs.

CCB and BOC are busy preparing their IPOs. Both have invited overseas and domestic strategic investors. The introduction of strategic investors is an important step before public listing. It prompted SOCBs to transform operation mechanism, intensify internal administration, modernize business management and foster a good image in the

capital market. According to the agreement on strategic investment and cooperation, strategic investors will provide assistance to CCB and BOC in a wide range of fields, which include corporate governance, risk management, information technology, financial management, human resources management, private banking business (including credit card) and global capital services.

BOCOM is a successful example for the restructuring and overseas IPO of China's commercial banks. Since the State Council approved the general plan for further shareholding reform of BOCOM on June 14, 2004, the bank has undertaken financial restructuring and introduced strategic investors. It successfully invited HSBC to be a shareholder, which is of great significance to the bank's overseas IPO. After busy preparations, BOCOM officially listed its stocks on Hong Kong Stock Exchange on June 23, 2005, thus becoming China's first commercial bank with overseas IPO. The IPO was priced at HKD2.5 per share. Based on its 2005 forecast on profits and net assets, the IPO's price-to-earnings ratio was about 15 and price-to-book ratio was 1.6, both reached the average IPO pricing of Hong Kong banking institutions. This is also quite good when compared with other large state-owned enterprises' overseas IPO in recent years. BOCOM raised HKD16.82

billion in total, equivalent to RMB17.863 billion yuan, by issuing 6.734 billion shares. After the IPO, the bank has 45.803 billion shares in total, with a CAR of around 11.52% and core CAR of

8.88%. On the IPO day, the stock of BOCOM opened at HKD2.8, a 12% increase over the issuing price, and closed at HKD2.825, up by 13% over the IPO price.

### *To Further Deepen RCCs Pilot Reform and Press ahead with Rural Financial Restructuring Comprehensively*

Pilot reform of RCCs must be carried out through meticulous efforts on institutions, mechanisms and management. First, to further standardize the ways to replenishing capital and increasing shares in a legal and consistent manner and money is genuinely injected into the institution. It is essential to fully understand the intent of the state's supportive policies and ensure bills are issued and distributed smoothly. There must be strict criteria, strict procedures and strict enforcement and greater efficiency, to ensure that money paid for reform can achieve its task of improving the mechanism of the institution. Second, to improve various internal control measures in RCCs and urge them to transform mechanisms, give full play to the role of shareholders and cooperative members, and install a series of internal control system with effective incentives, strict discipline, explicit rights and obligations and well-defined rewards and punishments. Third, to improve financial services and extend efforts to support agricultural development. It is crucial to step up the promotion of micro credit for peasants, further improve the methods for the mutually guaranteed

farmer loan, and continuously explore new ways to provide agriculture-friendly services, to offer more effective and complete financial services for the development of agriculture, the rural areas and farmers.

In the meantime, it is necessary to push forward the overall reform of rural finance and accelerate the establishment of a rural financial system with complete functions, proper separation of duties, clearly defined ownership and forceful supervision. Efforts must be hastened to lay out an overall plan for rural financial reform in coordination with reforms of RCCs, ABC, Agricultural Development Bank of China, postal saving system, deposit insurance scheme and agricultural insurance in a bid to put in place a rural financial market system with moderate competition, a multi-layered rural financial institutional framework that is financially sustainable, and a comprehensive system for basic rural financial services and regulation.

### *To Continue with the Reform of JSCBs*

China must further reform and develop JSCBs. In the process of deploying risk prevention, risk mitigation and other various methods to reduce NPLs, it is essential to keep improving corporate governance and internal control, to ensure the healthy development of such banks.



### *To Fend off Risks for City Commercial Banks*

To fend off risks is an important prerequisite for future reform and development of city commercial banks. It is critical to further study and explore ways for city commercial banks to fend off risks while pressing ahead with capital restructuring. This is of great significance to risk prevention and mitigation and market competitiveness enhancement for these banks.

### *To Speed up the Alleviation of UCCs Risks*

The alleviation of UCCs risks must take the business development, reduction of bailout cost and financial stability into consideration. For UCCs whose closure has been announced, the closure and liquidation must be completed as soon as possible for them to exit the market; for high-risk UCCs, measures must be taken to manage risks on a case-by-case basis effectively.

### *To Define the Functions of Policy Banks*

The business environment for policy banks has changed, as China proceeds deeper in its economic restructuring and becomes more market-oriented and globalized. Therefore, the policy banks need to adjust themselves. In addition, after SOCBs carry out shareholding reform, their previous policy loans must be redeployed. Therefore, it is necessary to study and adjust the functions, operation model and future development of policy banks in accordance with the overall plan for the reform and development of China's banking institutions.

### *To Improve the Operation Mechanism of Financial AMCs*

At present, AMCs are insufficient in peeling off, managing and disposing of non-performing assets, and a sound market for non-performing asset disposal has not yet to take shape. It is essential to speed up the study on reform plans about AMCs, improve the management structure and the operation mechanism, establish modern financial enterprises systems, set up and improve the market for non-performing assets to support the comprehensive financial restructuring.

## Securities Sector

China's financial institutions in the securities business include securities companies, futures brokerage firms, fund management companies, securities consulting agencies and other securities intermediaries. At present, China's securities sector is in its infancy, with the market infrastructure improving, laws and regulations gradually in place, and business procedures being standardized. It has become an important component of the socialist market economy and financial system. China's securities sector has been trying to find its own development path. Its history is short and experience is inadequate, therefore some problems have occurred. At present, China's securities sector is having a hard time. Those problems and difficulties will be gradually resolved as the industry grows and

becomes better regulated.

## Current Development

### *Securities Companies Have Taken Their Initial Form*

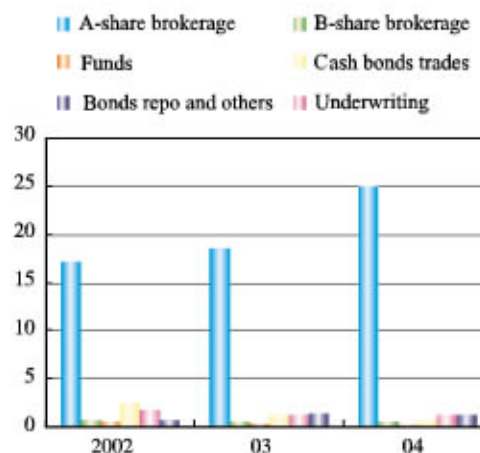
In recent years, securities companies have made some progress, as they have been adapting to the new competitive environment and working hard to innovate. Some of them have been restructured and have listed successfully. According to statistics from CSRC and SAC, there were 131 securities companies in the country by the end of 2004, of which 120 maintained normal operations, 72 were qualified to sponsor new companies to list in the market, and 36 were qualified to manage assets for clients. In addition, there were 2,935 securities business offices, and 78.7 thousands employees in the securities sector. Apart from 17 securities companies that were newly opened or had ceased operations for restructuring purpose, the remaining 114 companies had total assets worth RMB329.3 billion yuan, total liabilities of RMB262.5 billion yuan, net assets of RMB66.9 billion yuan, net capital of RMB45.3 billion yuan, market capitalization of stocks under proprietary trading about RMB47.2 billion yuan, and funds of RMB30.1 billion yuan under trust plan.

Brokerage remains the most important source of income for securities companies. In 2004, A-share brokerage business income accounted for 86.93% of the total income of securities

companies. Underwriting is assuming an increasingly important role in the business mix, while the percentage of income from proprietary trading and asset management was declining in last few years. Meanwhile, financial consultancy and other innovative services contribute little to the total income. The scope of business for securities companies need to be further expanded (Figure 4.3).

Figure 4.3 Securities Company's Income Structure, 2002-04

(billions of RMB yuan)



Source: The Securities Association of China.



As the securities market has remained in the doldrums for some years, the performance of securities companies has faltered. According to statistics from the SAC, in 2004, China's 114 securities companies had a total income of RMB16.9 billion yuan, operating expenditure of RMB29.3 billion yuan, and total losses of RMB16.7 billion yuan. Among those companies, 45 made aggregate profits of RMB1.2 billion yuan, while the remaining 69 suffered total losses of RMB17.9 billion yuan.

#### *Innovative Pilot Projects in the Securities Sector*

Since 2004, the securities regulatory authorities have introduced a series of policy incentives for qualified and well-performing securities companies to innovate their business operations within the boundary of regulatory provisions and in the light of market demands and their own conditions. By May 12, 2005, 12

securities companies had started such pilot programmes.

The official launch of pilot innovation project in securities companies is significant to the development of China's securities sector. First, this project has significantly boosted innovation in products, organization and businesses of securities companies, improved their business structure and enhanced their profitability and risk management capacity. Second, this project is likely to produce a number of well-run securities companies that are strong and internationally competitive, thus effectively improve the competitiveness of China's securities sector. Finally, this project will form a competitive pattern of "survival of the fittest" in the securities sector through market-oriented measures and introduce more competition to the industry based on scale of economy.

#### **Box 9 Significance of Public Listing of Securities Companies**

CITIC Securities Co. Ltd. was founded on October 25, 1995. On December 29, 1999, it was recapitalized, restructured and renamed CITIC Securities.

CITIC Securities officially issued its IPO prospectus on December 13, 2002, issuing 400 million new shares. After the IPO, its capital stock reached 2.48 billion shares, with net assets exceeding RMB5 billion yuan. CITIC Securities was China's first listed securities company. Its corporate governance has improved since its listing, its

operations have increasingly standardized, and its information disclosure has become more timely and transparent. At present, CITIC Securities is the biggest company in China's securities industry in terms of net assets and net capital. It was therefore among the first to win approval for pilot innovations. The company is exploring prospects for acquisitions and expansion, expanding into overseas markets and other business innovations. It has also taken an active part in the commercial disposal of high-risk securities companies.

The restructuring and listing of securities companies are important to optimise their financial position, capital structure, corporate governance, internal and external supervision, discipline and business performance. The restructuring and listing of securities companies also helps to adjust the composition of listed companies on China share markets and stabilize the capital market. There are more than 1,300 companies listed

in China, of which financial institutions account for less than 1%. Securities companies' account for an even smaller portion. However, in most countries, the listed companies in financial sector are a significant constituent in the stock market, which is important for the stabilization of the capital market. CITIC Securities' IPO was a milestone in the reform of China's securities sector.

### *Institutional Investors Keep Growing*

In 2004, institutional investors continued to grow rapidly, with the scale of the institutions expanding at higher speed. The previous situation of retail investors and short-term funds dominating the securities market is now changing. The growth of institutional investors is gradually steering the market in the direction of fundamental investment. According to CSRC statistics, by the end of 2004, China had 43 fund management companies, including 11 Sino-foreign joint ventures, and 161 securities investment funds, with a total size of 333.4 billion units and net asset value of RMB323.8 billion yuan, equivalent to 28% of the tradable A-share market capitalization of the Shanghai and Shenzhen stock exchanges. The market value of their stock holdings accounted for 13% of the negotiable market capitalization. In 2004, 54 securities investment funds completed subscriptions, attracting a total of RMB185.4 billion yuan, more than the sum of the previous five years. QFIIs have accelerated their entry into China's stock market. By the end of 2004, there were 27 QFIIs with assets invested in China worth USD3.7

billion. In addition, pension funds, insurance funds and corporate annuities are also joining the stock market with faster pace. Commercial banks have begun to set up fund management companies. ICBC Credit Suisse Asset Management Co. Ltd. and BOCOM Schroder Fund Management Co. Ltd. were set up in June and August 2005, respectively.

### *Brokers Have Become a Major Force in the Development of the Futures Market*

In recent years, futures brokerage firms have grown stronger while practising "closed" management of funds from customer deposits accounts, i. e. such funds cannot be used for proprietary trading by the brokerage firms concerned. With their operations properly managed, they have become a driver for the development of China's futures market. According to CSRC statistics, by the end of 2004, China had 187 futures brokerage firms and 339 business offices. Institutions doing futures business had total assets of RMB21.888 billion yuan, net assets of RMB7.387 billion yuan and customer deposit balances worth RMB13.32 billion yuan, up by 11.2%, 2.2% and 14.3%, respectively, from 2003.



China's futures brokerage firms earned net revenue from commission charges of RMB1.482 billion yuan and net profits of RMB111 million yuan in 2004.

### *Securities Investment Consulting Agencies Have Become a Component of the Securities Market*

According to CSRC statistics, by the end of 2004, China had 111 securities investment consulting agencies and more than 3,000 qualified financial consultants. Securities investment consulting agencies have become a component of China's securities institutions.

If we divide securities institutions into different categories and examine their development separately, we find that institutional investors such as fund management companies, future's brokerage firms and securities investment consulting agencies are basically operating normally, but securities companies are at a rather difficult stage, and their reform and opening up deserve greater attention. The following discussion on the reform and development of China's securities sector will focus on securities companies.

## Key Areas to Focus on in Developing the Securities Sector

According to the categories formulated by IOSCO, market risk, credit risk, liquidity risk, operational risk, legal risk and systemic risk deserve great attention and tight control.

As a result of the weak performance of China's securities market, problems with securities companies have been substantially ex-

posed. Some companies have violated laws or regulations, and some others have suffered serious losses, generating a negative impact on the stability of the securities market and financial stability. The relevant authorities have taken measures to overhaul securities companies, and their risks have been put under effective control. Given the relatively small scale of their assets, China's securities companies have not triggered systemic crisis in the financial system; however, we should pay close attention to the causes of all those risks.

First, some securities companies have not yet improved their corporate governance structure, their risk management capacity and internal control mechanisms need to be strengthened. In addition, except for a small number of listed firms, there are no external audits or requirements regarding information disclosure for securities companies. Therefore, it is difficult to determine the business performance of securities companies.

Second, securities companies suffer from their low profitability, underdeveloped agency business and absence of an environment for innovative development. In a mature securities market, securities companies (or investment banks) are generally being recognized as the sell side, which is the major channel for selling securities products like stocks. While funds, insurance companies, pension funds, corporate annuities and other institutional investors constitute the buy side. The main business of securities companies is to create and sell securities products in exchange for com-

mission income and to assume the risks inherent in the market transactions. The sell-side businesses include share placements and market-making transactions. The buy-side business is mainly about using proprietary capital or funds raised in the market to trade securities for investment returns, and the assumption of investment risks. It includes such aspects like asset management and proprietary trading. The business model of China's securities companies is very skewed, with their buy-side business growing fast while their sell-side business is lagging behind, thus weakening their ability to fend off risks. The current institutional environment in China also makes it hard for securities companies to innovate their business and difficult to foster a business model, which focus on the sell-side business.

Third, such services as custodian of client deposits, treasury bond repo and asset management are not well designed, which provides room for securities companies to operate illegally. (1) There is a multi-layer deposit and custodian system for clients' settlement deposits, where securities companies deposits such funds to commercial banks under their own names, thus allowing the possibility for securities companies to impropriate these funds or use them as collateral for financing or providing external guarantee. (2) There are flaws in the design of the treasury bond repo system. There is no clear ownership for treasury bonds under the trustee of the same desk in the same securities company, which provides opportunities for these companies to impropriate their clients' T-bonds and engage in chain repo business. (3) Basic supervisory and regulato-

ry measures for account management, transaction process, reporting system and prevention of transfer of benefits in securities companies do not exist. Investors thus find it difficult to monitor the asset management business of securities companies, and there is no institutional guarantee for risk control in this business. When share prices fall, some funds under the management of securities companies incur huge unrealised losses, but if these stocks are sold at a depressed prices, it may lead to losses and financial risks.

Fourth, the legal system and regulation of the securities sector must be further strengthened. It is essential to improve the securities-related legal system and enforcement, investigate violations by securities companies in a timely and effective fashion, and maintain an effective control over the companies already in financial troubles. In the meantime, more stringent penalties must be implemented to prevent violations.

## Reform and Development

In accordance with the *Opinions*, the primary objective for the reform and development of securities companies is to ensure the securities companies become competitive modern financial enterprises. In order to achieve this objective, efforts must be made in parallel to reform and develop securities companies, including strengthening supervision and regulation, appropriate handling of risks, better institutional development, fostering a favourable information disclosure system and an enabling environment for development, and further



opening up. In dealing with risks, prevention and control must be combined, with the focus on prevention. The objective in the next two years is to mitigate present risks and effectively fend off new risks to lay the foundation for standardized, sustainable and stable development of the securities sector.

### *Strengthening Risk Monitoring and Supervision*

It is important to continue to strengthen risk monitoring and supervision over securities companies, adopt forceful measures to ensure investors' rights and interests and restore market confidence. These measures must be designed: (1) to carry out comprehensive monitoring based on different categories of the firms and put in place an effective day-to-day supervisory system; (2) to reinforce supervision over senior executives and shareholders in securities companies and regulate their behaviour; (3) to improve the internal and external monitoring mechanism for the proprietary trading of securities companies; (4) to push securities companies to practise the third-party custodian system for clients' securities transaction and settlement funds and establish an effective and self-sustained system for the operation and management of such funds.

### *Proper Risk Mitigation*

The securities investor protection fund must be improved gradually, new approaches must be explored for risk mitigation and a market-driven "survival of the fittest" mechanism must be put in place, to properly alleviate securities companies' risks. When tapping government

resources to mitigate risks, it is also critical to handle non-performing assets and liabilities in the market, and introduce and improve the risk mitigation mechanism based on market principles.

### *Intensified Restructuring of Securities Companies and Faster Growth of Better Ones*

Since 2005, the PBC has been working with CSRC and the MOF to restructure some large securities companies. Effective measures have been adopted to encourage and support further growth of the better securities companies in China. China Galaxy Securities, Shenyin & Wanguo, Guotai Jun'an, Huaxia Securities and other large securities companies are now undergoing overall restructuring. In the future, it will be necessary to further intensify the efforts to consolidate and restructure securities companies, support the growth of the better ones, let the best ones lead as examples and guide the whole sector to change the operational mechanism, improve business models and promote further development of the securities industry in China.

### *Stronger Institutional Development*

The first aim must be to develop the third-party custodian system for clients' securities transaction and settlement funds, improve the treasury bond repo system and resolve the risk control mechanism for asset management business, to put an end to business violations by securities companies. The second aim must be to improve the legal system for the securities industry. Activities such as stealing from the companies by executives and the misappropri-

ation of clients' assets by securities companies should be categorized as criminal offences. Companies and individuals with a history of serious violations of laws and regulations and serious breaches of duty should be banned

from participating in the market, to increase the punishment and form adequate deterrence. The third aim must be to improve enforcement mechanisms and increase supervisory methods in the industry.

### **Box 10 Third-party Custodian System for Clients' Securities Transaction and Settlement Funds**

The clients' securities transaction and settlement funds, also known as guarantee deposits, refer to the funds clients deposit with specified institutions in order to ensure there are sufficient funds for settling securities transactions.

According to the types of depository, the management of these funds falls into the following categories: the securities firm-led model, the bank-led model and the registration and settlement company-led model. The latter two models separate securities companies' own capital from clients' deposits, so they are also called independent custodian systems. In the bank-led model, the bank is a third-party to the security firm and the client, so this model is also known as the third-party custodian system for clients' securities transaction and settlement funds (referred as the third-party custodian system).

At present, the prevailing model in China is the securities company-led custodian system. Under this system, the clients' securities transaction and settlement funds are vulnerable to misappropriation by securities

companies. It is thus a potential institutional risk. In order to prevent securities companies from misappropriating clients' securities transaction and settlement funds, to ensure the security of such funds institutionally, to fend off systemic risks and better protect the investors' rights and interests, it is necessary to adopt the third-party custodian system as soon as possible. This third-party model can ensure the separation of clients' securities transaction and settlement funds from the securities companies' own capital and put an end to misappropriations of those funds by securities companies.

In January 2004, the PBC and CSRC put forward a proposal to adopt the third-party custodian system for clients' securities transaction and settlement funds. They kicked off a pilot project, which incorporated risk mitigation practices implemented for securities companies such as Southern Securities and Minfa Securities, and have made material progress. At the moment, the PBC is working vigorously with relevant authorities to introduce the third-party custodian system in a larger scale.



### *Standardized and Compulsory Information Disclosure*

Securities companies should adopt a standardized and compulsory information disclosure system, and a dynamic information inquiry system established with increase in both contents and scope of information disclosure to enable a shift from post-event discovery and action to ex-event real-time discovery and action.

### *An Enabling Environment for Further Growth and Incentives for Business Innovation*

China will create a favourable operating environment and ample room for healthy development of securities companies in accordance with international best practices. It is essential to create conditions to set up a business model focused on sell-side business, encourage securities companies to innovate, develop further covered warrants and other new products, push for the growth of new services such as financial advisory for M&A and restructuring, and expand the source of income for securities companies. It is important to expand the overseas business of securities companies in a proactive and prudent fashion, further broaden the financing channels for securities companies, and continue to facilitate the issuance and management of short-term financing bills by securities companies based on the approval given to Guotai Jun'an and three other securities companies for issuing such bills in 2005.

### *Opening up to Foreign Investment*

The securities sector needs to promote further

opening up, actively invite overseas strategic investors, attract foreign participation in risk mitigation, draw upon advanced managerial expertise of others and encourage securities companies to improve their corporate governance.

## Insurance Sector

China's financial institutions in the insurance sector mainly include property insurance companies, life insurance companies, reinsurance companies, insurance intermediaries and other institutions. The sound operation and a strong and sustainable repayment capacity of insurance institutions are the prerequisite for the stable development of the insurance sector, and one of the important elements for maintaining financial stability. In recent years, China's insurance sector has made remarkable progress in its reform and market opening, as the insurance institutions become increasingly more profitable and their management and operation more standardized. However, China's insurance sector is still in its infancy, with good potential to be tapped. China will speed up its reform and market opening in the insurance sector to achieve comprehensive, coordinated and sustainable development.

## Current Development

Since the start of economic reform, China has

been working to forestall risks in its insurance sector with reform as the driving force, product line readjustment as the main strategy and market development as the basis, making notable achievements in all respects, as suggested by the following.

First, the insurance business continues to develop and the market is growing fast. Since the domestic insurance business was reopened in 1980, China's insurance sector has maintained an annual growth rate of over 30%, one of the fastest growing sectors in the national economy. By the end of 2004, total assets of China's insurance companies exceeded RMB1.1 trillion yuan.

Second, there are more participants in the insurance sector and the market system is further improving. Insurance companies are becoming more professional and diversified, and an insurance market system featuring coexistence of multiple insurance institutions and competition between domestic and international insurance companies has taken initial shape. In 2004, 3 agricultural insurance companies and 5 health insurance companies received a licence to operate.

Third, structural reform programmes are making further progress. At present, state-owned insurance companies, which account for a considerable share of the market, have basically finished their restructuring programmes. The results of the shareholding reform have been consolidated. Following the successful overseas IPO of PICC P&C and China Life, Ping An Insurance also went public in Hong Kong. There has been major breakthrough in

the reform of the management system of insurance companies.

Fourth, the programme to modify product lines has had initial success and the market pricing mechanism is gradually starting to function. In 2004, the product structure of the life insurance sector was improved. Companies started to pay greater attention to regular premium business. As a result, this business grew quickly and has become the major revenue generator in the personal insurance sector. Bank insurance products are gradually transforming and risk protection products are gaining momentum. The quality of services has improved. Life insurance companies have visibly increased their intrinsic value and thus have greater capacity for sustainable development. Concentration on the property insurance market has been reduced substantially and asset allocation structure has improved somewhat. A market-pricing mechanism for insurance products has gradually been formed through regulatory reform of insurance premium rates.

Fifth, the insurance sector has been opened up to foreign participation. In accordance with China's WTO commitments, on December 11, 2004, the CIRC approved foreign life insurance companies to engage in health insurance, group insurance and the pension/annuity business, removed geographical restrictions on setting up branches of international insurance institutions, and raised the ceiling for foreign shares in insurance brokerage joint ventures to 51%. The pace of opening up the insurance market is accelerating, with international ex-



changes and cooperation rising. China's insurance sector is undergoing comprehensive market opening. The introduction of foreign insurance companies into China's market and for-

ign investment by domestic insurance companies have both made major progress, reducing the gap between domestic insurance sector and the international one.

### **Box 11 Significance of Public Listing of Insurance Companies**

On November 6, 2003, PICC P&C went public in Hong Kong, leading China's insurers into foreign capital markets. China Life went public on December 17 and 18 of that year in New York and Hong Kong. On June 24, 2004, Ping An Insurance was listed in Hong Kong. The three companies raised about RMB48.7 billion yuan through their overseas listings, and these events marked the beginning of global competition and cooperation for China's insurance sector. Its significance is shown in the following aspects.

First, public listing has increased business transparency and helped the restructuring of state-owned insurance companies. Overseas IPOs enable insurance companies to optimise their share ownership structure and improve their equity position, which in turn lays the foundation to improve their corporate governance. In the meantime, insurance companies listed overseas are facing very transparent supervision, any behaviour that violates international market conventions will affect their share price and the confidence of international investors. The companies therefore must strengthen their management, complete their mechanism transformations, maintain profitability and

keep a sound and stable business operation.

Second, public listing improves the capacity of insurance companies to underwrite policies, to compete and to invest, enabling China's insurance companies to venture into the international insurance market. On the one hand, a diversified fund raising mechanism for listed insurance companies can rapidly increase their equity and enhance their solvency capacity in a very short period of time, allowing the companies to attract more attention from overseas and potential investors, lift their international reputation and competitiveness, and help them open up insurance business in overseas market and compete in the international insurance market. On the other hand, this mechanism diversifies the operational risk of the insurance market to the capital market, the commodity market and the entire market system, thus laying foundation for sound and stable operation and sustainable development of the insurance sector.

Third, public listings improve the quality of both products and services on China's insurance market and promote the betterment of operation and management in the entire insurance sector. After overseas listings, the

international capital market and investors will use international criteria to assess PICC P&C, China Life and Ping An Insurance, therefore, pressure for good performance is bound to make the three companies shift from competition on premium rates only to competition on products and services as well. It will also force companies to adapt their products and services to better suit the needs of policyholders, improve each

company's business operation and work towards a streamlined and professional operational model. Following the example of the three listed companies, the entire insurance sector in China will improve on operation and management as well.

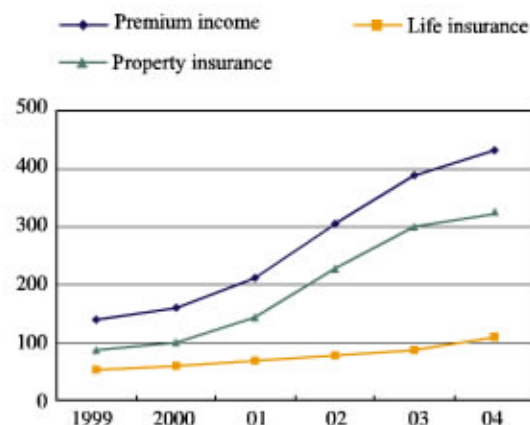
Fourth, listings of insurance companies provide invaluable experience for shareholding reform and public listing of large state-owned financial enterprises.

China's insurance sector showed the following trends in 2004:

First, the insurance business was growing at a slower pace. In 2004, the national premium income was RMB431.3 billion yuan. The growth rate was 15.84 percentage points lower than in 2003 (Figure 4.4). The total assets of insurance companies were RMB1.19 trillion yuan, up RMB273.07 billion yuan from the beginning of the year. However, the growth rate was 17.54 percentage points lower than that in 2003.

Second, the property insurance market was growing fast and recorded premium income of RMB111.18 billion yuan in 2004, up by 24.55% y-o-y; the life insurance market was growing up steadily, with premium income of RMB320.15 billion yuan, up by 7.19% y-o-y; the insurance intermediary market continued to develop on a stable track, with premium income collected through intermediaries reaching RMB290.27 billion yuan, accounting for 67.2% of the sector's total income.

Figure 4.4 Premium Income of China's Insurance Sector  
(billions of RMB yuan)



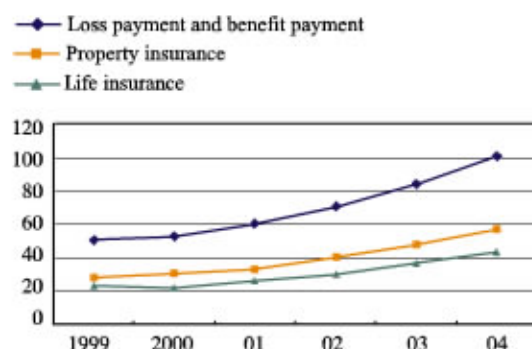
Source: China International Insurance Forum 2005.



Third, the insurance sector continued to play a bigger role in the overall economy. Loss payment and benefit payment were rising in the sector. In 2004, these expenses totalled RMB101.44 billion yuan, up 19.4% y-o-y (Figure 4.5). In terms of capital utilization, the insurance sector had assets worth RMB1.07 trillion yuan in 2004, including treasury bonds of RMB265.17 billion yuan, financial bonds of RMB115.68 billion yuan, bank deposits of RMB496.84 billion yuan and securities investment funds of RMB67.316 billion yuan. Participants in the sector are aware of their responsibilities to raise awareness of insurance and risk in society. The insurance sector's role in social management has been further strengthening.

**Figure 4.5 Loss Payment and Benefit Payment in China's Insurance Sector**

(billions of RMB yuan)



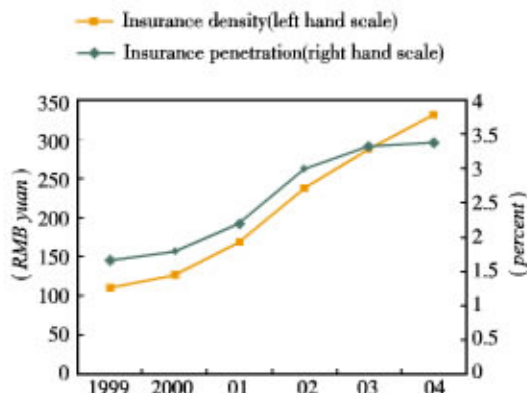
Source: China International Insurance Forum, 2005.

## Key Areas to Focus on in Developing the Insurance Sector

According to the *Insurance Supervisory Principles* released by the International Association of Insurance Supervisors, insurance institutions face the following major risks: underwriting risk, risk relating to reserve valuation, market risk (including interest rate risk), operational risk, legal risk, institutional and group risk (including pass-through risks, correlated risks and risks brought by other entities in the group) and credit risk. Given the current status of China's insurance sector, we should pay attention to the following.

First, China's insurance sector is still at its initial developing stage, and its potential is yet to be tapped. At present, the key indicators of China's insurance sector are lower than the global average, and the ratio between present insurance premium income and potential income is low. In 2004, China's insurance penetration (the percentage of national premium income in relation to GDP) was 3.4%, insurance density (per capita premium income) was RMB332 yuan, and the assets of insurance companies accounted for 8.68% of the country's GDP (Figure 4.6). In 2003, the world's average insurance penetration was 8.06% and average insurance density was USD469.6. In China, the penetration for household property insurance was around 5% and that for public liability insurance less than 10%. Even motor insurance, the major type of property insurance, had only around 30%

Figure 4.6 China's Insurance Penetration and Density



Source: China International Insurance Forum, 2005.

penetration. In contrast, the penetration rate of such insurance is generally above 80% in developed countries. In addition, China's insurance sector is not developing evenly between different regions. In terms of both per capita and aggregate amount of premium income, the more developed eastern China far exceeds its western and central counterparts.

Second, China's insurance sector must be wary of interest rate risk, asset/liability mismatch risk and capital utilization risk. In the mid- and late 1990s, China had a fairly high interest rate and life insurance companies pledged high returns to clients. As interest rates fall, negative interest spread increasingly becomes a problem for insurance companies. At the same time, while pricing their products, some China's life insurance companies did not take into full consideration the issue of

maturity matching, interest-rate matching and currency matching for assets and liabilities, so their long- and medium-term assets and liabilities are not properly matched. In addition, certain risks in capital utilization by insurance companies have emerged in recent years. For example, some insurance companies have their bank deposits with risky small and medium-sized banks, and funds invested in the domestic securities markets have suffered considerable losses as a result of sustained weak market performance and risk exposure at some securities companies.

## Reform and Development

China must take a scientific approach to the entire process of the development of its insurance sector, accelerate reform and development and pursue comprehensive, balanced and sustainable development.

### *Building a Dynamic, Systematic Supervision Model*

The insurance supervisory authorities are currently building five lines of defence to forestall risks in the insurance sector. The focus is on defending against systemic risk. Corporate internal control is the basis, supervision of solvency capacity is the core, on-site inspection is an important measure, supervision of capital utilization is the key, and insurance protection fund is the guarantee. It is necessary to develop guidelines for governance and supervision of insurance companies and rules on transaction counter parties as soon as possible, further improve risk control on insurance capital



utilization and management system for insurance protection fund, and strengthen the credit rating system. In the meantime, it is vital to reinforce information disclosure, increase transparency in the supervision information and operational and financial information of insurance companies to enable the public to learn more about risk status in the insurance sector. In terms of methodology, it is necessary to learn from international best practices, speed up the establishment of the risk warning system and off-site inspection system for the insurance sector to better predict future risk changes and effectively reduce sector-specific risks.

#### *Improve Corporate Governance in Insurance Companies and Set up Sound Risk Management and Internal Control System*

Attention should be given to introduce advanced risk management skills and methods from abroad, improve risk management capacity and gradually adopt a comprehensive, concentrated risk-management model in all areas, including product R&D, marketing, business management, solvency management and capital utilization management. Efforts must be made to improve the risk underwriting mechanism, standardize procedures for claim adjustment, strengthen agent management, reform commission system, develop assessment indicators and enhance the business performance of insurance companies.

#### *Promote Honesty and Integrity and Foster Awareness of Insurance Credibility*

To achieve this target, the following actions must be taken: (1) to foster awareness of insurance credibility and carry out an extensive

credibility education campaign; (2) to study and formulate sector-wide service standards, introduce a standardized policy contract and regulate insurance marketing; (3) to enforce penalties and sanction all dishonest acts in accordance with law to increase the penalty for poor credibility; and (4) to reinforce social supervision and set up a credit information inquiry system on insurance sales agents.

#### *Accelerate Adjustments to Product Line and Encourage Innovation in Insurance Products*

Insurance companies must be motivated to adjust their current product line, pay more attention to protective insurance products, vigorously develop pension and health insurance, strengthen the basic pension insurance system for corporate employees, improve unemployment insurance, expand the coverage of basic medical insurance, develop commercial pension and medical insurance, to balance the development between protective insurance products and investment insurance products, which are for high and medium income population.

#### *Improve the Supporting Policies for the Insurance Sector*

The government's aims are: (1) to accelerate the formulation and improvement of insurance regulations and bring about a better operating environment for insurance companies; (2) to improve taxation policies and promote coordinated development for all types of insurance; (3) to remove institutional barriers on capital utilization, open more investment channels to insurance companies and enhance the capacity for risk control, investment and profitability.

**Box 12 Regulation and Development of Integrated Financial Services**

Integrated financial services refer to a business that involves at least two financial markets, such as the money market, capital market or insurance market, or at least two financial sectors, such as banking, securities, insurance, trust and investment. Under the basic structure of segregated operation and supervision in China's financial sector, with the further reform, opening up and development, businesses in the banking, securities, insurance, trust and investment and other financial sectors are converging, bringing about rapid growth of integrated financial service.

*Current Development of Integrated Financial Services*

At present, the integrated financial services offered by China's financial institutions could be divided into the following two main categories.

The first category is cross-market financial business, that is, a financial business that involves multiple financial markets simultaneously. Typical cross-market financial businesses include treasury bond repo and stock collateralised loan business, which are offered by securities companies, and foreign exchange structural deposit and assets securitization business, which are offered by commercial banks. In March 2005, the PBC, the MOF and CBRC released the *Administrative Measures for the pilot of Credit*

*Assets Securitization*, which approved some commercial banks to carry out credit assets securitization and the property mortgage-backed securitization on a pilot basis.

The second category is cross-sector financial business, which takes three forms: (1) A financial business conducted by financial institutions from different sectors through co-operation. For instance, commercial banks and securities companies work together on account transfers between banks and stock exchanges; a commercial bank cooperates with an insurance company serving as an agent for insurance sales and obtains intermediary commissions. (2) A financial business conducted by a financial institution that does not traditionally participate in that sector. An example would be investment-banking business conducted by commercial banks. Some commercial banks have established basic business structure of corporate credit services, corporate financing advisory, restructuring and M&A advisory, structural financing advisory, consortium underwriting arrangement and management, indirect consortium and asset securitization business. (3) A financial business conducted jointly by financial institutions from different sectors. The management and investment of corporate annuity is a typical example. In April 2004, the Ministry of Labour and Social Security, CBRC, CSRC and CIRC jointly released the *Trial Measures of*



*Enterprise Annuity Fund Management*, which stipulates that all qualified commercial banks, securities firms, fund companies, TICs and insurance companies can participate in the management and investment business of corporate annuity.

RMB entrust financing business is the most active type of cross-sector financial business now. Wealth management business provided by commercial banks, client assets management business provided by securities firms, unit-linked insurance and universal life insurance provided by insurance companies and collective fund trust investment provided by TICs, despite the different names, all have the similar rights and obligations, fund-management model and the similar risk and return profile for investors.

Apart from financial institutions like banks, securities companies, insurance companies and trust companies participate in some integrated financial services, there are three kinds of crossholdings between financial institutions and those between financial and non-financial companies. First, commercial banks may control other types of financial institutions. The PBC, CBRC and CSRC released the *Administrative Rules for Pilot Incorporation of Fund Management Companies by Commercial Banks* in February 2005 to regulate such activities on a pilot basis. Second, TICs, insurance companies and other non-banking financial institutions may control OFIs. Third, non-financial corporations may control financial institutions.

### *Key Focus Areas for Integrated Financial Services*

Integrated financial services involve multiple financial sectors and financial markets and employ complex financial products that go beyond the boundaries of traditional banking, securities and insurance business, therefore, it could lead to cross-sector, cross-market financial risks. Cross-sector, cross-market financial risks are not only harmful to the financial system due to their complexity, but more importantly, such risks may transfer, spread and proliferate quickly among various financial markets and sectors. Without strong risk mitigation measures, such cross-sector, cross-market risks could generate catastrophic consequences for the entire financial system.

Therefore, it is crucial to enhance the capacity of China's financial sector to forestall cross-sector, cross-market financial risks. Firstly, financial institutions must build effective risk management and internal control system. Moreover, more importantly, the central bank, regulatory authorities and other government agencies must coordinate their policies and approaches with regard to integrated financial services, improve information sharing, set up a coordination mechanism for the supervision of cross-sector, cross-market financial risks and build an early warning and risk mitigation system.

### *Development of Integrated Financial Services*

On a global level, the traditional boundary

of financial sector has blurred since the 1980s. Financial liberalization, which is taking place through the integration of financial business, has become the main trend in the global financial development. Against this background, China's financial institutions are also experimenting with business innovations in order to enhance their capacity for sustained development. As an innovation in the financial business, integrated financial services can meet the clients' diversified and individual needs, re-

duce the operating cost of financial institutions, improve the international competitiveness of these institutions and inject new dynamism into China's financial sector. We should take the current conditions of Chinese economy and the financial sector into full account to ensure the healthy development of integrated financial services. This development should proceed in an orderly, steady and phased manner, after sufficient efforts are made to mitigate cross-sector and cross-market financial risks.





# Part V

## ***Financial Infrastructure, Financial Ecosystem and Financial Stability***

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**F**inancial infrastructure refers to the hardware and regulatory arrangements for financial operations, which mainly include the payment and settlement systems, laws and regulations, corporate governance, accounting standards, the credit information system, the anti-money laundering system and a financial safety net composed of prudential financial supervision, the central bank's role as the lender of last resort and the investor protection system. The financial ecosystem, in a narrow sense, refers to the financial infrastructure and its operational status. In a broader sense, it means the external environment in which the financial system is operating, and the combination of the factors, such as the economy, politics, culture, geography and population that are closely related to the operation of the financial system. A sound financial infrastructure and the financial ecosystem are the basic conditions and key cornerstones for the maintenance of financial stability.

Over the years, China has continuously deepened its financial reforms, with major progress made in building its financial infrastructure. China's payment system has put in place a structure in which the CNAPS is the core; the intra-commercial bank clearing system is the basis, accompanied by the intra-city clearing house and clearing system, foreign currency clearing system and bank card payment system. At the same time, payment and settlement systems have adopted a real-time gross settlement and a DVP system for bond trading. The accelerating development of the financial legal framework and the improve-

ment of the legal environment and financial law enforcement have enabled further enhancement of the financial legal environment. Corporate governance of financial institutions continues to improve. International accounting standards are being adopted for listed financial institutions. Creditors' rights are assured and protected by law. Pilot programmes for credit information system are being carried out among enterprises and individuals. Anti-money laundering laws and regulations and working mechanisms are beginning to take shape, and related supervision has been strengthened. Prudential financial supervision has been further enhanced, and the investor protection system in the banking, securities and insurance sectors is either being established or improved.

Chinese government attaches great importance to financial infrastructure development and will accelerate the modernization of payment and settlement systems, strengthen the legal framework of the financial sector, further improve corporate governance, raise accounting standards, establish and improve the credit information system, step up efforts to combat money laundering and strengthen international cooperation in this connection, improve the system of prudential surveillance and the role of the central bank as the lender of last resort, expedite the establishment and improvement of investor protection system in the banking, securities and insurance sectors and explore the possibility of establishing a coordination mechanism for financial supervision.

Chinese government will continue to improve



the financial ecosystem and take active measures to maintain financial stability. The financial ecosystem, while influenced by the level of compliance of the market participants, is at the same time, largely dependent on whether the whole society is giving enough attention, focus, understanding and support to financial stability. More and more people are beginning to recognize the importance of the financial ecosystem to financial stability. As the next step, we have to continue to strengthen financial law enforcement and the concept of corporate governance, release information in strict accordance with related accounting standards, improve the education of financial knowledge and risk awareness among investors, raise credit awareness among the general public, cultivate a credit culture of honesty and trustworthiness, highlight the concept of financial supervision coupled with its strengthening.

## Payment Systems

Payment systems are the core infrastructure of the financial system. Safe and efficient payment systems are crucial for unimpeded monetary policy transmission, tightening the links among the financial markets, accelerating the liquidity flow, efficient allocation of resources, mitigating financial risks, fostering innovation of financial instruments, improving financial service and maintaining public confidence in the currency.

### Payment Systems and Financial Stability

China's payment systems are mainly composed of four parts: payment service organizations, payment instruments, payment system, and payment and settlement management. Payment service organizations are the entities that provide payment instruments and system and other related services. Its service quality plays a decisive role in determining the quality of financial services in society as a whole. Payment instruments are the vehicle to realize money transfer and settlement of debt and credit. Efficient payment instruments help reduce cash in circulation, reduce transaction costs, curb corruption and tax evasion, regulate financial order and improve social credit. Payment system is the "highway" to support the application of various payment instruments and operation of capital. Its operating quality has a major impact on the security and efficiency of the financial system as a whole. Payment and settlement management is the comprehensive employment of economic, legal and administrative measures to supervise and control the payment service organizations and their related activities in order to maintain order in payment and settlement and to fend off and mitigate payment risks. Its proper functioning is an important guarantee for the smooth operation of the payment systems. However, malpractice of some payment service organizations or system imperfection are all possible causes of credit risk and liquidity risks, or even, systemic risks. To maintain

stability of the financial system, it is imperative to step up the efforts to build a secure and highly efficient payment systems.

The *Law on the PBC* establishes the legal status of the PBC as the organizer, manager and supervisor of the payment systems and bestows on it the responsibility maintaining the normal operation of the payment, clearing and settlement systems. The PBC, through improving laws and regulations, improving policy environment, encouraging payment business innovation, regulating market order and enhancing the capability to manage risks, guides and fosters the development of the payment and settlement system, promotes orderly competition, reduces risks and safeguards financial stability.

## Current Development of the Paymet Systems

### *Payment Service Organizations*

With economic and financial development and more specific division of labor, China has formed a structure of diversified development of its payment service organizations. The PBC is the owner and operator of China's core payment systems—CNAPS. Policy banks, SOCBs, JSCBS, city commercial banks, UCCs and RCCs, foreign banks and OFIs in the banking sector provide payment and settlement service to clients directly, and they constitute the core of the payment service organizations. With the deepening of the financial reform, the role of non-financial institutions is developing in the payment service market, making them an impor-

tant addition in that market.

### *Payment Instruments*

At present, China has put in place a diversified non-cash payment tool system with bills and bank cards as the main body and e-payment as its future direction of development. The system covers many payment methods that are widely used, such as exchange and remittance, term debit, term credit and collection.

The bills include bills of exchange, promissory notes and cheques. Bills of exchange are further divided into bank drafts and commercial drafts. Cheques and bank drafts are the most popular and are mainly used within the intra-city network or elsewhere. More people increasingly use bank acceptance, while fewer people are using commercial acceptance and cashier's cheques. In recent years, the development of the bills service has demonstrated the following features: (1) the major users of the bills service are no longer restricted to state-owned financial institutions and large enterprises; (2) new varieties of bills products continue to surface, for instance, the bill discount business with interest covered by buyer, and the bill discount business abandoning partial recourse etc; (3) intermediaries are gradually taking shape in the bills market and bills intermediaries specializing in bills trading and consulting have emerged; (4) the bills market has become the fastest-growing one among all the financial markets and is becoming more important in terms of allocation of funds, liquidity management, risk diversification, monetary policy transmission and helping small-and medium-sized enterprises address financing difficulties.



Bank cards are the most used non-cash payment instruments by individuals in China, and these include debit cards, quasi credit cards and credit cards. Within which, the quasi credit card is the one with “Chinese characteristics”. Bankcards have enjoyed rapid growth in recent years, with more than 800 million cards issued in aggregate. Most bank cards have now been interconnected and can be used in different banks, and the card consumption environment has been greatly improved. The volume of card transactions has been quite remarkable in its initial phase of development. The payment function of bank cards continues to improve, and the market division of labor is becoming more specific. An industry value chain composed of card issuance institutions, bill gatherers, information exchange organization, specialized service agencies and suppliers of related products and technologies has taken an initial shape. China’s bank card payment network is gradually taking part in the global payment and settlement system. China has become the country with the greatest potential globally in terms of bank card development.

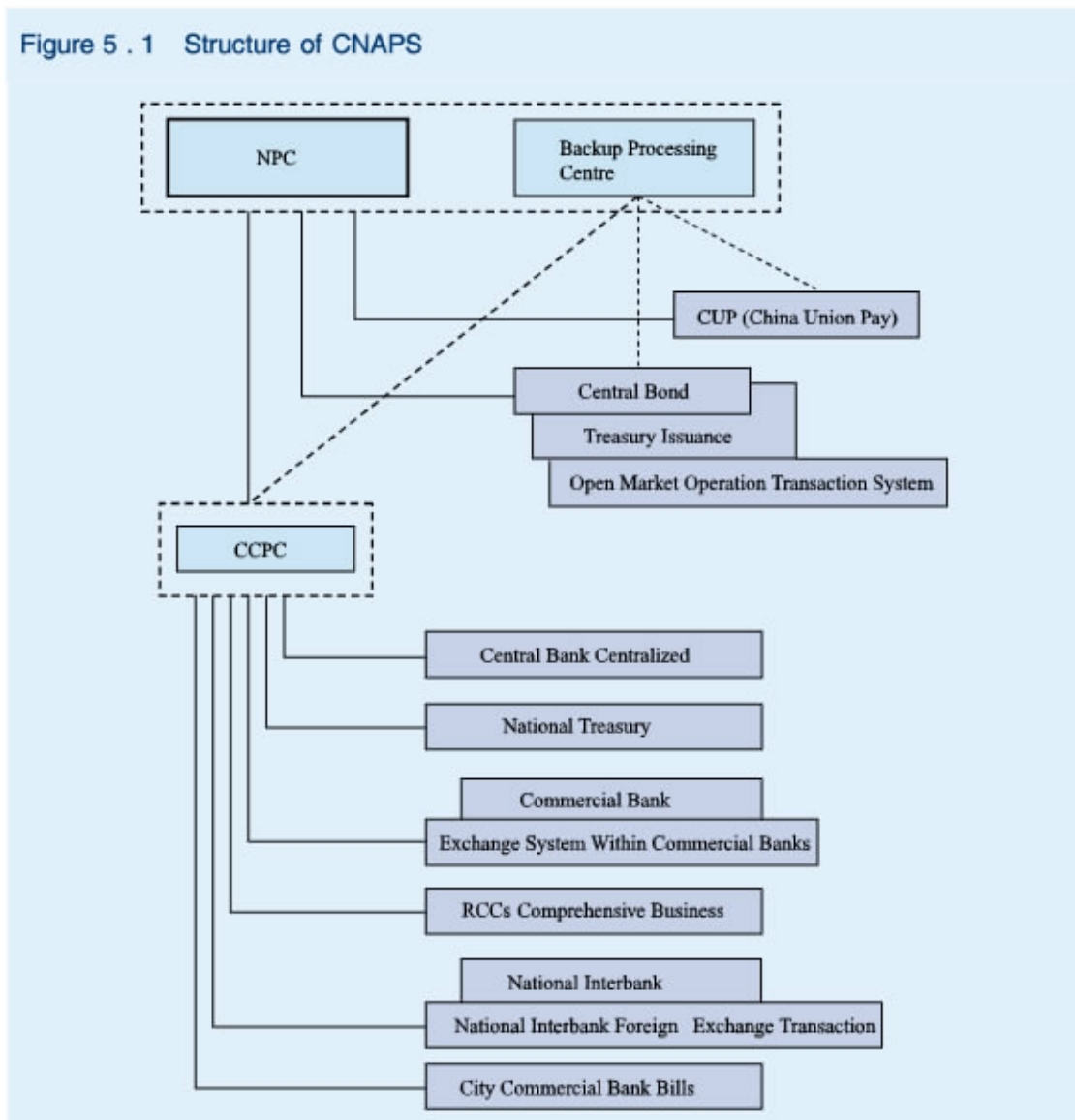
### *Payment system*

At present, China’s payment system has put in place a pattern in which the CNAPS is the core; the intra-commercial bank clearing system is the basis, accompanied by the intra-city clearing house and clearing system, foreign currency clearing system and the bank card payment system.

*CNAPS.* CNAPS is the public payment platform provided by the PBC to the financial in-

stitutions and the money market and mainly includes processing centers at two levels and a backbone network of the payment system. The processing centers at two levels are respectively the NPC and the 32 CCPCs situated in 31 provincial capitals (or municipalities directly under the central government) and Shenzhen City (Figure 5.1). The CNAPS is a major core system with two sub-systems: the Real Time Gross Settlement (RTGS) system and the Deterred Net Settlement (DNS) system. The LVPS is a RTGS system mainly providing efficient and convenient service to large-value and emergency low-value credit transactions. The DNS system is a retail system, mainly providing low-cost, bulk-volume service to interbank paper certificate retained debit and small-value credit transactions. The two systems are independent from each other in logic, but enjoy full sharing of physical resources. At present, the RTGS system has been introduced and used in most places in China, and all policy banks, Chinese and foreign-funded commercial banks and the majority of RCCs have been connected with this system, with more than 1,500 direct participants in the system and more than 60,000 bank branches connected. It handles an average of 450,000 payment transactions, with a total daily turnover of RMB700 billion yuan. Each transaction is completed real-time within one minute of entry. The system has been operating with stability, and all the payments have been handled correctly. The RPS is going to have pilot programmes soon and is expected to be promoted on a national scale by the end of June 2006.

Figure 5 . 1 Structure of CNAPS



To ensure the security and stability of the payment system, CNAPS has taken into full consideration of the requirements of the *Core Principles for Systemically Important Payments Systems* of the BIS with regards to its design and has introduced advanced payment and settlement methods and technologies that are universally recognized. First, it has estab-

lished an improved risk control mechanism. To prevent liquidity risks, the payment system has adopted the RTGS and bulk net settlement for bulk payments, and for those insufficient account balance cases, they are held in a “No Settlement File Queue”. To prevent clearing risks, the operating time of the clearing window is fixed. If a payment instruction remains



in the queue after the window is closed, it will be returned to the sending bank, or liquidity supply may be obtained from the PBC with a high penalty. To prevent credit risks, a reasonable daytime overdraft limit is verified and approved for commercial banks, requiring the banks to provide effective guarantees for high penalty loans and the clearance account of a bank could be deprived of debit functions or even be closed. At the same time, since the system participants use their deposit account at the PBC to complete settlement, the reliability of the settled capital is guaranteed. Second, it has realized DVP settlement of the national interbank bond market and the central bank's open market operations. Third, it has given full consideration to security control problems in terms of hardware, software and management. Fourth, it has an open standard for access. All eligible small- and medium-sized financial institutions can become direct participants and get connected to the system to handle their payments.

*Intra-city clearing house and clearing system.* The intra-city clearing house and clearing system are supplements to CNAPS at regional levels. The former deals with the exchange and clearance of paper bills, while the latter deals with the exchange and clearance of electronic information. At present, 1,936 cities above the county level nationwide have established clearing houses, Beijing-Tianjin, Shanghai-Nanjing and Guangzhou-Shenzhen have become regional clearing centers, and pilot programmes, such as cheque retention, bills imaging technologies have been implemented.

*Foreign currency clearing system.* At present, seven regions in China have established foreign currency clearing centers handling interbank foreign currency clearing business. Up till now, there has not been a unified national interbank foreign currency clearing system. The USD and Hong Kong dollar are the major currencies in the clearing process. Inter-city foreign currency clearance among the domestic Chinese banks is handled by the foreign exchange linkage bank system while the clearance outside the system is realized via three means—the SWIFT system, the settlement account of foreign currency clearing centers abroad or entrusted to large banks, such as the BOC. Foreign currency clearance of the foreign-funded banks is mainly through the SWIFT system.

*Bank card payment system.* Bank card payment system is the network specialized in dealing with bank card interbank data information exchange and is a major component of the RPS. The national bank card payment system is operated by CUP. The CUP network includes the Shanghai information processing headquarters and 18 branches. In 2004, the bank card information exchange network was connected with CNAPS and real-time funds transfer was made possible via the authorized settlement account established at the PBC. This has made the clearing process more efficient. To cope with the need of centralized data processing and enhance the interbank network service, CUP made adjustments to its network structure in 2004 and set up a new generation interbank exchange system to handle information transfer and clearance in a

centralized manner, while the branches will only provide such services as preparing financial statements and billings.

### *Payment and Settlement Management*

The PBC, in accordance with its public policy goal of a safer and more efficient payment system, has adopted active measures to set up a basic framework of the payment system. It has initially put in place a legal structure with the *Negotiable Instruments Law* as the backbone and payment and settlement management rules and regulation documents as supplements. It has made vigorous efforts to create a level playing field for the payment service market, built an automated payment system and promoted diversified development of non-cash payment instruments. At the same time, the PBC has also established uniformed, secure and efficient central bank centralized accounting system and account management system, among others.

Over the years, China's payment and settlement management has made the following achievements.

First, it has improved payment and settlement rules and regulations, providing legal guarantee to supervise the payment system. At present, China has put in place a fairly sound system of payment rules and regulations, with the *Negotiable Instruments Law*, *Rules on Bill Management*, *Payment and settlement Rules*, *Administrative Rules for RMB Bank Settlement Accounts* as the main body and supplemented by other relevant regulations or bylaws. In particular, with regards to payment instru-

ments, a systematic legal institution has been shaped that not only covers laws and regulations related to paper-based payment instruments as mentioned above, but also includes those related to card-based payment instruments like the *Regulations on Bank Card Business Management* and the *Regulations on Bank Card*, which is being drafted. In addition, nine ministries and agencies including the PBC and the NDRC, jointly issued the *Opinions on Promoting the Development of the Bank Card Industry*, which would serve as the guideline for the bank card business in China in the future. In order to regulate and promote e-payments, relevant rules and regulations are also being researched and drafted.

Second, it has strengthened the payment system oversight and management to fend off payment system risks. To ensure the security and stability of the LVPS, the PBC improved the related legal institutions, promulgated the *Business Rules of LVPS* and strengthened regulations governing system operation management. It enhanced the accountability for the operation, maintenance and management of the payment system to prevent system risks. It also formulated pre-emptive plans dealing with potential payment system risks and a contingency plan in times of crisis together with a working mechanism dealing with risk settlement. It improved payment system operation status reporting and information feedback system to ensure that the problems in the system are spotted and identified at an early stage. It closely followed up on the new issues that came with the introduction of the LVPS and looked at ways to build a payment system



operation maintenance mechanism to ensure the security and stability of the payment system and other related systems.

The PBC is also the operator and manager of the development of the RPS. When developing the RPS in full alliance with the principle of forward-looking, secure, high efficiency and universal usage, it took concrete measures in legislation. At present, a series of the RPS related system management regulations, such as the *Business Rules of RPS*, the *Business Procedures of RPS*, the *Operation Management Rules of RPS* are being drafted.

Third, payment service continues to see new innovation. To solve the difficulty of settlement for small- and medium-sized banks, a settlement proxy system is being vigorously promoted and money-clearing centers are encouraged among city commercial banks. To promote the use of bills, regional bills centers are set up and Hong Kong dollar cheque two-way settlement service between Guangdong and Hong Kong, Shenzhen and Hong Kong has been launched to integrate existing bills and settlement documents and the issuance of blank cheques will receive administrative punishment. To encourage bank card development, commercial banks and CUP are allowed to tap overseas market business together.

Fourth, bank settlement accounts are more strictly managed to safeguard normal economic and financial order. Bank settlement account is the starting point as well as the end of fund movement. To implement the policy of having each account using the owner's real name and curb money laundering, corruption and finan-

cial fraud from their root, the PBC, while vigorously strengthening legal framework regarding bank settlement account management, completed the introduction of the account management system to the whole country in June 2005 so that it is able to examine and verify the authenticity, completeness and legitimacy of the depositor's information as well as the uniqueness of the basic deposit account.

Fifth, the accounting system of the central bank continues to grow and improve. The integration and improvement of existing accounting systems, the establishment of a united and secure central bank centralized accounting system and unified accounting at city and prefecture levels have reduced business operation links and conform to the central bank's requirements of averting capital risks and raising accounting quality.

Sixth, risk oversight and management are strengthened. The oversight and management of the PBC's payment system, while emphasizing its legality, attaches even more importance to prevent systemic payment risks and the research and oversight of major payment systems. In this connection, the PBC has taken an active part in self-evaluating the payment system under the auspices of the cross-ministry "FSAP" a self-evaluation leading group. It has studied and formulated the payment clearing organization management system, putting forth requirements on clearing organization's market access and withdrawal, business management and risk control. It has strengthened the oversight and management of the central bank inter-branch accounting service and es-

tablished a standardized inter-branch accounting examination system.

Seventh, payment information collection and analysis system is under construction. The PBC is building a comprehensive payment information collection and analysis system that will include three categories: management information, business information and specialized information.

### Key Areas to Focus on in Developing the Payment Systems

In December 1999, the CPSS formulated the *Core Principles for Systemically Important Payments Systems*. According to the core principles, payment systems can be subject to a range of risks, including: (1) credit risk: the risk that a party within the system will be unable to meet its full financial obligations within the system currently or at any time in the future; (2) liquidity risk: the risk that a party within the system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future; (3) legal risk: the risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks; (4) operational risk: the risk that operational factors such as technical malfunctions or operational mistakes will cause or exacerbate credit or liquidity risks; and (5) systemic risk: in the context of payment systems, this is the risk that the inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other

system participants or of financial institutions in other parts of the financial system to meet their obligations. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the system and financial markets.

To address the above-mentioned risks, the *Core Principles for Systemically Important Payments Systems* lay out the principles that should be observed to ensure a safer and more efficient payment and settlement system, including: (1) the system should have a well-founded legal basis under all relevant jurisdictions; (2) the system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation; (3) the system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and provide appropriate incentives to manage and contain those risks; (4) the system should provide prompt final settlement on the day of transaction, preferably within the day and at least by the end of the working day; (5) the system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation; (6) assets used for settlement should preferably be a claim on the central bank, when other assets are used, they should carry little or no credit risk; (7) the system should ensure a high degree of security and operational relia-



bility and should have contingency arrangements for timely completion of daily processing; (8) the system should provide the means for making payments which is practical for its users and efficient for the economy; (9) the system should have objective and publicly disclosed criteria for participation, which permit fair and open access; (10) the system's governance arrangements should be effective, accountable and transparent.

CNAPS has basically met the requirements for safety and efficiency of the *Core Principles for Systemically Important Payments Systems*, however, there is still room for improvement in some areas.

#### *Payment Service Organizations*

The problems with the payment service organizations are: (1) a market-based operational system for payment service has yet to be fully formed; (2) for non-financial institutions participating in the payment service market, there is a lack of corresponding laws and regulations concerning their legal status, management requirements and risk control; (3) after SOCBs streamlined their branch networks, RCCs have become the main supplier of payment service in the rural areas. However, since they are usually small-sized and poorly equipped with modern technology, their payment means are very limited and the channel for funds settlement is also impeded—this has put a constraint on the improvement of financial service quality in the rural areas; and (4) with the transitional period after China's WTO accession coming to an end, more foreign institutions are entering China's market and they

will bring certain impact to Chinese institutions in terms of customer base, profit margins and human resources.

#### *Payment Instruments*

Non-cash payment instruments enjoy a fairly complete spectrum of varieties but they are not fully utilized. Transactions in cash still account for a fairly big proportion and cash circulation makes up about 16% of GDP, whereas in most developed countries, this proportion is usually less than 6%. The excessive use of cash has not only resulted in a lot of inconvenience, but has also been detrimental to tax collection and management, anti-money laundering and safeguarding financial order.

As far as non-cash payment instruments are concerned, the following areas should receive enough attention. (1) Bad credit and fraud induced credit risks. Since non-cash payment instruments are not the legal payment method, their existence can only rely on bank credit, commercial credit and individual credit instead of on state credit. However, as China's credit information system still has a lot of room for improvement, most of the people lack the awareness of the credit concept and the country's credit examination remains sluggish, credit risk has become the biggest risk faced by the development of non-cash payment instruments. (2) Irregularities of usage might easily trigger operational risk. Most of the bills fraud cases in recent years were caused by the failure to strictly abide by relevant laws and regulations. (3) Technological risk of counterfeiting caused by the low level of counterfeiting-proof skills that fall short of safe

management requirements. Such risk exists in both bills and bank cards. (4) Legal risk. Bills and bank card-related business still follow the laws and regulations made many years ago, and some market innovation products face a reasonable amount of legal risks. They are either put to a halt or allowed to develop freely in the absence of corresponding regulations.

### *Payment System*

Problems with the payment system are mainly in the following four areas.

With regard to CNAPS, first, the legality of payment made by a market participant in bankruptcy circumstances is yet to be legally confirmed; second, processing centers at the two levels have to develop the disaster backup system as early as possible; third, with CNAPS becoming more popular, it is imperative to take effective measures to raise business handling capacity; and fourth, as the risk control ability of some of the small- and medium-sized financial institutions is still quite weak, the risk of payment clearance has increased consequently.

With regard to intra-city clearing house and clearing system, they also have a problem with the final legal confirmation of the payment made.

With regard to foreign currency clearing system, the system is yet to be unified and is separated from the corresponding RMB system in terms of management and operation, which has resulted in low efficiency of interbank foreign currency clearance in the domestic mar-

ket. It is also harmful to the PBC's monitoring of capital in foreign currency and makes it difficult to fulfill the development and management requirements in view of economic and financial globalization and China's target of gradual liberalization of capital control.

With regard to the bank card payment system, with the growth of bank card business, the outsourcing activities of the bank card payment system, the card issuance and acquirer system of commercial banks and related data processing will have increasingly large influence on the security of the payment system as a whole as well as the financial information safety. This will bring about serious challenges to the managers and operators of the payment system. As CUP expands its business overseas, it will face higher requirements with regard to the reliability and safety of its transaction network and its system management ability.

### *Payment and Settlement Management*

The main problem with the payment and settlement management system is: the legal basis for the oversight of relevant payment system in China is still a far cry from the goal of building a stable, clear and transparent payment system oversight framework. First, oversight responsibilities have yet to be clarified and coordination between different government agencies needs to be strengthened. Second, most of the existing laws deal with payment instruments and they are quite insufficient when it comes to the payment system and the payment service market. Internal conflicts still exist between some rules and regulations.



## Development and Improvement of the Payment Systems

To meet the requirements posed on payment and settlement systems development by economic growth and financial stability, the PBC has set up targeted plans for its development, namely: to establish a realistic and forward-looking payment regulation system that suits national conditions, conforms to international practice and combines market competition with standardized management; to create a payment service organization system with the PBC and banking institutions as the core and payment clearing organizations as supplements; to improve the payment instruments system with cheques, promissory notes, bills and bank cards as the mainly body and e-payment instruments as the future direction that will be able to suit the need of various forms of economic activities and the daily household demands; to establish a payment clearing system with CNAPS as the core, intra-commercial bank exchange and remittance system as the basis and the coexistence of clearing house and card-based payment systems; to establish and improve a scientific and efficient payment and settlement management institution that can fully utilize innovation of payment service organizations and promote the diversified development of payment instruments and the stable operation of the payment system.

### *Payment Services Organizations*

With in-depth development of the market economy and expansion of reform and opening

up, China's payment service organizations will take positive measures to confront the challenges. On the one hand, they will step up the innovative efforts to establish and improve the fee-collection mechanism and enhance payment service quality. On the other hand, they will carry out more cooperations with overseas institutions with regards to funds settlement and credit cards. In addition, the PBC is undertaking relevant legislative measures to improve the payment and settlement service market. It is also making use of the opportunity brought about by the financial reform in the rural areas to enrich the access models of CNAPS so as to address the difficulty of money wiring and remittance in RCCs and improve the quality of rural financial services.

### *Payment Instruments*

The PBC will promote non-cash payment instruments. In the first place, it will further improve the legal framework by accelerating the revision of the *Negotiable Instruments Law*, the formulation of the *Regulations on Bank Cards* and the legislation with regards to e-payment. Secondly, it will strengthen the credit information system and cultivate a good credit environment. Thirdly, it will improve the technical methods for bills and bank card counterfeit-prevention and raise safety management levels. Fourthly, it will improve market product mix and promote the use of commercial acceptance bills and cheques. Commercial paper will also be introduced on a trial basis. It will continue to promote the development of debit cards and e-payments and

let credit cards grow steadily. Fifthly, it will raise consumers' awareness concerning the risk prevention knowledge related to specific payment instruments.

### *Payment System*

The PBC, as the operator and manager of CNAPS, will, in accordance with the *Core Principles for Systemically Important Payments Systems*, continue to improve the design, operation, maintenance and oversight mechanisms of the system and optimize business processing procedures to make the payment system safer and more efficient. The PBC will step up its efforts to build a disaster back up system and improve its operational and maintenance mechanism. It will improve the functions of the LVPS and study and launch the automatic impawn financing function while accelerating the outreach of the retail system at the same time. It will lose no time to build a payment management information system and the business monitoring system.

For local level clearing houses and clearing systems, the PBC will have an integrated plan and coordinated arrangement for them. First, to set up regional clearing centers based on market demand and economic inter-connectivity. Second, to promote innovative cheque processing methods such as cheque retention and imaging in areas where conditions meet. Third, to improve intra-city clearing house management system and regulate bill-exchanging activities. Fourth, to expedite the development of a cheque credit support system and realize the inter-connectivity between the

clearing house system and bank systems to make cheques safer.

With China's WTO accession, the domestic financial environment will be undergoing changes. The market liberalization will see more frequent exchanges between banks internationally. All these make it imperative to build an integrated foreign currency clearing system. The PBC will look at the possibility of establishing a new foreign currency clearing channel and an integrated domestic and foreign currency clearing system within the country on the basis of CNAPS.

### *Payment and Settlement Management*

To build safer and more efficient payment systems and maintain financial stability, the PBC will, in compliance with the requirements of administration according to law and market based management, endeavor to explore more models to ensure financial stability, encourage and promote security and efficiency in the payment systems with the view to realizing the set goals for China's payment systems development as early as possible.

## Legal Environment

A good legal environment is the guarantee for a fair and efficient market mechanism and the foundation for combating financial crimes, preventing moral hazards and cultivating sound market players. Therefore, the prevention of financial risks and maintenance of financial



stability cannot be separated from the establishment and improvement of the legal system and its effective enforcement.

## Current Development of the Legal Environment

Since the reform and opening up, with the constant deepening of financial restructuring, China's financial legal development has embarked on a fast track and made tremendous achievements. The *Law on the PBC*, the *Law on Commercial Banks*, the *Law on Banking Regulation*, the *Securities Law* and the *Insurance Law* were promulgated, and a basic financial legal system has been set up to mainly regulate financial practitioners, operating activities and financial supervision and regulation. Based on these basic financial laws, the State Council and other related agencies have formulated corresponding administrative regulations, rules or regulatory documents. Besides, on the laws on administrative activities, there are such laws as the *Administrative Licensing Law*, the *Administrative Reconsideration Law* and the *Administrative Punishment Law* to regulate the administrative activities of the financial supervisor. On the civil commercial law front, there are such laws as the *General Principles of the Civil Law*, the *Contract Law*, the *Company Law*, the *Bills Law*, the *Guarantee Law* and the *Trust Law* to regulate the civil commercial activities. On the criminal law front, there are legal provisions on the punishment of financial crimes in the *Criminal Law* and other related legislations or judicial interpretations. Generally speaking, up to

now, China has already formed a fairly clearly defined financial legal system composed of laws, administrative regulations, rules, regulatory documents and related judicial interpretations, providing a fair amount of systematic protection to the normal functioning of the financial sector.

In the financial legal framework, basic legal system for the maintenance of financial stability has been initially established. These legal systems can be divided into the basic legal system bearing on financial stability and the legal system for the prevention of systemic financial risks and risk mitigation. What is worthy of special mentioning here is the newly revised the *Law on the PBC* in 2003, which bestowed the responsibility of maintaining financial stability directly on the PBC.

### *The Basic Legal System Regarding Financial Stability*

In a broad sense, the basic legal framework regarding financial stability includes the civil commercial legal system for financial stability, financial regulation legal system and criminal legal system combating financial crimes. In a narrow sense, it mainly includes enterprise bankruptcy legal system, criminal legal system preventing and combating financial crimes, anti-money laundering legal system and other legal systems that have a direct influence on maintaining financial stability.

*The enterprise bankruptcy legal system.* The protection offered by the enterprise bankruptcy legal system to the creditors directly bears on the safety of assets in financial enterprises.

The current enterprise bankruptcy system mainly includes the *Enterprise Bankruptcy Law (proposed)* of 1986, which applies to all SOEs, Chapter 19 on Debt Repayment Procedure for Enterprise Legal Person Bankruptcy of the *Civil Procedure Law*, which applies to other types of enterprises, a series of judicial interpretation promulgated by the Supreme People's Court, administrative regulations and regulatory documents made by the State Council or relevant ministries and local regulations on enterprise bankruptcy.

*The criminal legal system preventing and combating financial crimes.* The 1997 revised the *Criminal Law* uses 31 articles in two sections to define "crimes undermining financial management order" and "crimes of financial fraud". Later on, in order to cope with the new circumstances of preventing and combating financial crime, SCNPC made supplements and revisions to the provisions of combating financial crimes in the *Criminal Law* by the form of amendments or decisions.

*The anti-money laundering legal system.* Article 119 of the *Criminal Law* clearly defines money laundering as a criminal offence and stipulates corresponding criminal punishment. In January 2003, the PBC promulgated the *Anti-money Laundering Regulations of Financial Institutions*; the *Administrative Rules for the Reporting of Large-value and Suspicious RMB Payment Transactions*, and the *Administrative Rules for the Reporting of Large-value and Suspicious Foreign Exchange Transactions of Financial Institutions*, clarifying procedures must be taken by financial institutions

to guard against money laundering. The *Law on the PBC* revised in December 2003 defines the mandate of the PBC to guide, deploy and monitor the fund for anti-money laundering work. The drafting of the *Anti-money Laundering Law* began in March 2004. In addition, China has acceded to many international conventions of anti-money laundering, such as the Vienna Convention and Palermo Convention.

#### *The Legal System for the Prevention of Systemic Risks*

In a broad sense, legal system for the prevention of systemic risks includes the various legal systems that regulate behaviors of financial institutions and the operation of the financial market. In a narrow sense, the legal system directly prevents systemic financial risks include: (1) the legal system preventing systemic financial risks established by the *Law on the PBC*; (2) the legal system for financial supervision and regulation authorities to prevent risks established by the *Law on Banking Regulation*, the *Securities Law*, the *Insurance Law* and the *Company Law*; and (3) the legal system to ban illegal financial institutions and illegal financial activities established by the *Rules on Banking Illegal Financial Institutions and Illegal Financial Activities* promulgated by the State Council.

#### *The Legal System to Mitigate Financial Risks*

Mitigation of financial risks is mainly the assistance and relief to financial institutions with payment difficulties to let them withdraw from the market smoothly. Relevant legal systems



include: (1) the legal system of the takeover, rectification and restructuring of financial institutions established by the *Law on Commercial Banks* and *Law on Banking Regulation*; (2) the legal system of the removal (administrative closure) of financial institutions established by the *Regulations on Closure of Financial Institutions*; (3) the legal system of financial institution bankruptcy; (4) the legal system of relief re-lending provided by the central bank; (5) the legal system of non-performing asset disposal established by the *Regulations on Financial AMCs*; (6) the legal system for investor protection.

#### *The Central Bank Legal System for the Maintenance of Financial Stability*

The *Law on the PBC* bestows on the PBC the responsibility of maintenance of financial stability in accordance with law. There are 5 specific provisions related financial stability that clearly stipulate that under the leadership of the State Council, the PBC forms and implements monetary policy, prevent and mitigate financial risks and maintain financial stability. The branches of the PBC maintain financial stability within their jurisdictions authorized by the PBC. The PBC may, according to the need to implement monetary policy and maintain financial stability, recommend that the banking regulatory authority to inspect relevant financial institutions. When payment difficulties in banking institutions and the possibilities of financial crisis occur, the PBC, in order to maintain financial stability, with the approval of the State Council, has the right to conduct

examinations and supervision of banking institutions.

The establishment of the above-mentioned legal systems has played a vital role in the improvement of the legal environment, strengthening of financial law enforcement, prevention and mitigation of financial risks and maintenance of financial stability.

### Key Areas to Focus on in Developing a Sound Legal Environment

China's financial rule of law development is conducted in the process of economic transition. Despite its huge success, the legal system still has a lot of room for improvement. In the future, in order to deepen financial system reform, accelerate the opening up of the financial sector and enhance its innovation capability, the following aspects need to be considered.

First, a number of important market economy laws need to be amended and improved. For instance, the existing *Company Law*, *Securities Law* and *Insurance Law* do not suffice in stipulating the rights and obligations of the financial market participants in an explicit and balanced way. The *Property Right Law* is under consideration and the *Guarantee Law* has yet to provide comprehensive and equal protection to the property rights and interests of various kinds.

Second, bankruptcy legal system needs to be established and improved as soon as possible. The soundness of the bankruptcy system of a

country has become an important benchmark measuring economic maturity as well as a major factor bearing on financial stability. As a universally accepted standard and norm, the *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* issued by the World Bank emphasize that a country should build a certain, transparent and low-cost credit enforcement system, with fair treatment to creditors, and provide timely, effective and fair insolvency solutions. In line with the above-mentioned standards, China's enterprise bankruptcy legal system, with the *Enterprise Bankruptcy Law (proposed)* enacted in 1986 as the main content, is no longer adaptable to the requirements of the socialist market economy development in terms of its scope of application, resolution procedures and bankruptcy and corporate restructuring. At the same time, China lacks legal basis for bankruptcy of financial institutions. The *Regulations on the Closure of Financial Institutions* issued by the State Council in 2001 is only an administrative regulation on the closure of financial institutions instead of a law on financial institution bankruptcy. It has also exposed a number of problems in practice that need to be addressed and improved.

Third, the criminal legal system to prevent and punish financial crimes needs to be improved. In particular, the existing law lacks strength in combating such behavior as loan fraud through using fake financial information by enterprises and the embezzlement of customers' funds by financial institutions. Further revisions and amendments are necessary.

Fourth, imperfect social credit legal system including contract freedom, transaction safety and fair competition has hindered the establishment of a social credit system and needs to be improved.

Fifth, the anti-money laundering legal system is still in the fledgling stage and the related working mechanism needs to be developed and improved.

Sixth, the legal system that regulates financial innovation activities is not sufficient, and there is still no proper legal supervision system that governs cross-sector and cross-market financial product innovations.

## Improvement and Development of the Legal Environment

It is imperative to improve the financial legal system and facilitate the development of the financial legal environment. On the one hand, the *Company Law* needs to be revised to further improve corporate governance and compliance. The *Securities Law* needs to be revised to protect the legitimate rights and interests of securities investors. The *Property Rights Law* needs to be drafted, and the *Guarantee Law* needs to be improved to more clearly and to define the various kinds of property rights and interests. The *Enterprise Bankruptcy Law* needs to be made and promulgated to strengthen market disciplines on enterprises and offer effective protection to the legitimate rights and interests of the creditors.

On the other hand, investor protection systems, such as the financial institution bank-



ruptcy legal system and deposit insurance system, need to be established to strengthen market disciplines on financial institutions to guard against moral hazards at the managerial level of financial institutions and raise risk awareness among depositors and investors. Legal systems to prevent and combat financial crimes need to be improved to guard against moral hazards. The legal development of the social credit system needs to be accelerated to build an honest and trustworthy society. Anti-money laundering legal system needs to be set up to check and fight against all sorts of money laundering crimes in order to maintain financial stability. Research must be done concerning the legal system pertaining to financial innovation to encourage and regulate financial innovation. For some financial product innovations that cross several sectors and markets, supervision coordination must be strengthened and an institutionalized financial supervision coordination mechanism needs to be put in place.

## Corporate Governance

Corporate governance is the core of the modern enterprise system. Corporate governance of financial institutions is an important factor affecting financial stability. To shape and improve corporate governance of financial institutions is both a complicated, arduous and systematic project, and an important goal for the financial reform.

## Corporate Governance of Financial Institutions and Financial Stability

Corporate governance bears on a series of relationships among the board of directors, shareholders, the management and other stakeholders of a firm. Fully-fledged corporate governance can provide proper incentives to the board of directors and the management to seek maximum value, thus playing an effective checks and balances role.

Compared with non-financial institutions, corporate governance in financial institutions has certain special features. First, external oversight is required. The failure of financial institutions, especially commercial banks may have huge negative impact. The closure of one financial institution may have a contagion effect that gives rise to financial turbulence and even crisis. Therefore, financial institutions need to be put under strict regulation. Second, the importance of market discipline should be emphasized. Governmental supervision alone cannot guarantee sound corporate governance. Greater transparency is needed to increase the checks and balances of market participants and stakeholders regarding the operation and management of financial institutions. Third, internal risk control should also be stressed. The high leverage of financial institutions makes the establishment of a well-functioning internal risk control system even more important.

Sound corporate governance can improve the credibility of financial institutions, reduce fi-

nancing costs, promote prudent operation, and provide a microcosmic basis for financial stability. First, the extent to which financial institutions follow the principles of sound corporate governance is an important factor affecting investors' decisions. Sound corporate governance can effectively protect the legitimate rights and interests of investors, boost the confidence of the general public and investors in financial institutions, and contribute to lower financing costs, better management and higher profitability of financial institutions. Second, sound corporate governance allows shareholders and other stakeholders to play a bigger role in oversight the management behavior, facilitating the financial institutions to improve their internal control mechanism and promote prudent operation.

### Current Development of Corporate Governance in Financial Institutions

The Third Plenary Session of the 16th National Congress of CPC put forward the idea of defining rights and responsibilities of shareholders' meeting, board of directors, board of supervisors and the management and improving the appointment system of enterprise leadership according to the requirements of modern enterprise system. The shareholders' meeting determines the composition of board of directors and board of supervisors while board of directors selects the management which exercises the power of using human resources, thus forming a balanced system of the executive body, decision-making body, supervisory body and the management. At the same time,

financial institutions should turn themselves into modern financial corporations through reform to achieve adequate capital, strict internal control, safe operation and good services and returns. All these have provided a guideline for the reform of financial institutions in China and establishment and improvement of their corporate governance.

Guided by the aforementioned principles, relevant departments have formulated and promulgated a series of regulatory decrees to provide implementation bases for the improvement of corporate governance of financial institutions. According to the stipulations of the *Guidelines for Corporate Governance of Joint-stock Commercial Banks* and the *Guidelines for Independent Director and External Supervisor System of JSCBs* issued by the PBC in 2002, commercial banks should build up an organizational structure with shareholders' meeting, board of directors, board of supervisors and senior management at the core, establish an institutional arrangement that ensures independent operation and effective checks and balances of all bodies, and foster scientific and efficient mechanisms for making decisions, providing incentives and providing checks and balances. The *Code of Conduct for the Governance of Listed Companies* issued by CSRC in 2002 set forth clear requirements with regard to shareholders and shareholders' meetings, directors and boards of directors, supervisors and boards of supervisors, controlling shareholders and listed companies, performance evaluation and incentives, checks and balances, as well as information disclosure and transparency. This document also



provided a set of evaluation standards for governance quality of listed companies, including listed financial institutions. Following the establishment of CBRC, corporate governance remained the focus of supervision over banking institutions. In 2004, the Commission issued the *Guidelines for the Reform of Corporate Governance and Supervision over BOC and CCB* to spell out the general goal of the shareholding reform in these two pilot banks, evaluation criteria and requirements for corporate governance. It has become the guideline document for the improvement of corporate governance of SOCBs. At present, relevant financial regulatory bodies are drawing up codes of conduct for corporate governance in securities firms, insurance companies and trust investment institutions.

In recent years, China's financial institutions,

especially those that have been transformed into joint-stock companies through reform, have registered marked progress in establishing shareholder meetings, board of directors and supervisors, with clarified responsibilities, strengthening internal control and risk management, improving information disclosure, and enhancing market discipline. Since 2003, the state has recapitalized BOC, CCB, BOCOM and ICBC through China SAFE, and started reforming SOCBs and major financial institutions into joint-stock companies. Since its inception, China SAFE has fulfilled the rights and obligations of shareholders of the recapitalized financial institutions according to law on behalf of the state, and promoted the establishment and improvement of modern corporate governance structure in financial institutions.

### Box 13 Twelve Topics Concerning Corporate Governance in China<sup>1</sup>

Since the concept of corporate governance was introduced to China, great progress has been made in corporate governance of China's financial institutions. Here, 12 topics merit our consideration.

First, the concept of corporate governance. The Third Plenary Session of the 14<sup>th</sup> National Congress of the CPC in 1993 attempted to introduce the concept of corporate governance to its documents. In 1999, the 4<sup>th</sup> Plenary Session of the 15<sup>th</sup> National Congress of the CPC officially drafted this

concept in major party documents. In recent years, certain departments have also been issuing guidelines in this regard. Based on international experiences, the state has taken a clear attitude towards the *Principles of Corporate Governance* issued by the OECD in 1999, that is, to play out its role in promoting the formulation of complete institutional and legal framework of corporate governance. This is also what the OECD paid special attention to when it issued the *Principles of Corporate Governance (Revised Version)* in 2004.

Second, choice of corporate governance models. According to international practices and experience, there are different models of corporate governance, including the Anglo-Saxon model, the Rhine model and the Japan-ROK model. The practical experience of the past years shows a tendency of convergence of different models. Despite lots of differences, they are moving closer to each other in many aspects. China should choose one model that suits China's economic and social conditions.

Third, ownership ambiguity and the problem of insider control. The most important reason why China introduced the concept of corporate governance at the beginning of the 1990s was that many enterprises had serious problems of insider control and ownership ambiguity. So far, there has been no satisfactory solution to these important problems.

Fourth, solution to problems left over by debt-equity swap. One problem closely related to control by insiders is the many distortions and violations of corporate governance principles that occurred in large-scale debt-equity swaps in China in 1999, which needs to be properly addressed in the future.

Fifth, the role of public listing. China's experience shows that those who have done the best in corporate governance are mostly listed companies. This is because listed companies have guidance from regulatory authorities and supervision from investors,

general public and the market. The experience of listed companies has made people realize that the reform to establish joint-stock company is a major direction of China's economic restructuring. To encourage large- and medium-sized companies to go public is an important and effective measure.

Sixth, the role of Party Committees. Apart from the relationships among investors, board of directors, the management and stakeholders, Party Committees should play an active role in corporate governance, which is also a feature of "Chinese characteristics".

Seventh, the role of stakeholders. China has learned from good experiences in corporate governance in other countries. However, the five principles put forth by OECD lacked mentioning of the role of stakeholders. The revised version puts more emphasis on this role in corporate governance than the 1999 version. It is imperative to accurately define stakeholders and give full scope to their role in corporate governance.

Eighth, protection of shareholders' interests. A fairly obvious deviation of corporate governance in China is lack of regard to shareholders' interests. For example, some traditional SOEs delay paying dividends time and again. How to reflect and represent shareholders interests? This remains one of the important topics in the improvement of corporate governance in China.



Ninth, the role of independent directors. In recent years, the independent director system has started from scratch and made remarkable progress. There was quite a lot of skepticism when this system was first introduced to China. However, thanks to training and hard work, independent directors have been playing a more and more prominent role in promoting corporate governance in China. More work is still needed to further enhance its role.

Tenth, the role of institutional investors. Recent years have seen the emergence of many new institutional investors in the capital market, such as closed-end investment funds, open-ended investment funds, other types of venture capital funds, industry investment funds and social security funds. Given the ongoing acute problem of shareholder absence and insider control, we need to discuss whether institutional investors should participate in corporate governance as passive or active investors.

Eleventh, the role of banks in corporate governance. Many China's enterprises have high leverage, which means they have a large amount of bank loans and a small equity base. Banks are the single most important creditors. Therefore, the role of creditors in corporate governance, mechanisms for the protection of creditors' rights and effective repayment structure are all important content in the OECD corporate governance principles. China's banking sector needs to emphasize the important role of banks, as creditors, in corporate governance.

Twelveth, corporate governance in non-state-owned enterprises. One important aspect of the progress that China has made in corporate governance is that the topic is not only discussed in SOEs, but also stressed in the reform of various kinds of enterprises with different private ownerships.

1 This is quoted from the speech by Governor ZHOU Xiaochuan of the PBC at the *China Forum: Capital Market and Corporate Governance* on December 1, 2004.

## Problems and Future Direction of Corporate Governance of Financial Institutions

The *Principles of Corporate Governance* issued by the OECD has become an international standard for all countries to evaluate and improve their corporate governance. The essence of this document is that corporate governance structure should protect shareholders' rights, treat all shareholders equally, recognize the statutory rights of stakeholders, en-

courage companies to enter into active cooperation in generating wealth and employment and maintaining sound financial condition with stakeholders, ensure timely and accurate disclosure of all major events including corporate financial condition, performance, ownership and governance, and ensure that the board of directors provides strategic guidance to the company, effective supervision over the management and be liable to the company and shareholders.

Despite great progress, there is still a gap between corporate governance of China's finan-

cial institutions and requirements of the OECD principles. Particular attention should be given to the following two aspects. First, ownership ambiguity and the problem of insider control of financial institutions. Commercial banks and other major financial institutions mostly are organized under the headquarter-branch structure. The big number of outlets, the large scale, multiple level and long chain of internal management all lead to weak control of the headquarters over branches. The weakness of internal control gives rise to frequent violation of rules and regulations. Second, market-driven incentives and checks and balances. Over the past years, state-owned and state-controlled financial institutions have linked personnel appointment and performance evaluation with administrative levels. There were no market-driven incentives or checks and balances. No matter for senior management or for ordinary employees, there was no close link between remuneration and performance. That is to say, there is no effective incentive mechanism, nor good mechanism to provide checks and balances.

In future, corporate governance of financial institutions should be further improved in the following four aspects.

First, promote the reform of transforming financial institutions into joint-stock companies, create diversified ownership, enhance the state's function as the investor, reform internal control mechanism and establish a modern financial institution system.

Second, improve handling of insider control. The functions of shareholders' meeting, board

of directors and board of supervisors and their relationships with senior management should be clarified. A standardized mechanism to balance shareholders' meeting, board of directors, board of supervisors and the senior management should be developed. Information disclosure and market checks and balances should be stepped up to provide effective supervision over financial institutions.

Third, develop an effective mechanism in selecting senior manager for financial institutions. The mechanism for the selection of senior managers and performance evaluation in financial institutions should be reformed by gradual introduction of market-based operation. A fully functioning market for selecting executives should also be developed for financial institutions.

Fourth, establish and improve internal incentives and discipline mechanism as well as external supervision mechanism. On the one hand, design an effective internal incentive mechanism for senior managers according to the principle of matching responsibilities, rights and interests and the demand of human resources management in modern financial institutions in order to mobilize, to the largest extend, their enthusiasm, ensure their behavioral goals are in line with the objectives of the owners, and prevent management from abusing power and advantageous position in information to prejudice lawful rights and interests of shareholders and other stakeholders. On the other hand, an external supervision system should also be in place to ensure the impartiality and objectivity of supervisory



agencies. Market discipline need to be strengthened, transparency improved and compulsory disclosure of financial and accounting information introduced in a bid to enhance social oversight.

## Accounting Standards

As a basic institutional arrangement for financial stability, high-quality accounting standards can truthfully reveal the whole picture of profitability and financial status of financial and non-financial firms at the micro-level, thus contributing to accurate measurement, effective risk control and financial stability at the macro-level.

### Accounting Standards and Financial Stability

#### *How Do Accounting Standards of Financial Institutions Affect Financial Stability*

At present, financial institutions and non-financial enterprises in China are following different accounting standards. Accounting standards of financial institutions can affect financial stability in the following three ways.

First, determine the truthfulness of key indicators, such as the CAR of commercial banks, the net capital of securities firms and the actual solvency positions of insurance companies. The level of CAR is determined by the proportion of capital and risk-weighted assets. High-

quality accounting standards can truthfully reflect the status of risk-weighted assets of a commercial bank and also measure owners' equity, which is a major component of the core capital of a commercial bank, by calculating various costs and fees incurred in its operation. Therefore, accounting standards bear on the truthfulness and reliability of the measurement of commercial banks' CAR—which is crucial in monitoring a bank's expansion under the capital adequacy constraint. To securities firms, insurance companies and OFIs, the accurate measurement of such crucial indicators as net capital and actual solvency positions plays a critical role in promoting prudent operation of financial institutions and maintaining overall financial stability.

Second, truthfully reveal profitability and financial status. High-quality accounting standards calculate and record the economic activities of a financial firm. Financial information based on this can truthfully reflect the firm's operational performance and financial status. At the same time, financial information disclosure is one of the important requirements of accounting standards. Financial information including that of operational performance, especially the firm's liquidity, solvency and risk level, is disclosed through accounting statements, their appendix and other instruments. Therefore, high-quality accounting standards, which can enhance information transparency, help with appropriate decision-making by shareholders, creditors and other stakeholders, increase public confidence in the firm's information disclosure and avoid financial panic resulted from information asymmetry, are an

important means to assess financial firms' risks and fend off systematic financial risks.

Third, promote the improvement of corporate governance. As one of the important information flows arising from corporate operations, financial information can help shareholders, creditors and other stakeholders to evaluate, provide incentives to and exercise control over the management and contribute to the establishment and implementation of internal incentive and check-and-balance mechanisms. Hence, high-quality accounting standards and financial information based on these factors can help to improve the corporate governance in financial institutions.

#### *How Do Accounting Standards of Non-financial Firms Affect Financial Stability*

As the creditor, one important way financial institutions to acquire information about the debtors is through the financial statements the debtor provides. The purpose for acquiring debtor's information is for one thing, to decide whether and how big a loan should be provided to the non-financial firm and what kind of risk management measures should be adopted based on judgment on the debtor's financial standing and operational performance, and for another, to track the development of solvency of the debtor so as to determine the safety of the loan and the introduction of timely remedy measures. The quality of accounting standards determines the truthfulness and reliability of the financial information provided by the debtor and to some extent, influences the decision-making and asset quality of such financial institutions as commercial banks, and

subsequently affects the performance and prudent operation of financial institutions.

### Current Development of Accounting Standards for Financial Institutions

#### *Accounting Standards Adopted by Listed Financial Institutions Are Largely in Line with International Practices*

In recent years, listed financial institutions have improved their accounting standards and gradually narrowed the gap with international accounting norms, thus playing a positive role in maintaining and promoting financial stability.

Domestic regulations concerning accounting standards are relatively mature

The *Accounting System for Financial Enterprises* promulgated in 2002 is currently adopted by financial institutions listed in China's stock market, foreign financial institutions and commercial banks that have been transformed into joint-stock companies. The system requires that at the end of a period, financial institutions shall analyze the chance of recovery of various loans (excluding mortgage and trust loans, similarly hereinafter), predict possible losses, and prepare special and differential provisions as well as provisions for asset impairment on short-term investment, long-term investment, fixed assets, intangible assets, construction work in progress, collateral assets and other types of assets so as to give better presentation according to the prudence principle and largely converge with the international



accounting standards in such important aspects of accounting items and the financial reporting as the definition, identification and calculation system.

**Table 5 . 1 Length Change of the Period after Which Overdue Interest Receivables are not Computed in the Net Profit or Loss for the Period**

| Year | Period      | Details                                                                                                                                                                                                                                                                                                                                                          | Documents                                                                                                                                                                                           |
|------|-------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1993 | Three years | Loans overdue for three years and more (including rollovers) shall be regarded as notifiable loans and their interest shall not be included in the net profit or loss for the period.                                                                                                                                                                            | <i>Notice Concerning the Issuance of the "Accounting System for Financial and Insurance Enterprises"</i><br>(Cai Shang Zi No. 11)                                                                   |
| 1998 | One year    | Loans overdue for one year and more shall be regarded as bad loans and their interest shall not be included in the net profit or loss for the period.                                                                                                                                                                                                            | <i>Notice of the MOF Concerning the Modification of the Computing Period of Interest Receivables and Bad Loan Provisioning of Financial Institutions</i><br>(Cai Shang Zi [1998] No. 302)           |
| 2001 | 180 days    | Loans with their interest overdue for 180 days and more, no matter whether their principals are overdue, shall not have their uncollected interest receivables included in the net profit or loss for the period.                                                                                                                                                | <i>Notice Concerning the Adjustment of the Computing Methods of Interest Receivables of Financial Enterprises</i><br>(Cai Jin Zi [2001] No. 25)                                                     |
| 2001 | 90 days     | Non-accrued loans are the loans of which principal or interest is not called back 90 days after maturity. On the 90th day of the overdue, the principal or the interest of the loan shall be calculated separately and written off by the already-recorded interest revenue and interest receivables.                                                            | <i>Notice of the MOF Concerning the Issuance of Accounting Standards for Financial Enterprises</i><br>(Cai Kuai Zi [2001] No. 49), effective as of January 1, 2002 to listed financial institutions |
| 2002 | 90 days     | Loans with their interest overdue for 90 days and more, no matter whether their principals are overdue, shall not have their uncollected interest receivables included in the current income statement. Those uncollected interest receivables already computed in the current period shall be written off when the overdue exceeds 90 days (excluding 90 days). | <i>Notice of the MOF Concerning Shortening the Computing Period of Interest Receivables of Financial Enterprises</i><br>(Cai Jin Zi [2002] No. 5)                                                   |

Source: Based on the MOF documents.

The reducing gap and convergence between domestic and international accounting standards for listed financial institutions are also well reflected by the gradual shortening of the grace period during which overdue interest receivables are excluded in current profit or loss. The accrual-based accounting system helps to accurately reflect the financial status and performance of the firm and conforms to the matching principle. However, abuse of this system will lead to an inflated revenue figure, due to the inclusion of those interest receivables that cannot actually be recovered. In the past, this problem was addressed by computing the overdue interest receivables into current period losses (Table 5.1), resulting in untruthful reflection of operational performance. Thanks to the continuous reform, it is now required by the accounting standards that the principal and interest of a loan should be computed separately and written off by the already-recorded interest revenue and interest receivables when they are overdue for 90 days and more. This integrates China's system with the international practice and helps to truthfully reflect the real operational performance of financial institutions.

#### Information disclosure of listed financial institutions basically meets statutory disclosure requirements

Listed financial institutions in China are required to issue their annual reports by the end of April every year, disclosing their financial status and operational performance of the previous fiscal year and explaining risk management policies. Take listed commercial banks for example, a comparison between the 2004

annual reports of all listed commercial banks and the disclosure requirements of the *No. 7 Compiling Rules on Information Disclosure of Listed Securities Companies: Special Requirements for the Content and Format of Annual Reports of Commercial Banks* (promulgated by the CSRC in 2000) and the *Provisional Methods for Information Disclosure of Commercial Banks* (promulgated by the PBC in 2002), shows that information disclosure of China's listed commercial banks can largely meet the domestic requirements for disclosure. However, some gaps still exist. First, exposure disclosure was inadequate. Analysis of the current risks and counter-measures was relatively simple. Except for Shenzhen Development Bank, no banks explained the losses of the current year that were caused by undisclosed risks of the previous year. Second, due to limited data and analytical capability, the quantitative risk analysis was not sufficient, while the focus was on qualitative explanation. Third, some banks did not state whether there were changes in the policy of writing off NPLs. Fourth, some banks did not disclose the evaluation of intangible assets and amortization policies.

#### Relevant accounting standards followed by listed commercial banks are almost the same as international accounting standards

Since 2000, listed commercial banks have been employing overseas accounting firms to audit their financial statements based on international accounting standards, while inviting China's firms to audit their financial statements based on domestic standards. The



differences between the two types of statements show that the gap between the domestic and international accounting standards has been narrowing in recent years, thanks to the continuous improvement of China's accounting standards and policies. Now, the two sets of standards are almost identical. Some differences, however, still exist. On the whole, the domestic standards are more prudent.

Judging from the differences in net profits of listed commercial banks that have been disclosed in recent years, the discrepancies of data between the financial statements based on domestic and international accounting stand-

ards are sometimes positive and sometimes negative, with a reducing level of differences. Especially in the past three years, discrepancies have been reasonably small and stable. All these point to the reducing differences between the accounting standards applied by China's listed commercial banks and the international practice.

A further analysis on the causes of these differences shows a major gap between the domestic and international standards in the measurement of financial derivatives, amortization of organization cost and accounting disposal of convertible bonds and income tax (Table 5.2).

**Table 5.2 Differences Between China's and International Accounting Standards for Listed Commercial Banks**

| Items                                | China's standards                                                                                                                                                                                                                        | International standards                                                                                                                                                                                                                                                                                                             |
|--------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Measurement of financial derivatives | Incomplete transactions of financial derivatives shall be listed out of the statement. Related profit or loss shall be confirmed when the transactions are being completed.                                                              | Listed by fair value.                                                                                                                                                                                                                                                                                                               |
| Organization cost                    | Calculated under the item of organization cost when incurred, and allocated once and for all to the month when production or operation starts.                                                                                           | Confirmed as expenditure of the current period when incurred.                                                                                                                                                                                                                                                                       |
| Convertible bonds                    | Liability shall be determined by the actual IPO price. The difference between IPO price and the book value shall be amortized during the period of the bonds as discount or premium. The value of convertible options is not determined. | The fair value of the principal and interest shall be determined at the time of issuance by the market interest rate of the same type of bonds without convertible options. The balance shall be listed when the bonds mature or before they were converted. The value of convertible options shall be listed separately in equity. |
| Securities to be sold                | Computed with lower of cost or market price method. Returns are confirmed according to cash basis of accounting.                                                                                                                         | The investment to be sold is calculated with fair value. The incurring unrealized profit or loss shall be directly confirmed as those of the current period.                                                                                                                                                                        |

Source: Based on 2004 annual reports of all listed commercial banks.

Related accounting standards adopted by listed securities firms are almost the same as international accounting standards

Similar to listed commercial banks, listed securities companies have also adopted a set of domestic accounting standards almost the same as international standards. The major differences between the two systems are reflected by differences in the following three aspects (Table 5.3). First, trusted financial gains. According to the domestic standards, bonds purchased with trusted funds are calculated with the lower of cost or the achievable market value. While according to international standards, the investment made by trusted funds is regarded as the group's investment made for the purpose of its

own transactions and measured by its fair value. The profit or loss realized or unrealized due to the change of the fair value shall be reflected in the income statement of the current period. Second, gains from management of trusted assets. According to China's domestic standards, such gains should be calculated into the income statement at the time of settlement with the trustor, while according to the international standards, they should be calculated on accrual basis. Third, sellable investment and proprietary securities. Domestic standards require that the investment and proprietary securities to be sold shall be measured according to the lower of cost and market price, while international standards require they be listed with fair value.

Table 5.3 Differences between China's and International Accounting Standards for Listed Securities Companies

| Items                                 | China's standards                                                          | International standards                                  |
|---------------------------------------|----------------------------------------------------------------------------|----------------------------------------------------------|
| Trust financial gains                 | Lower of cost or market price method                                       | Fair value                                               |
| Returns from trusted asset management | Cash-based accounting                                                      | Accrual-based accounting                                 |
| Investment returns                    | Lower of cost or market price method                                       | Fair value                                               |
| Proprietary securities                | Lower of cost or market price method                                       | Fair value                                               |
| Organization cost                     | Pre-calculated and amortized on the first month of production or operation | Recorded as current profit or loss at time of incurrence |

Source: Based on the 2004 annual report of HongYuan Securities Company and CITIC Securities Company.

### *Gradual Improvement of the Accounting Standards for Unlisted Financial Institutions*

Gradual improvement of transparency

After rounds of rectification of trust investment

firms, the first batch of 30 pilot companies issued their 2004 annual reports at the end of April 2005 according to the *Provisional Administrative Methods for Information Disclosure of Trust Investment Companies* promulgated lately by the CBRC. All TICs will be re-



quired to do the same by the end of April 2008. Greater transparency of TICs should contribute to the healthy development of the whole sector. Securities firms are also following the instructions of CSRC to gradually disclose their annual report. The gradual improvement of the transparency of unlisted financial institutions will boost public confidence in these firms.

#### The new accounting approach conducive to financial risk control

This is best shown by the accounting standards for trust activities. Under the *Accounting Methods of Trust Business* that officially came into effect on January 5, 2005, trust projects should take ongoing operation as prerequisite. The management, usage and disposal of trusted assets should be accounted separately. Different trust projects should have different accounts with separate accounting and financial reports, and be independent in opening accounts, fund appropriation and bookkeeping. The accounting approach ensures that the trusted assets are separated from the non-trusted assets of the trustor and that the trusted assets of different trustors are separated in management. This is conducive to risk control of the trust business and financial stability.

### Problems and Reform Direction of Accounting Standards for Financial Institutions

First, improve the quality of accounting standards for unlisted financial institutions. All financial institutions, except for the listed

ones, are applying the *Accounting System for Financial Enterprises* that came into effect in 1993 and specific sectoral accounting standards. Some regulations of them are relatively obsolete and unable to fully satisfy the demand of risk management of financial institutions.

Second, enhance the transparency of unlisted financial institutions. Lack of information disclosure of unlisted financial enterprises will, to a certain extent, cover up such problems as inadequate reserve for bad loans, low asset quality and inflated profits, which is detrimental to rational and effective allocation of resources and comprehensive risk management. Therefore, an information disclosure system for unlisted financial institutions should be gradually set up for regular disclosure to stakeholders.

Third, improve the system of reserve for loan losses. Reserve for loan losses refers to the provisions made by financial institutions to prepare for the risk that the loans cannot be recovered at the time of maturity. A scientific system of reserve for loan losses can better reflect the CAR and the profitability of financial institutions. The *Accounting System for Financial Enterprises*, the *Guidelines for Provisioning for Bank Loan Losses*, and related regulations of the administrative measures for the bad-loan provisioning published by the MOF constitute the current bad-loan reserve system for China's commercial banks. However, these regulations do not have a unified provisioning practice, nor do they fully reflect the features of economic cycles. Moreover, the five-category classification for loans, which is

the basis for provisioning, is not mature. The taxation system has too many constraints on loss-related loan write-offs. All this has prevented scientific and rational provisioning for loan losses by financial institutions. Therefore, it is imperative to further improve this system in order to promote adequate reserves for commercial banks and effective aversion of credit risks.

Fourth, draw on international accounting standards to further improve accounting standards for emerging businesses. The current businesses of financial institutions in China still concentrate on traditional areas with small variety and scale of emerging businesses such as financial derivatives. Therefore, the development of related accounting standards is not only difficult but also faced with technical problems and risks in terms of determination and measurement. In view of the high risks and possible damages of the financial derivatives and other emerging financial businesses, it is necessary to solve the problem of backward national accounting standards in this regard as soon as possible in the context of the current development status of these businesses and step up risk control over this category of financial businesses. The recent *Provisional Regulations on the Determination and Measurement of Financial Instruments* is an encouraging step forward.

Fifth, intensify supervision over the implementation of accounting standards. There are some problems with the listed and unlisted financial institutions in their application of accounting standards. For example, the five

listed commercial banks do not have a unified approach with the five-category classification for loans system and the provisioning for bad loans. Therefore, oversight of the implementation of accounting standards should be stressed to prevent the occurrence of financial risks, due to the lax application of accounting standards by some financial institutions, which will eventually endanger the whole financial system.

## Credit Environment

Credit environment refers to the legal, institutional and cultural environment in which credit transactions take place and credit resources are allocated. The legal environment mainly concerns the improvement in finance-related legal framework and law enforcement. The main purpose is to protect the rights of creditors. The institutional environment mainly includes establishment and improvement of a credit information system that directly serves financial institutions and financial market. Its purpose is to guard against financial risks, maintain financial stability and promote the development of the financial sector through sharing of credit information. Cultural environment refers to the modern credit culture commensurate with the present economic and financial development. Its purpose is to encourage enterprises and individuals to put emphasis on their credit behavior. This is of great significance to improvement of credit awareness of the entire society.



## Credit Environment and Financial Stability

First, a good credit environment contributes to fairness of credit transactions, and protection of the legitimate rights and interests of creditors and debtors. It also helps financial institutions to control credit risks at the source.

Second, a good credit environment, particularly a fully fledged credit information system, helps financial institutions identify and fend off credit risks, improve asset quality and the efficiency of the credit market. The credit information system in essence means credit information services, including credit records, credit investigation, credit scoring and credit rating, the purpose of which is to provide lending institutions with reliable credit information on enterprises and individuals. The development of a credit information system is proved an effective way to reduce NPLs in commercial banks. There are many causes for NPLs, but lending institutions' lack of reliable access to comprehensive and true credit information about debtors is one of the main causes.

Third, a good credit environment makes it easier for small- and medium-sized enterprises and individuals to raise funds. Difficulty for small- and medium-sized enterprises to raise funds is a prominent problem plaguing the development of China's market economic system. The crux of the problem is lack of a credit report system, which renders it impossible to measure and fend off credit risks faced

by small- and medium-sized enterprises and individuals. Development of a credit information system for individuals and enterprises, therefore, will help reduce costs of commercial banks for information collection and credit risks management, strengthen financial support for small- and medium-sized enterprises and individuals, and promote the comprehensive development of the economy in general and the financial sector in particular.

Fourth, an effective and reliable credit information system helps lending institutions reduce the costs of investigating debtors' credit status. Lending institutions could thus lower the price they charged, and expand the scope of their customers. This helps to resolve the problem of adverse selection in the credit market, and create a favorable external environment for financial stability.

## Current Development of Credit Environment

China's credit environment has been improving in recent years, which is mainly reflected in the following three aspects.

### *The Rights of Creditors Are Recognized and Protected by Law*

The promulgation of the *General Principle of Civil Law*, the *Contract Law* and the *Guarantee Law* has gradually established legal protection of various types of property right, and clarified guarantor's preferential right over the guaranty. Meanwhile, the judicial institutions are protecting creditors' rights and the sound development of the credit market through legal

interpretation and strengthening law enforcement.

*Progress Has Been Made in Building the Credit Report System for China's Enterprises and Individuals*

First, initial development of the credit information industry. Since the 1980s, in some regions of China, originated by commercial banks and other organizations, a number of credit inquiry and credit rating companies were established. On July 1, 2000, thanks to the active participation and support of the PBC, Shanghai took the lead in carrying out pilot projects of credit report system of individuals. Some famous foreign credit reference agencies also started to show strong interest in China's credit report system market. Some even started to carry out business in this area, with the portfolios of a few of them reaching a considerable scale.

Second, clear definition of the functions of a credit information system. In 2002, the State Council set up a "Special Task Force on Establishing a Credit Information System for Enterprises and Individuals", led by the PBC and composed of 17 government agencies and five commercial banks. Its mission was to study and formulate an overall plan for the establishment of a credit information system for enterprises and individuals, and draft the *Management Regulations on Credit Information System* and industry standards for credit information. In 2003, a Credit Information System Bureau was set up in the PBC under the authorization of the State Council and in accordance with the plan set force by the office of

the Committee for Government Structure, with a view to strengthen the function of the PBC "manage credit information industry and push for the development of a social credit system".

Third, the initial establishment of a basic credit information database. The PBC started the preparatory work for the establishment of a national registration and consultation system for bank credit in 1997 and established the system by the end of 2002. The system encompasses all the current lending institutions within China's territory. With the expansion of its functions and services in recent years, it has emerged as an important tool for lending institutions to fend off financial risks, reduce credit costs and improve loan efficiency. It also contributes to the implementation of the monetary policy and financial regulation. Currently, the upgrading of the system is already under way. The purpose is to improve the current system to expand the types of data and products covered by the system, and increase its functions, with a view to upgrading the system into a national database for enterprise credit information. By the end of 2004, the system had included over 4.35 million lending institutions, with an outstanding RMB denominated loan over RMB15 trillion yuan, which accounted for 87% of the total outstanding loans in the financial system. The enquiry to the system reached 1.49 million times per month. According to the analysis by a questionnaire to financial institutions through 500 information regulators, in 2004, thanks to access to the system, lending institutions rejected up to 15,000 loan applications, or



RMB94.1 billion yuan of potentially risky loans, accounting for 2.9% of total value of loan applications. Currently, commercial banks have made inquiry of the system a prerequisite procedure for loan approval.

In December 2004, a unified national individual credit information database started operation in some cities, and the network will be extended to the entire country by the end of 2005. The individual credit information database is a shared platform of credit information for all commercial banks, mainly focused on collecting and keeping individual credit information concerning loan application, loan repayment, credit cards and guarantees, as well as other related personal identification information. The system is accessible by commercial banks to enquire credit information of individuals for credit evaluation purpose. The database forms an important basis for China's credit information system. It is not only conducive to the sharing of individual credit information among commercial banks to fend off risks relating to consumption loans, but also serves the steady development of individual credit. With the increasing amount of personal credit information accumulated, it will be of far-reaching significance to the improvement of China's financial environment and credit level of the Chinese citizens.

#### *Initial Progress Has Been Made in the Development of a Modern Credit Culture*

At present, China is trying to develop a modern credit culture. Valuing personal credit records, paying public utility fees and repaying bank loans in time have gradually become a

way of accumulating creditworthiness and wealth by the general public. The mechanism of punishing those who lose their credibility in a modern credit culture is showing its influence.

### **Key Areas to Focus on in Developing the Credit Environment**

A credit environment is currently developing in China, but special attention needs to be paid to the following areas.

First, lack of unified understanding of the need to build the credit system. There are various perceptions for the basic concepts, functions and development process of a social credit system, which have hindered the progress in credit legislation and credit information system building. In terms of the basic concept, the concepts of "faithfulness", "creditworthiness" and "law-abiding" are mixed up. The substantial difference between sharing of government public information and commercial transaction information is blurred.

Second, inadequacy in standardization of credit information development. With the gigantic development of electronic technology, all sectors, agencies, and regions in China are undergoing an office automation and informatization process, as evidenced by their efforts to make electronic copies for printed documents and set up databases for their information. This creates the necessary conditions for the development of a modernized social credit information industry. Due to lack of unification of marks and basic technology

among different parties, it is difficult to exchange and share the information contained in their systems.

Third, lack of market-oriented institutions with good creditworthiness. A credit information system involves private and commercial secrets, which may affect the competitiveness of the lending institutions that provide information for the system. One of the prerequisites for the development of a credit information system is that data providers (lending institutions) should fully trust the credit reference agencies. However, credit information business is itself a service industry. Competition and market-oriented operation are preconditions for efficient service. Now China's actual situation dictates that the commercialization of credit agencies is still in its initial stage of development, and it is hard to achieve a balance between credibility and efficiency.

Fourth, inadequacy in regulation and monitor of credit information business. Some credit institutions and practitioners, due to inadequate qualifications, cannot make scientific analysis and evaluation about the credit status of their customers. To make things worse, under the pressure of competition, credit institutions even lower their service prices or upgrade credit ratings for their customers in order to attract more customers. At the same time, lack of laws and regulations on credit information undoubtedly leads to lack of monitoring, which in a long run will seriously undermine the healthy development of the credit information industry.

## Improvement and Development of the Credit Environment

The key for establishing a social credit system, which is supported by morality based on property rights and guaranteed by law lies in the establishment and development of an enterprise and individual credit information system. It is not only the foundation for operation of the modern financial system, but also a necessary condition for the establishment of a modern market system and an important yardstick of a mature market economy. To develop China's credit environment, first it is imperative to raise the credit awareness of the whole society. It is also important to follow the principle of legal framework, concession, business operation and specialized service to speed up the establishment of an enterprise and individual credit service system. In addition, a credit monitoring system and penalty system for poor credibility must be set up. Lastly, the credit service market should be gradually liberalized. This includes the following aspects.

First, improving the legal system and strengthening law enforcement to protect the creditors' rights by law better. The *Enterprise Bankruptcy Law* should be revised and the *Property Rights Law* should be enacted to protect the legitimate rights and interests of creditors, and form effective market constraints on enterprises. Law enforcement should be strengthened to protect the legal rights of creditors, ensure more financial lawsuits are tried in time and enforced, and crack down on debt evasion and nullification in accordance with the law.



Second, encouraging local governments to strengthen credit development, and giving full play to the initiative of local governments. Local governments can take effective measures to speed up local credit system building. On the one hand, vigorous measures should be taken to improve law enforcement environment and execution rate of courts' rulings so as to protect the legitimate rights and interests of OFIs creditors. On the other hand, moral education focusing on honesty and trustworthiness should be given to local enterprises and citizens to reduce failure by enterprises to pay off financial loans with a view to improving local credit environment.

Third, strengthening the penalty system for losing credibility. More serious sanctions should be imposed on those who breach or damage creditworthiness. Violators should be disclosed by the news media, and sanctions, such as stopping loans, suspending accounts of bank settlement, should be imposed on those who escape debt obligation.

Fourth, speeding up the establishment of a credit information system. (1) Enact at an early date a credit information law and formulate supporting implementation measures. (2) Establish a unified national credit information database for enterprises and individuals and form a nationwide credit information service network. (3) Construct a multi-level social credit institution system. (4) Strengthen sharing of government public information. (5) Put in place a market monitoring and regulation system that includes regulation by government agencies and self-

discipline of specific industries. (6) Set forth key technical standards for the credit information industry and measures to adopt the standards, and promote information sharing and development of the credit information market.

Fifth, strengthening publicity and fostering a modern credit culture. The principle of emphasizing positive guidance, equal importance to rights and obligations, and market orientation should be followed to carry out comprehensive reform, eliminate public ignorance and misunderstanding of the credit system, strengthen credit risk awareness of lending institutions and enterprises, foster the credit market and improve the credit awareness of society.

## Anti-Money Laundering

While fomenting and breeding crime, money laundering activities also distort the effective allocation of social resources, undermine the level playing field for the financial sector, trigger needs for illegal financial services and disrupt financial order. The magnitude of cross-border money laundering and the consequent flow of capital may worsen disturbances in the financial market and swings of the macro economy. Based on its clear understanding of the harm of money laundering, Chinese government has all along attached importance to cracking down on money laundering. The *Criminal Law*, which was revised in

1997, criminalizes money laundering. In 2003, the *Law on the PBC* authorizes the PBC to guide and organize campaigns against money laundering in the financial sector, and be responsible for asset monitoring in anti-money laundering. As a result, regulations on anti-money laundering endeavor by financial institutions and asset monitoring have become powerful means through which the PBC maintains financial stability.

### Anti-money Laundering and Financial Stability

Money laundering refers to activities to hide or cover up the nature, origin, location and flow of criminal proceeds, and make them legal. Money laundering is the derivative crime of one type or several types of predicate crimes. It usually has three stages: one is the placement stage, in which criminal proceeds find their way into various financial or non-financial systems; the second is the disassociation stage, in which criminal proceeds placed in various financial or non-financial institutions are disassociated from their origin through various complicated transactions; the third is the integration stage in which the cleaned up assets are mingled with legal assets so that criminal proceeds are reasonably and lawfully accounted for. Theoretically speaking, any transaction can be used for money laundering. Since financial institutions, commercial banks in particular, are centers of money flow in a modern economic system, money laundering often takes place and causes serious implications in sectors or places where the financial

system is weak.

Money laundering activities are exerting increasing impact on economic development and financial stability. Strengthening anti-money laundering contributes to financial stability.

#### *Negative Impact of Money Laundering on Financial Stability*

First, money laundering disrupts the financial market. In countries where money laundering runs rampant, large amount of criminal profits are not included in official statistics. Their inflow and outflow will seriously affect the fluctuations of money supply, interest rates and exchange rates, undermine the financial market's function of resources allocation and reduce the efficiency of the financial market. At the same time, money laundering activities are mostly carried out in underground banks and foreign exchange black markets. This seriously disrupts the financial order of a country, and even triggers financial crisis, and jeopardizes financial stability and economic development.

Second, money laundering threatens the security and reputation of financial institutions. Financial institutions are not only special enterprises engaged in money business, but also use advance technology to provide efficient and high quality financial services for customers. Using financial institutions as a carrier, assets in huge quantities can flow in a very short period of time. In reality, financial institutions have emerged as the most important link in the chain of money laundering, and a useful shelter and important channel for blatant



money laundering activities by criminals. Once financial institutions engage in or are involved in money laundering, their image and reputation will no doubt be tarnished and public trust in financial institutions will be eroded. This will affect the financial institutions' business operations, and could even trigger crisis. The bankruptcy of BCCI is a typical example.

Money laundering, if not checked effectively, will pose serious threats to financial market and financial institutions, and exert extremely adverse impact on the normal functioning of the macro economy and financial stability.

#### *Contribution of Anti-money Laundering Endeavor to Financial Stability*

First, improvement of legislation on money laundering, strict regulation and control of anti-money laundering efforts and effective law enforcement are important foundations for financial stability. A healthy financial system is characterized by fair competition, survival of the fittest, and constant improvement of the overall level of social welfare. Without necessary anti-money laundering measures, various financial institutions in their pursuit of profits maximization may deliberately or inadvertently channel various illegal assets into the financial system. This not only erodes the efficiency of resource allocation, but also reduces the overall welfare of society.

Second, increased intensity and scope of anti-money laundering endeavor will reduce the "living space" of illegal financial services.

Given that a significant amount of illegal financial activities are concealed in regular financial systems, strengthening anti-money laundering monitoring and control in regular financial systems make it less likely for illegal financial activities to be carried out. In addition, anti-money laundering endeavor has been extended from banking industry to the entire financial sector. Many sectors that are closely related to financial services and asset transactions are under monitoring and regulation, which further reduces the space for illegal capital flow.

Third, scientific and well-established anti-money laundering asset monitoring systems together with judicial measures can restore the maximum amount of capital loss and prevent risks by timely detection of irregular money flow. Focus on monitoring of suspicious transactions and complemented by monitoring large-value transactions, asset monitoring forms the basis of anti-money laundering endeavor. The monitoring system can effectively detect suspicious transactions that may be illegal, and then measures can be taken. Meanwhile, when there is already loss of assets, judicial departments may use the records made by the monitoring system to trace money flow and restore the lost assets to the greatest possible level. In addition, the system may also detect irregular flow of money across the border, or within financial holding companies, thus providing basis for regulators to take timely risk-control measures.

Fourth, a good internal mechanism against

money laundering facilitates corporate governance of financial institutions, and various risks control in the course of business operation. A sound and effective internal mechanism forms an important component of good corporate governance. As an essential part of the internal control mechanism, anti-money laundering mechanism can avoid “insider control” in financial institutions, and prevent management from undermining the interests of shareholders and creditors. Meanwhile, strengthening internal control can help financial institutions avoid moral hazards in day-to-day operations and legal risks triggered by operational risks, and thus preserve the reputation of financial institutions.

Fifth, a sound anti-money laundering system constitutes a necessary foundation for safeguarding national reputation in the international financial arena. The FATF of OECD member states, since its establishment, has publicized NCCT lists and urged its members to strengthen examination on transactions taken by enlisted countries or regions, which greatly increases the costs of international money flow by NCCT. To hedge risks, some large international financial institutions have carried out credit ratings for anti-money laundering systems of individual countries, and imposed restrictive measures on or denied transactions with countries and territories prone to money laundering. This shows that a sound anti-money laundering system has a direct bearing on whether a country will be accepted by the international financial community. Establishment and improvement of an anti-money laundering system marks a necessary step in the

integration of a country into economic globalization.

## Current Development of Anti-money Laundering Endeavor

### *Gradual Improvement of the Legal System Against Money Laundering*

The *Criminal Law* revised in 1997 criminalizes money laundering in a special article. On April 1, 2000, the State Council issued the *Rules on Using Real Name for Opening Individual Deposit Account*. On December 29, 2001, the SCNPC adopted Amendment 3 to the *Criminal Law*, revising Article 191 of the *Criminal Law*. It lists crime of terrorism as the predicate crime of money laundering, and intensifies the seriousness and penalty for institutional involvement in money laundering. In January 2003, the PBC issued the *Rules for Anti-money Laundering by Financial Institutions*, the *Administrative Rules for the Reporting of Large-value and Suspicious RMB Payment Transactions*, and the *Administrative Rules for the Reporting by Financial Institutions of Large-value and Suspicious RMB Payment Transactions*, which for the first time clearly defined the administrative management system against money laundering and marked the establishment of a comprehensive anti-money laundering regulatory system with the banking industry at its core. The *Law on the PBC* revised in 2003 sets forth a basic legal framework for administrative management system against money laundering in China's financial sector, providing that it is the statutory



responsibility of the PBC to guide and organize anti-money laundering endeavor by the financial sector, and take charge of asset monitoring concerning money laundering. It clarifies the PBC's functions in enforcing anti-money laundering rules, and authorizes the PBC to conduct inspection and monitoring on the behaviors of financial institutions, other institutions and individuals. For breach of the rules, the PBC has the authority to issue a warning, confiscate illegal proceeds or impose fines.

On March 22, 2004, the Budget Committee of the SCNPC spearheaded the drafting of China's anti-money laundering law. At the same time, the legislative organ is now looking into the possibility of revising articles on money laundering in the *Criminal Law* to extend the scope of predicated crimes of money laundering to adapt to the needs of guarding against and cracking down on money laundering.

#### *Initial Establishment of an Anti-money Laundering Coordination Mechanism*

Anti-money laundering endeavor involves many government agencies and institutions, and requires the participation of all government agencies, industry regulatory agencies and self-disciplinary organizations as well as the support of the entire society. In May 2002, the State Council approved the estab-

lishment of the inter-agency anti-money laundering joint conference system headed by the Ministry of Public Security and participated by 16 departments including the Supreme People's Court, the Supreme People's Procuratorate, the MOF and the PBC. In May 2003, the State Council decided to shift the function of anti-money laundering endeavor from the Ministry of Public Security to the PBC. In April 2004, the PBC convened a discussion conference on anti-money laundering endeavor by financial institutions, establishing an anti-money laundering coordination mechanism of financial institutions headed by the PBC, and participated by CBRC, CSRC, CIRC and SAFE. In June 2004, at the PBC's request, the State Council increased the number of agencies participating in the inter-agency joint conference on anti-money Laundering to 23. On August 27, 2004, the joint conference convened its first meeting, adopting the document of *Inter-agency Joint Conference System on Anti-money Laundering Endeavor*, which was printed for dissemination and implementation in December 2004 with the approval of the State Council. As a coordinating working mechanism on anti-money laundering endeavor for government agencies, the joint conference has provided an organizational and institutional guarantee for inter-agency cooperation against money laundering.

**Box 14 Anti-money Laundering Joint-ministerial Conference Mechanism**

To implement the series of instructions by the CPC and the State Council on anti-corruption, integrity and crackdown on economic crimes, and effectively guarding against and combating money laundering, safeguarding political, economic and financial security and normal economic order of the country, the inter-agency joint conference system on anti-money laundering endeavor was established in China under the instruction of leaders of the State Council.

The participants include 23 agencies, such as the PBC, the Supreme People's Court, the Supreme People's Procuratorate, the General Office of the State Council, the Ministry of Foreign Affairs, the Ministry of Public Security, the Ministry of Supervision, the Ministry of Justice, the MOF, the Ministry of Construction, the Ministry of Commerce, the General Administration of Customs, State Administration on Taxation, State Administration for Industry and Commerce, State Administration of Radio, Film and Television, Legislative Affairs Office of the State Council, CBRC, CSRC, CIRC, the Postal Bureau, and SAFE. The PBC is designated by the State Council as the leading agency for the joint conference.

Under the leadership of the CPC and the State Council, the joint conference provides guidance on national anti-money laundering efforts, formulates important state policies and anti-money laundering principles, sets

forth policy measures for international cooperation in this area, coordinates the efforts of different departments, and mobilizes the whole society resources to engage in anti-money laundering.

The joint conference usually convenes one to two plenary sessions every year. Meetings between some members can be convened at any time as proposed by member agencies.

Agenda items of the joint conference include disseminating and implementing instructions by the leaders of the CPC and the State Council on anti-money laundering, examining new developments and problems in anti-money laundering endeavor, discussing policies, rules and working priorities, exchanging views and briefing on anti-money laundering efforts, holding consultations and coming up with recommendations on related work. Major issues concerning anti-money laundering endeavor should be submitted to the State Council for approval upon deliberation by the joint conference.

The joint conference has an office to carry out the day-to-day operation. The office is affiliated to the Anti-Money Laundering Bureau of the PBC, and is led by the director-general of the Anti-Money Laundering Bureau. Members of the office include liaison officers designated by each participating agency.



The functions of the office of the joint conference include: supervise the anti-money laundering endeavor of different localities and departments of the country, strengthen research into the means, principles, and characteristics of money laundering activities, and submit proposals and recommendations on anti-money laundering policies, measures and plans to the joint conference; prepare for meetings, supervise implementation of decisions made by the joint conference, and give timely briefings on anti-

money laundering endeavor; coordinate the anti-money laundering work of different industries and sectors, gradually achieve sharing of information on related work; conduct and coordinate international cooperation on anti-money laundering endeavor, take charge of cooperation with international or regional anti-money laundering organizations and various governments and comply with obligations as prescribed by relevant international conventions.

### *Strengthening of Anti-money Laundering Regulation*

To ensure the effective execution of the anti-money laundering system and full implementation of the measures, the PBC carried out its first nationwide anti-money laundering inspection from April to August 2004, fully examining the anti-money laundering endeavor of SOCBs, JSCBs and city commercial banks in the period from March 1, 2003 to February 29, 2004. Some valuable clues to economic crimes involving money laundering were found. The inspection also helped the PBC to clarify the status of the anti-money laundering work in China's commercial banks, their problems, and the gap with international standards. It helped commercial banks to have a better understanding of anti-money laundering, and improved the effectiveness of the anti-money laundering system. Altogether 72 main branches of commercial banks were sanctioned by the PBC in 18 provinces and key cities.

### *Effectiveness of Monitoring and Analysis Concerning Anti-money Laundering Endeavor*

In April 2004, with the approval of the State Council, the PBC set up the China Anti-Money Laundering Monitoring and Analysis Center to collect, handle and analyze information on various large-value and suspicious transactions. The establishment of the center facilitates unified monitoring and analysis of transactions in RMB or foreign currency denominations, and improves the efficiency and quality of analysis for suspicious transactions. By December 31, 2004, the Center had received 3,217,227 entries on foreign currencies, and 10,740 reports on suspicious transactions, including 2,824,293 entries received by a pilot monitoring system on large-value transactions submitted by commercial banks. The center received 10,740 printed reports on suspicious transactions, involving 25 provinces, municipalities directly under the central government and autonomous regions. The center has handed over to the PBC 150 reports on transactions that were preliminarily identified as suspicious

through analysis and screening.

### *Remarkable Progress in Dealing with Money Laundering Cases*

In early 2004, the Ministry of Public Security, the PBC and the SAFE jointly issue the *Circulation on Joint Crackdown on Criminal Activities by Illegal Private Banks*, ordering local public security authorities, the PBC branches and exchange control agencies to carry out special campaigns against illegal ac-

tivities by illegal private banks, breaking a large number of major cases. By December 31, 2004, the PBC and the SAFE, coordination along with public security authorities had cleared 50 cases related to money laundering with a total value of RMB 0.57 billion yuan and USD0.47 billion. During the special campaigns, a total of 155 illegal private banks and exchange transaction sites were banned, RMB0.11 billion yuan of cash confiscated and 274 criminal suspects arrested (Table 5.4).

Table 5.4 Statistics for Suppressed Illegal Private Banks, 2002-04

|      | Number of banned illegal private banks | Confiscated cash and proceeds (millions of RMB yuan) | Number of arrested criminal suspects |
|------|----------------------------------------|------------------------------------------------------|--------------------------------------|
| 2002 | 32                                     | 30                                                   | 90                                   |
| 2003 | 30                                     | 100                                                  | 100                                  |
| 2004 | 155                                    | 110                                                  | 274                                  |

Source: China Anti-money Laundering Report (2004) by the PBC.

### *Deepening of International Anti-money Laundering Cooperation*

Since the 1980s, China has signed, ratified and implemented a series of important UN legal instruments against money laundering and financing of terrorism, including the *UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*, *International Convention for the Suppression of the Financing of Terrorism*, and the *UN Convention against Corruption*. On the premise of maintaining state sovereignty, China has also actively requested to join international anti-money laundering organizations. In November 2004, China, Russia, Kazakhstan, Tajikistan, Kyrgyzstan and Belarus launched

the EAG as founding members. In February 2005, China joined the FATF as an observer.

Currently, China has signed judicial assistance treaties with 32 countries, 23 of which have come into force. China has signed mutual extradition treaties with 21 countries, such as Russia, Thailand and Mongolia. Sixteen of the treaties have taken effect. All the above treaties are applicable to anti-money laundering endeavor.

### *Related Issues Concerning Anti-money Laundering Endeavor*

The FATF was an intergovernmental organization set up by G7 in Paris in 1989 to study the harm and prevention of money laundering,



and to coordinate international action against money laundering. It put forward 40 recommendations on anti-money laundering measures in 1990, and made two revisions to the 40 recommendations in 1996 and 2003, respectively. In October 2001, FATF raised eight special recommendations on combating financing of terrorism, and adopted the ninth special recommendation in October 2004. The 40 recommendations on money laundering and nine special recommendations on combating financing of terrorism, or 40 + 9 recommendations, form international standards on anti-money laundering endeavor and anti-financing of terrorism, and constitute the basic principles and requirements for an anti-money laundering legal system. They provide a basic legal framework on anti-money laundering for countries, regions and related international organizations. Each country may have a certain degree of flexibility in implementing the 40 + 9 recommendations in accordance with its own national conditions and legal system, but FATF asks its member states to meet the standards of the core provisions of the recommendations in formulating anti-money laundering laws.

China needs to do more to meet the requirements of the international standards embodied in the 40 + 9 recommendations. The heart of the recommendations is Article 1, Article 5, Article 10 and Article 13. Article 1 provides for expansion of predicate crimes for money laundering. Article 5 requires financial institutions to conduct due diligence investigation into their customers. Article 10 provides that financial institutions must keep transaction in-

formation intact. At present, China's relevant requirements are as strict as those of FATF, but leave much to be desired in terms of implementation, such as incomplete account opening documentation of institutional legal entities and incomplete records on personal transactions. Article 13 provides for report of suspicious transactions. Banking institutions in China started the practice in 2004, but few reports were made.

## Improvement and Development of Anti-money Laundering

### *Improving Legal Framework*

A complete set of anti-money laundering system includes the following aspects. First, a fairly complete set of rules and regulations on money laundering. The *Law on Anti-Money Laundering* needs to be enacted at an early date to define the division of labor among relevant government agencies, cooperation mechanism, and related rights, obligations and working procedures. It is imperative to revise the provisions on money laundering in the *Criminal Law* to enlarge the scope of its predicate crimes and define conviction standards on money laundering. Second, there should be a well-established regulation system. The scope of regulation should extend from banks to include the securities industry, insurance industry and all OFIs, and some non-financial sectors with high risks, such as auction houses. To this end, the PBC needs to coordinate with relevant departments to revise and improve anti-money laundering regulations for the

banking industry, draft related regulations on the securities industry, insurance industry and non-financial sectors, so as to develop a regulation system encompassing the entire financial sector. Third, the institutions being monitored and regulated must have an effective internal control system on money laundering. At present, commercial banks in China have started to establish such internal control systems in light of their own operational characteristics so as to control money laundering-related risks in the process of their operation.

#### *Improving Efficiency in Collection and Analysis of Asset Transaction Information and Anti-money Laundering Law Enforcement*

At present, an asset monitoring and analyzing system on money laundering has been established and put into operation. However, the system needs to be further optimized to enrich and improve its functions, simplify the procedures for information collection, reduce operational costs, and improve the system efficiency and quality of analysis. At the same time, the Ministry of Public Security and the PBC should strengthen cooperation in investigation of money laundering cases, share information, and explore mature and highly operational investigation methods to effectively crack down on money laundering.

#### *Effectively Strengthening the Monitoring on Money Laundering*

Inspection and monitoring of the implementation of anti-money laundering regulations are primary tools and necessary measures in anti-money laundering endeavor. The PBC has

made anti-money laundering inspection a routine for its branches and sub-branches in 2005. Through regular and consistent monitoring and inspection, financial institutions will be prompted to weigh the huge costs caused by breach of regulations with the profits generated by anti-money laundering work. This will contribute to the improvement of anti-money laundering internal control systems within financial institutions.

#### *Strengthening International Cooperation*

International cooperation is an important component of anti-money laundering endeavor. China has launched preparations for receiving FATF evaluation. China will strengthen its anti-money laundering endeavor, narrow its gap with FATF standards, and meet FATF evaluation requirements so as to become a full member of FATF at an early date. This will contribute to international cooperation on anti-money laundering in more areas, including financial regulation, intelligence sharing, judicial assistance, and more effectively fending off and cracking down on money laundering to serve China's interests.

## Financial Safety Net

A financial safety net refers to a series of institutional arrangements for fending off and mitigating financial risks with the purpose of maintaining smooth operation of the financial system. It usually includes prudential financial



regulation, a central bank's role as the lender of last resort and a deposit insurance system. In China, due to serious historical legacy problems in the securities market, a securities investor protection fund and an insurance protection fund were established. So, a financial safety net is not limited to a deposit insurance system, but also includes a securities investor protection system and an insurance protection system to maintain stability of the securities and insurance markets. These protection systems are jointly referred to as an investor protection system. Together with prudential regulation and the central bank's role as lender of last resort, it constitutes the fundamental element of China's financial safety net. Today, considerable progress has been made in the development of the net. We should build on the achievements, further strengthen prudential financial regulation, increase the regulatory coordination and information sharing among the relevant agencies, improve the function of the PBC as the lender of last resort, and establish or improve investor protection systems for banking, securities and insurance industries.

## Financial Regulation

Conducive to corporate governance and sound operation of financial institutions, effective financial regulation provides important systemic assurance for financial stability. In China, we need to further improve the regulation system on banking, securities and insurance industries, set up and improve the coordination mechanism among the central bank, the MOF

and financial regulators, improve the level of financial regulation to fend off and mitigate financial risks and maintain financial stability.

### *Current Development of Financial Regulation*

Financial regulation means regulation and supervision over financial institutions and financial market, with a view to protect the legitimate rights and interests of depositors, securities investors and insurance policy holders, ensure stability of the financial system, and avoid economic and social disruption caused by financial risks. Financial regulation includes both regulation over a specific type of financial institutions and financial market, and systemic regulation over financial institutions and market. The former is regulation over financial institutions' market entry, ongoing operation, and market exit mechanism, and regulation over the openness, fairness and justice of the financial market. The purpose is to promote sound operation of financial institutions and effectiveness of the financial market. Generally speaking, these functions are mainly performed by regulatory agencies on banking, securities and insurance. Systemic regulation is focused on the entire financial architecture. The purpose is to prevent risks in individual financial institutions or individual market from spilling over and causing systemic risks. This function is usually performed mainly by the central bank. To maintain financial stability, many countries seek to establish effective regulatory coordination and information sharing mechanisms between their central banks and financial regulatory agencies.

The effectiveness of financial regulation not only lies in good corporate governance of financial institutions and effective market discipline, but also depends on sound regulatory philosophy, clearly defined regulatory objectives, appropriate regulation system and methods, consistent regulatory policies, and credible and authoritative regulators. Drawing on the international experience and lessons on financial regulation, the IMF recently initiated a concept of financial regulatory governance to

define and formalize the control and regulation of, and intervention in, financial institutions and financial markets by regulatory authorities.

In recent years, China has made considerable progress in clarifying its regulatory philosophy, improving regulation system and related legal framework, enhancing its regulatory means, and upgrading the specialization and scientific management of regulation.

### **Box 15 Financial Regulatory Governance**

The main purpose of financial regulatory governance is to standardize the behavior of regulatory agencies. This can be assessed in terms of four key attributes, namely independence, accountability, transparency and integrity.

First, independence. To ensure sound regulatory governance, it is essential to allow regulatory agencies a certain degree of independence so that it can avoid political intervention and the adverse impact of institutions being regulated. Independence includes independence in making rules, supervisory, organization and budget. It can be further divided into goal independence and institutional independence. The government may set regulatory goals, but regulatory agencies should be able to independently decide on how to achieve the goals. Generally speaking, independence refers to

instrument independence.

Second, accountability. Independence cannot be achieved without accountability. There is no conflict between independence and accountability. On the contrary, they are mutually reinforcing. Without accountability, independence cannot be achieved. Accountability is of great importance to ensuring that regulatory agencies exercise their power and perform their duties in accordance with law. Accountability means that regulatory agencies must give reasonable account for all of their decisions. Meanwhile, regulators should not only be responsible to government or legislative authorities that entrust the power on them, but also be responsible to regulated institutions and the public.

Third, transparency. Transparency means that the public should be informed of the



regulatory goals, framework, decisions and their basis, data and other information in a comprehensive, convenient and timely manner. Greater transparency helps improve the legislative and operational levels of regulation, and reduce uncertainty in the market. It also helps to realize other regulatory and management goals and increase the credibility of regulatory agencies.

Fourth, integrity. Regulatory agencies and personnel must show integrity, selflessness, and faithfulness in performing their functions in the consistent pursuit of the regulatory goals.

Independence, accountability, transparency and integrity are mutually influencing and reinforcing. Independence and accountabili-

ty are like two sides of a coin. Transparency is an effective tool to ensure independence and the effective implementation of accountability. Transparency can better protect regulatory personnel through disclosure of detailed information, and help establish and bolster the credibility of regulation. Independence and integrity are also mutually reinforcing. For instance, legal protection for regulatory personnel and clear-cut provisions on the appointment and dismissal of regulatory personnel can strengthen both independence and credibility. Accountability and integrity are also complementary to each other. The implementation of accountability helps to maintain the professional integrity of regulatory personnel.

Source: the IMF.

*The establishment and development of the regulation system for the banking industry.* Before 1995, regulations on banking mainly focused on approval of institutions and operations. Since 1995, with the initial establishment of China's legal system on financial regulation and the deepening of banking reform, regulation of banking has registered gradual development and improvement. Since 2002, banking regulation has gradually shifted from compliance supervision to equal emphasis on compliance supervision and risk supervision. In 2003, Chinese government made a major adjustment to the financial regulation system, establishing CBRC to perform the functions of regulation and management over banks, financial AMCs, TICs, and other deposit-related

financial institutions. After its establishment, CBRC further clarified its regulatory objectives and fostered a new regulatory philosophy of "focusing on legal entities, risks and internal control and improving transparency". China has initially formed a rule of law system for prudential banking regulation, which is centered on the *Law on Banking Regulation and Supervision* and the *Law on Commercial Banks*, supported by financial administrative decrees and prudential regulation rules, including those on asset regulation, asset risk classification, loan-loss reserve provisioning, legal entities governance, risk management and internal control, and encompasses the entire regulation process of market access, ongoing operation and market exit. In addition,

continued regulation means improving the combination of off-site supervision with on-site inspection, and a risk assessment system and an early-warning mechanism for banking have initially taken shape.

*Progress made in regulation on the securities industry.* Since its establishment in 1992, CSRC has gradually strengthened its regulation on listed companies, securities companies and the securities market. CSRC has explored ways to protect the legitimate rights and interests of investors, and properly mitigate market risks through establishment of basic rules, seeking to establish a long-term mechanism for risk management. Meanwhile, attention is focused on legislation and administration based on law, regulation and promotion of opening up and international exchanges for the securities industry.

*Gradual standardization of regulation of the insurance industry.* Since the establishment of CIRC in 1998, a standardized insurance regulatory system has initially taken shape. In recent years, CIRC has vigorously promoted the reform of the administrative approval system for the insurance industry, improved insurance market entry mechanism and facilitated structural adjustment of insurance products. It has intensified on-site examination and strengthened regulation on use of funds, focusing mainly on repayment capacity. At the same time, an insurance protection fund were set up on a trial basis to prevent systemic risks in insurance industry. As a result, the operations of the insurance industry as a whole are more standardized.

### *Issues Related to Financial Regulation*

In keeping with the generally accepted *Core Principles for Effective Banking Supervision*, *Objectives and Principles for Securities Regulation*, and *Insurance Supervisory Principles* formulated by relevant international organizations, the following aspects need to be focused on as China further improves its financial regulation system.

First, regulatory objectives need to be better defined. Due to institutional and historical reasons, China's financial regulatory authorities often perform the dual functions of both industry development and industry regulation. Multi-faceted regulation objectives lead to both regulatory forbearance and over-regulation.

Second, it is necessary to improve the effectiveness of financial regulation. Effectiveness of financial regulation to a large extent is restrained by its external environment. Inadequacy of the social credit environment, lack of an advanced accounting system, weak discipline from social scrutiny and underdeveloped corporate governance are all drags on effective financial regulation.

Third, the means of financial regulation need to be further strengthened. At present, there need to be more means for financial regulation. For instance, the *Securities Law* provides very slight legal liability for failure of investigation targets to cooperate with the investigation, and the provision is also difficult to be implemented. Securities regulators have limited law enforcement power, leading to difficulty for them to detect potential risks and violations. Operations of securities agencies need to be further standardized.



Fourth, further exploration needs to be made on the coordination mechanism for financial regulation. Given the global trend of integrated financial services, cross-sector and cross-

market risks are emerging as new elements affecting China's financial stability. This makes it imperative to set up a coordination mechanism for financial regulation.

### Box 16 International Standards on Financial Regulation

International norms on financial regulation are important standards measuring the development of China's financial regulation system. Effective regulation on banking institutions provides an important guarantee for the healthy development of the banking industry. The *Core Principles for Effective Banking Supervision*, which was released by the Basel Committee on Banking Supervision in September 1997, has become a reference standard for international banking regulation. The Core Principles set forth detailed provisions on preconditions for effective banking supervision, licensing, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, regulatory authority and cross-border banking supervision. The purpose is to ensure that banking institutions operate smoothly and have adequate capital to fend off risks. The core principles emphasizes that regulatory authorities must have a full understanding of the nature of the business undertaken by banks, try their best to ensure that banks are managed properly and have enough resources to undertake various risks, examine the risk profile of each bank, encourage banks to develop good corporate governance, and work to

foster an efficient and competitive banking system so that the banks can provide sound financial services with reasonable costs. The core principles also points out that banking supervision is a dynamic function that needs to respond to changes in the market place and that regulatory agencies must be prepared to reassess periodically their supervisory policies and practices in the light of new trends or developments, and that supervision in itself cannot and should not guarantee the elimination of bankruptcy of banks, but appropriate arrangements should be made for problematic banks. At the end of 2003, the Basel Committee on Banking Supervision put forward the *New Basel Capital Accord*, which is composed of three pillars: minimum capital requirement, supervisory inspection by regulatory agencies and market discipline. The Accord emphasizes the close link between capital adequacy and major risks faced by banks, encourages banks to strengthen managerial capability and improve risk evaluation level.

A properly functioned and effective securities regulation is essential to the development of the securities market. In 1997, IOSCO adopted the *Objectives and Principles*

for *Securities Regulation*, which sums up the experience and lessons of securities regulatory agencies in various countries and regions, and reflects the development and regulation trends of global securities market. It sets forth detailed provisions on securities regulation including principles related to capital market regulator, principles for self-regulation, principles for the enforcement of securities regulation, principles for cooperation in regulation, principles for issuers, principles for collective investment schemes, principles for market intermediaries, and principles for the secondary market. The main purpose is to protect investors, ensure market fairness, efficiency and transparency, and reduce systemic risks. It emphasizes that, in order to achieve the regulatory objectives, regulators should, among others, require listed companies to fully disclose the important information that will affect investors' investment decisions, set the minimum standard for market participants, guarantee equal opportunity for investors in using market facilities and obtaining market and price information, prevent unfair transactions and make legal arrangements for effective crackdown on misconduct, and ensure that regulation will increase market efficiency. In addition, securities regulation should recognize the benefit of market competition, promote effective allocation of resources, promote and allow for effective risk management, allow for an appropriate degree of speculative investment, although excessive speculation should be prevented.

In its 1997 annual meeting, International Association of Insurance Supervisors adopted the *Insurance Supervisory Principles*, which was amended several times. It provides a universally recognized framework for evaluation of insurance legislation, insurance regulatory system and procedures. It sets forth detailed provisions on insurance regulation in areas such as regulatory conditions, regulatory system, regulatory subject, ongoing regulation, prudential standards, market and consumers, anti-money laundering, and anti-financing of terrorism. The main purpose is to protect the rights and interests of the insured, promote the efficiency, fairness, security and stability of the insurance market. It emphasizes that effective insurance regulation depends on the regulatory policies, system and legal framework of the financial regulatory agencies, development of well-functioning and effective financial market infrastructure, and an effective financial market, that there should be a clear definition of the main objectives of insurance regulation, and that regulatory agencies should be authorized by law and operate in a transparent and responsible manner so as to foster authoritativeness and credibility and maintain efficiency and stability of the insurance market. It also points out that countries need to implement and apply standards in accordance with their own national conditions and bear in mind the impact of newly emerging financial groups and cross-industry financial institutions to realize effective regulation.



### *Study and Establishment of a Coordination Mechanism for Financial Regulation*

With the acceleration of China's financial innovation, there will be an increasing amount of integrated financial products and enterprise groups with the features of financial holding companies. To avoid a regulatory vacuum and promote the healthy development of the financial sector, it is necessary to establish a coordination mechanism for financial regulation among the central bank, the MOF, financial regulatory authorities and other related departments on the basis of the existing functional regulatory systems.

The newly revised the *Law on the PBC* provides that the State Council shall establish a coordination mechanism for financial regulation, and the PBC, banking regulatory authorities and other financial regulatory agencies should establish an information sharing mechanism for regulatory purchase. In recent years, China has made useful attempts to establish a financial regulation coordination mechanism. In 2000, the PBC, CSRC and CIRC established a joint conference mechanism for the financial sector, formulating rules on the system of tripartite regulation, and this has achieved good results. In 2003, following the reform of financial regulatory system, three regulatory commissions signed the *Memorandum of Understanding on Specialization and Cooperation in Financial Regulation*. Under the leadership of the State Council, departments concerned have summed up their experience and lessons in financial regulatory coordination and increased their efforts to establish an efficient

coordination mechanism for financial regulation.

### **Function of Central Bank as the Lender of Last Resort**

As a component of the financial safety net, the function of the central bank as the lender of last resort refers to the liquidity support provided by central bank to financial institutions in order to prevent systemic risks. Generally speaking, central bank only provides liquidity support to financial institutions with systemic impact, sound financial position and normal operation which encounter short-term liquidity difficulty. The financial institutions that may trigger systemic risks but at the same time highly insolvent and cannot carry out ongoing operations are usually dealt with by fiscal authorities depending on their situations. The following aspects should be particularly emphasized when central bank performs its function as the lender of last resort.

First, prevention of systemic risks. Systemic risks lead to financial instability and hinder economic growth, so during financial crises, central banks often perform the function of lender of last resort.

Second, prevention of moral hazards. The function of the central bank as the lender of last resort is usually performed when financial institutions that may cause systemic risks are involved. Central bank usually does not intervene in financial institutions with financial difficulty which are not likely to cause systemic risks. Instead, it would rather allow market

mechanisms, such as bankruptcy or liquidation, to play their role. This helps prompt investors and senior managers of financial institutions to bear the responsibility and costs for operational failures, strengthens market discipline on business activities of financial institutions, and prevents moral hazards.

Third, emphasis on establishment of a fully-fledged investor protection system. The improvement of the investor protection system provides an important guarantee for the proper performance of central bank's function as the lender of last resort. Given the lack of a mature investor protection system and unemployment and medical welfare systems, when performing its function as the lender of last resort, the PBC should take full account of the possibility not only of systemic risks but also of the social instability that may be triggered by the bankruptcy of individual financial institutions. In this sense, the PBC performs partly the function of public financing. To maintain financial stability, it is essential to improve the investor protection system and balance the relationship between the system and central bank's role as the lender of last resort.

Fourth, strengthening the coordination with monetary policies to prevent inflation. In performing the function of lender of last resort, central bank needs to do its utmost to ensure the smooth implementation of monetary policies.

To fully perform the function of central bank as the lender of last resort, it is necessary to effectively prevent moral hazards. Theoretically speaking, ways to prevent moral hazards include: charging a high loan interest rate for liquidity support, exercising the lender of last resort function in a manner of constructive ambiguity (Box 17), encouraging private capital to participate in the reorganization of risky financial institutions and strengthening market discipline. In practice, to prevent and defuse financial risks and maintain financial stability relies not only on the central bank performing the function of lender of last resort, but also on the establishment and improvement of corporate governance and internal control mechanism in financial institutions, strengthening of regulation, establishment of the investor protection system, improvement of mechanism for market exit of financial institutions and strengthening of market discipline mechanisms.

### **Box 17 Constructive Ambiguity as Central Bank Exercises Its Function of Lender of Last Resort**

To prevent moral hazards in performance of central banks' function as lender of last resort, Mr. E. Cerald Corrigan of New York Reserve Board put forward the proposal of "constructive ambiguity" in 1990, i. e., the central bank should declare to the

market in advance that in case of a crisis in the banking industry, the central bank may not provide liquidity support to banks, with a view to promoting prudential bank management. In 1997, Basel G-10 set forth an informal definition for constructive ambiguity:



the financial authorities of each country should avoid making explicit statements on providing liquidity support to any financial institution. They should avoid directly clarifying when and under what circumstances such support will be given. In addition, in making such decisions, the possibility of systemic risks should be analyzed. If such risks do exist, it is necessary to consider measures to be taken to deal with proliferation of systemic risks and reduce the negative impact on market discipline.

In 1996, Andrew Crockett, the former president of the BIS, pointed out that another purpose of constructive ambiguity was to ensure that managers and shareholders undertake costs to the biggest extent possible when financial institutions encounter liquidity crisis due to imprudent management and need the liquidity support provided by the lender of last resort.

Nevertheless, constructive ambiguity also has a negative impact, i. e. , entrusting cri-

sis management authorities with a relatively large degree of discretion. Discretion may cause time-consistency problems, as is encountered by economic policy-makers in other areas. At first, crisis management authorities may believe they should not provide liquidity support to banks, but then when a crisis takes place they feel they should provide support. In 1997, the IMF researchers Charles Enoch, Peter Stella and May Khamis also proposed ways to restrict crisis management authorities' discretion in handling individual cases through strict post-event information disclosure requirement. The *Code of Good Practices on Transparency in Monetary and Financial Policies* issued by the IMF is a step in this direction.

In practice, such constructive ambiguity may "punish" the managers and shareholders of financial institutions plagued by imprudent operation and management, effectively preventing moral hazards.

## Investor Protection System

To protect the rights and interests of investors and enhance investors' confidence in the financial system, many countries have established deposit insurance, securities investor protection, insurance protection or other forms of investor protection system. The investor protection system varies in different countries. Some have separate investor protection systems for the banking, securities and insurance indus-

tries, while others have one uniform system for three industries. At present, China is establishing three separate investor protection systems in the forms of a deposit insurance system, a securities investor protection fund and an insurance protection fund.

### *The Time Is Basically Ripe for the Establishment of a Deposit Insurance System*

Since 1997 we have seen the closure and liquidation of many deposit-taking financial institutions whose liquidation assets were not enough to payoff the debts owed by individual invest-

ors. To maintain social stability, the State handled the problem by combining the use of fiscal support (including application of special loans by local governments to the central government) and loans provided directly by the central bank. Such an implicit deposit insurance system not only increases the burden of the State, but also hinders the improvement of investors' risk awareness. In addition, it weakens market discipline on the operation of financial institutions.

To establish an explicit deposit insurance system, using premium paid by deposit-taking financial institutions to support problem institutions, will help relieve pressure on government. At the same time, removing implicit State subsidies and establishing a market-oriented limited compensation mechanism will nurture risk awareness among market players and prompt them to make investment decisions in light of risk status of financial institutions and give full play to market discipline. A deposit insurance system bases insurance premium rates on the extent to which deposit-taking financial institutions are prone to risks, which is conducive to development of an incentive mechanism.

The internal and external conditions in China are primarily ripe for the establishment of a deposit insurance system. First, deepening of banking reform has laid a sound micro foundation for the system. At present, remarkable progress has been made in transforming commercial banks into joint-stock companies, the pilot project on deepening the reform of RCCs has been successfully extended to 29 provinces

(municipalities and autonomous regions), the shareholding reform of other commercial banks, city commercial banks, UCCs, TICs and other banking-related financial institutions has achieved positive results. The asset quality and CAR of China's banking industry is improving, and its performance is becoming more stable. Second, the financial regulatory mechanism is further improved with the strengthening and standardization of regulatory means. Third, financial legislation is gradually improved, laying a sound external legal foundation for the establishment of a deposit insurance system. Enactment of a series of laws and regulations, such as the *Law on the PBC*, *The Law on Commercial Banks*, the *Securities Law*, the *Accounting Law*, the *Guarantee Law*, and the *Company Law*, constitute a fairly comprehensive legal system. Fourth, the accounting standards of China's banking sector are gradually being brought in line with international standards. After getting listed on international capital markets, SOCBs will employ international accounting standards and financial regulatory standards, which will encourage China's banking sector to adopt prudential accounting policies. Fifth, many countries have already established deposit insurance systems, so China can draw on the experience of other countries and avoid the mistakes and so reduce the negative impacts. Sixth, years of sustained, rapid and sound development of China's economy and stable performance of the financial system provide a favorable macroeconomic environment for the establishment of a deposit insurance system. Currently, the PBC is conducting in-depth research in coop-



eration with other relevant departments of the institutional arrangements for deposit insurance, with a view to developing a deposit insurance system that is marked by positive incentives and gives full play to market discipline.

#### *A Protection Fund for Securities Investors Is Initially Put in Place*

A prolonged bear market, relative weaknesses of securities companies and some other historical problems have made the chronic risks of securities companies salient. The past two years have witnessed the successive closure and liquidation of many securities companies, such as Southern Securities, Xinhua Securities, Hantang Securities, Minfa Securities and Dapeng Securities. Some defiant securities companies present large potential risks. Their misappropriation of customers' transaction and settlement funds and negotiable securities hurts the immediate interests of investors and may trigger bank runs and undermine social stability. In this sense, it is necessary to establish a securities investor protection system to protect the rights and interests of small and medium investors, provide fair compensation in accordance with market-driven principles and thus increase investors' confidence.

On August 30, 2005, China Securities Investor Protection Fund Co. Ltd was set up. Following the principle of "from the market and to the market", it will provide compensation to investors according to relevant state policies in cases where securities companies are revoked, closed or declared bankrupt, or imposed by CSRC mandatory sanction measures,

such as administrative takeover or trust operation.

#### *An Insurance Protection Fund Is Initially Established*

In December 2004, CIRC released the *Provisions on Management of Insurance Protection Fund* (referred as *Provisions* below), which put in place an investor protection system for the insurance industry in the form of an insurance protection fund. The insurance protection fund is a statutory fund. Its source is the premiums paid by insurance companies in line with the requirements of the *Insurance Law*. Based on the principle of "centralized management and coordinated use", the fund is used to provide relief to insurance policy holders or insurance policy assignee companies when insurance companies are revoked or declared bankrupt. The model of the fund has three marked features. First, it combines proportional relief quota and absolute relief quota. This will better reflect the relationship between insurance profits and loss sustainability. Second, the relief quota is consistent with the economic conditions of China and can fully protect the interests of insurance policy holders. According to the *Provisions*, the absolute relief quota for non-life insurance policy holders is RMB50,000 yuan. 100% of the losses up to RMB50,000 yuan (inclusive) will be compensated, and for the part of losses exceeding RMB50,000 yuan, 90% and 80% will be compensated for individual and institutional insurance policy holders, respectively. Third, insurance policy holders are given the choice of "transferring rights and interests, and re-

ceiving relief first". If insurance companies are revoked or declared bankrupt, insurance policy holders may sign creditors' rights transfer agreements with the insurance protection fund so that the fund will provide relief payments to the insurance policy holders first and the insurance policy holders transfer their creditors' rights to the insurance protection fund. After liquidation, if the insurance protection fund gets more assets than relief pay-

ments, the fund should return the excessive assets to insurance policy holders. The establishment of the insurance guarantee fund further deepens the reform of the insurance industry and contributes to the establishment of a market-oriented exit mechanism for insurance companies. Such a system will reduce the social shocks caused by market exit of insurance companies and increase public confidence in the insurance industry.

#### **Box 18 Investor Protection Policy in the Transitional Period—Opinions of Acquisition of Individual Creditors' Rights and Claims on Securities Transactions Settlement Fund**

To integrate and standardize the principles for handling individual creditors' rights, protect the interests of small and medium investors, maintain the consistency and stability of the operation of the securities market, increase investors' risk awareness, establish a market discipline mechanism and prevent moral hazards, in October 2004, the PBC, the MOF, CBRC, and CSRC jointly formulated and issued the *Opinions of Acquisition of Individual Creditors' Rights and Claims on Securities Transactions Settlement Fund* (referred as *Opinions of Acquisition* below), which serves as an investor protection policy arrangement in the transitional period.

The acquisition scope as prescribed by the *Opinions of Acquisition* includes all the individual liabilities and customers' securities transactions settlement funds related to the

failed financial institutions (excluding insurance companies). Individual liabilities include individual deposit savings, creditor certificates issued by financial institutions which is owned by individuals, property that individuals entrust financial institutions to manage, and individual liabilities formed due to misappropriation by financial institutions of negotiable securities held by individuals that had been deposited in the related accounts.

Pursuant to the *Opinions of Acquisition*, individual deposits and legitimate principal and interest related to customers' transaction and settlement funds should be acquired in full. With regard to other individual creditors' rights that fall within the scope of acquisition and formed before and on September 30, 2004, principal worth up to RMB100,000 yuan (inclusively) will be acquired fully, and the part exceeding



RMB100,000 yuan will be acquired with 10% discount of the principal.

The release of the *Opinions of Acquisition* is conducive to protection of the rights and interests of investors and the safeguard of financial stability. Since a deposit insurance system is not yet in place, full repayment of the legitimate principal and interest of individual deposits means that the individual deposits are fully protected. Losses arising due to misappropriation of customers' securities transaction and settlement funds are caused by the misconduct of managers of financial institutions, and should therefore be compensated by securities companies with their capital. However, at a time when a securities investor protection system has not yet been established, in order to protect

investors' legitimate rights and interests, and to maintain the consistency and stability of the securities market operation, it is important to compensate in full the settlement funds of institutional and individual clients' securities transactions.

The implementation of the *Opinions of Acquisition* has also strengthened investors' risk awareness and contributed to the sound development of the financial market. According to the *Opinions of Acquisition*, with regard to other creditors' rights worth more than RMB100,000 yuan, the part exceeding RMB100,000 yuan will be acquired at a 10% discount to the original value. This is a risk reminder to investors and helps investors to be prepared to undertake investment risks.

## Strengthening Education of Financial Safety

Strengthening education on financial safety and spreading financial knowledge contributes to the fostering of a scientific financial development concept and financial risk awareness in all sectors of the society, increasing financial and legal awareness, and improving the creditworthiness of the whole society.

Financial safety knowledge education is an important component of public education. Due to differences in systems, historical background, culture and stage of development, countries may have different priorities in public education. For instance, the United States pays

much attention to public education on financial knowledge. The US Federal Reserve makes full use of various tools to educate the public on financial knowledge. It believes that financial knowledge education contributes to greater economic strength and higher living standards of the general public, and helps the public make correct financial decisions and choices to prevent financial fraud. Compared with the situation in Western countries, the objectives of China's financial knowledge education should be more specific and the content more comprehensive.

China's financial safety knowledge education may focus on the core subjects of risk awareness, rule of law and creditworthiness. Risk education should help investors understand

risks they may have to take while participating in financial activities, so that they will voluntarily bear the consequences of their own behavior. The nurturing of risk prevention awareness among the public and the strengthening of market discipline will contribute to better handling of the relations between safeguard of financial stability and prevention of moral hazards. Law awareness education aims at popularization of financial laws and regulations and fostering of the concept of the rules of law in the financial sector so that the general public will make correct judgments on the legality of financial activities, voluntarily resist illegal financial institutions and illegal financial activities, and develop a sense of making lawful investment. Creditworthiness education aims to foster a sound credit culture and credit environment.

China's financial safety knowledge education should not only be directed at the general public, but also the employees of the government, enterprises, financial institutions and the media, so that the society at all levels will be equipped with in-depth financial knowledge. Financial safety knowledge education for financial institutions and their employees is an important measure to strengthen risk prevention and internal control of financial institutions, and an effective tool to prevent financial crimes, eliminate all kinds of breach of financial laws and regulations, and hedge operational risks. Financial safety knowledge education for enterprises will improve the external environment of the financial sector and reduce the transfer of enterprise risks to the financial sector. Financial safety knowledge education

for employees of governments at various levels and relevant departments forms an important link in the chain of China's public education. The financial safety awareness of government officials has a direct bearing on the health of financial ecosystem.

To maintain financial stability, the PBC will intensify financial safety knowledge education, launch a comprehensive campaign and publicity effort centering on investor education to improve the general public's ability to judge the lawfulness of financial behavior, nurture their awareness of the possible consequences of participating in illegal financial activities, and increase their awareness of risks, financial rule of law and creditworthiness, so as to create a favorable social environment for reform, development and innovation in the financial sector.

## Financial Ecosystem

Maintenance of financial stability is a systematic project that requires a sound financial ecosystem. At present, the important impact of the financial ecosystem on financial stability is gaining the acknowledgement of the whole society. China will further improve its financial ecosystem in order to maintain financial stability.

### Definition and Elements of the Financial Ecosystem

In a narrow sense, financial ecosystem refers



to financial infrastructure and its operational status, mainly including payment and settlement systems, laws and regulations, corporate governance, accounting standards, credit information system, anti-money laundering system, and the financial safety net composed of prudential financial regulation, the function of the central bank as the lender of last resort and the investor protection system. In a broad sense, the financial ecosystem refers to the external environment in which the financial system operates, which combines various factors with impact on the survival and development of the financial system, including economic, political, cultural, geographical, demographical and other factors related to financial system development.

Elements that affect the financial ecosystem abound, such as the level of economic development, economic structure, openness to the outside world, historical background and cultural traditions, social customs and geographical environment. At the Seminar on Risk Management and Internal Control of the Commercial Banks held on January 8, 2004, the PBC Governor, ZHOU Xiaochuan, pointed out that the reasons behind regional difference in financial ecosystem could be summarized as follows. First, there are different degrees of intervention in banking business by the local governments. Second, different performance of the judiciary system and law enforcement has led to different protections for the rights of the creditors. Third, there exist different commercial cultures. In regions where cronyism or nepotism prevails, there is clearly a high proportion of NPLs. Fourth, in the past, the

commercial banks adopted a credit quota system that was not conducive to asset liquidity. Moreover, China's banking regulatory architecture in the past was also built along the administrative regions, which to some extent has obstructed capital flow within the country. Different financial ecosystems may lead to risk discrepancies among different regions.

## Financial Ecosystem and Financial Stability

The financial ecosystem has a direct bearing on economic development and financial stability. A sound financial ecosystem is the basic condition for financial operation. It contributes to normal display of financial functions. Lack of a good financial ecosystem hinders the development of the financial sector.

The financial ecosystem influences the implementation of macroeconomic policies. In a sound financial ecosystem, financial institutions can effectively transmit the intentions of monetary policies. This helps improve the effectiveness of monetary policies and realization of their goals.

The financial ecosystem influences the investment behavior of financial institutions. Financial institutions often make their investment decisions through credit ratings based on their internal standards and the financial ecosystem of a region.

The financial ecosystem has a bearing on the robust operation of the financial market. A sound financial ecosystem contributes to the transparency of the financial market, improve-

ment of the credit ratings of market players, strengthening of investors' confidence and the robust operation of the financial market.

The financial ecosystem affects the competitiveness of an economic entity. A sound financial ecosystem attracts more financial institutions and investment and contributes to stronger competitiveness.

### Improvement of Financial Ecosystem

Development of financial ecosystem is a long-term, complicated systematic project. Improvement of China's financial ecosystem is a gradual process. Related reforms will take a long time to show effect, and cannot be accomplished at one stroke. China will depend on the concerted efforts of all parties to improve its financial ecosystem and maintain financial stability through coordination and steady progress.

First, fostering and implementing a scientific development outlook, and promoting steady growth of the macro economy through strengthening macroeconomic regulation and maintaining the stability of RMB exchange rate. It is necessary to intensify economic restructuring, speed up institutional reform and the shift of economic growth pattern to maintain sound operation of the economy and avoid economic fluctuations.

Second, improving financial legislation and strengthening law enforcement capability on the basis of stronger legislation. A fully fledged legal system and strict law enforce-

ment can improve the behavior and expectations of market participants, effectively protect financial creditors' rights and curb vicious credit fraud or evasion of debts repayment. China will continue to perfect the relevant legislation, comprehensively rectifying the order of the financial market, step up crackdowns on debt evasion, and establish an effective judicial and law enforcement system to protect creditors' rights. In particular, it is necessary to improve the *Enterprise Bankruptcy Law* and the *Guarantee Law*, which are closely related to creditors' rights protection, strengthen creditors' legal status in enterprise bankruptcy and reorganization, especially the right of creditors to voluntarily apply for bankruptcy and liquidation of debt-ridden enterprises.

Third, deepening reform, particularly the reforms on administrative structure and state-owned enterprises to improve relations among banks, government and enterprises. Banks and enterprises should establish a new relationship featuring equality, mutual benefit and mutual trust. Government should take vigorous steps to shift its functions, facilitate institutional reform and nurture the development of market through improved local laws and regulation and credit management system, provide sound social service to market players, and create a favorable financial ecosystem.

Fourth, establishing and improving the market exit mechanism for financial enterprises in order to meet the requirements of the market economy. It is necessary to speed up the establishment and improvement of a deposit insurance system, securities investor protection



fund and insurance protection fund, so as to improve the credit awareness and risk awareness of the public.

Fifth, improving auditing, accounting and information disclosure standards and implementation capability and upgrading the quality of intermediaries. It is necessary to continue to disseminate and implement international accounting standards in enterprises, encourage and support the development of a number of specialized intermediary institutions related to the financial ecosystem, draw on the experience and organizational structure of foreign countries, strictly implement industrial thresholds and regulatory standards, foster higher moral standards in the intermediaries and improve the level of information disclosure.

Sixth, establishing and improving the social credit system, nurture public credit awareness, and building a sound credit culture. In collaboration with other departments, the PBC will take measures to push for the development of credit environment. It is necessary to carry out a nationwide education campaign on honesty and trustworthiness, build a complete set of incentive and penalty mechanisms, nurture a social atmosphere favoring honesty and creditworthiness, and improve the credit awareness of the public. Efforts will be made to speed up the establishment of an enterprise and individual credit information system, improve the

enterprise credit information system, push for the development of an individual credit information database, and strengthen information sharing with the business, commercial, taxation, judicial and other departments. Building on the existing laws, regulations and policies on credit and credit information, it is necessary to strengthen regulation on the credit information industry. A credit guarantee system for small- and medium-sized enterprises featuring government leadership, financial support, multiple fund-raising channels, flexible operation forms and diverse business variety should be developed at an early date. At the same time, vigorous support should be given to the development of asset evaluation agencies, credit rating agencies and other types of credit information agencies. Enterprise reform should move forward to ensure that state-owned enterprises as the main customers of bank loans become real independent market participants, so as to lay the groundwork for a sound relationship between banks and enterprises and an enabling credit culture.

Seventh, further improving the corporate governance of financial institutions and financial regulation to protect the legitimate rights and interests of shareholders and creditors, realize the goal of maximizing shareholders' profit and improve the effectiveness of financial regulation.