



Chapter I

Overview

In 2005 the Chinese economy continued to grow in a healthy and sustained manner with breakthroughs in financial sector development. Reform of RMB exchange rate regime was well implemented. Restructuring of SOCBs into joint stock banks recorded gratifying results. Restructuring of RCCs went on smoothly. Restructuring of securities companies went into full swing. Non-tradable state share reform continued steadily. Headway was made in the integrated financial services pilot programmes for the insurance industry. Risks revealed in the banking and securities industries were properly dealt with. The long-term mechanism for financial risk management started to be established. The financial industry was more open to international participation. As a result, the financial system has become significantly stronger.

Breakthroughs in Financial Reform, Proper Management of Financial Risks, and Overall Financial Stability in China

In 2005 the CPC central committee and the State Council required that a proper balance among reform, development and stability be achieved within the framework of the concept of scientific development; that economic development remain the focus but with transformation of development concept, innovation in development models and improving quality of

growth, and that the historical legacy problems be resolved through development and reform to keep the economic development sustainable. These guidelines and policies have created a sound political, economic and social environment for financial stability. With breakthroughs in financial reform and risk management, stronger financial infrastructure and a healthier financial ecosystem as well as wider opening up of financial industry, China enjoyed overall financial stability.

Steady and Rapid Development of the National Economy Laid the Ground for Financial Stability

The economy demonstrated a sound momentum featuring rapid growth, greater efficiency and stable prices. As issues related to the macro economy were being closely monitored and structural problems began to ease, economic performance was enhanced with balanced development in different sectors. Breakthroughs were made in the reform of some key areas, which enhanced the government's ability to manage the macro economy. Healthy and stable performance of the macro economy helped to maintain financial stability.

Breakthroughs in Financial Reform Improved the Competitiveness of the Financial Industry

Reform of RMB exchange rate regime was implemented smoothly; a managed floating exchange rate regime based on supply and demand with reference to a basket of currencies has taken shape. The market was playing an increasing role in the formation of exchange rate with greater flexibility. RMB exchange

rate remained stable at a reasonable and balanced level.

Reform of SOCBs went on smoothly. BOC, CCB and ICBC continued with shareholding reform. Having completed financial restructuring and established joint stock companies, BOC and CCB continued to improve corporate governance, internal control and risk management and pressed ahead with the introduction of strategic investors and IPOs subsequently. CCB was successfully listed on the Hong Kong Stock Exchange in October 2005. Reform of ICBC into a joint stock company with limited liability started in April 2005 and completed in October 2005. The corporate governance of ICBC is improving, and prepared for its IPOs. Reform of ABC is under active consideration within the framework of building a new socialist countryside and the overall strategy for rural financial reform. These reforms have proven effective with significant improvement in CAR, asset quality, profitability and financial sustainability of the restructured banks.

The pilot program of RCC reform has been extended to 29 provinces (autonomous regions and municipalities) with major breakthroughs. Firstly, with the implementation of various supportive policies, progress has been made to deal with legacy issues of the past. By end 2005, the PBC arranged the issuance of eight-year special bills valued at RMB 159.9 billion yuan to 2,263 counties (including county-level cities) to acquire NPLs and suspense accounts over previous years of RCCs. Secondly, property rights reform continued steadily,

particularly in the transformation of management practices. By end 2005, 72 rural banking institutions were formed together with 519 legal entities at the county level (including county-level city). Thirdly, pilot administrative reform has been undertaken, with regulatory responsibility of RCCs transferred to the provincial government and managerial duties of local governments for RCCs preliminarily identified. Fourthly, credit to agriculture sector continued to increase, contributing to the well being of farmers, agriculture and rural areas.

Non-tradable state share reform has begun to produce positive results. Under the overall plan of the State Council and in accordance with the concept of "centralized organization and decentralized decision-making" and operating procedure of "pilot program first, coordinated implementation and phased problem-solving", non-tradable state share reform proceeded steadily. Based on their individual circumstances, listed companies adopted a variety of compensation schemes to minority tradable shareholders, including the granting of free shares with cash dividends (only to holders of tradable shares), warrants, restructuring and reverse stock split. Generally speaking, a win-win situation for owners of both tradable shares and non-tradable state shares has been achieved. Having removed a major overhang and structural deficiency of the capital market, non-tradable state share reform helps to protect the legitimate rights and interests of all stock market investors, in particular the minority tradable shareholders, and safeguards stability of the securities market.

Restructuring of securities companies achieved positive development. In collaboration with other government agencies, the PBC restructured eight securities companies including China Galaxy Securities, Shenyin & Wanguo Securities, Guotai Jun'an Securities, Huaxia Securities, Beijing Securities, Tiantong Securities, Southwest Securities and Xinjiang Securities, with China SAFE Investments Limited and China Jianyin Investment Co., Ltd. as platforms for restructuring. The means of restructuring has taken various forms, such as capital injection by shareholders, liquidity support and introduction of strategic investors. Smooth restructuring facilitated resources allocation in the securities market, and laying down a solid foundation for improving the international competitiveness of securities companies. Meanwhile, system development gained momentum during the process, with third party custodian of securities purchased by investors and transaction settlement fund first introduced to restructured securities companies.

Progress was made in the reform of insurance industry. Firstly, the scope of insurance services was expanded. With active development of agricultural insurance and involvement in rural medical insurance and pension insurance for farmers, the insurance industry restored the agricultural insurance, which was declining in recent years. Insurance companies have developed over 200 liability insurance products, contributing to social stability. Secondly, the insurance industry made breakthroughs in investing their funds and exploring a variety of investment channels. By end 2005, direct eq-

uities investment by insurance companies amounted to RMB 15.888 billion. Insurance companies have also become the second largest institutional investor groups in the bond market. Thirdly, the pilot program of comprehensive insurance business was carried out smoothly. In 2005 a number of insurance companies have set up subsidiaries for piloted comprehensive cross-sector business. Meanwhile cooperation between the banking and insurance industries is shifting from loose business alliance to equity shareholding relationship.

Financial Risks Were Dealt with Properly and Financial Safety Net Was Gradually Established

Led by the State Council and with close inter-departmental cooperation, risk management and restructuring of banks and securities companies have accelerated, effectively reducing financial system risks. Firstly, existing financial risks of SOCBs were effectively reduced. BOC, CCB and ICBC have reduced their non-performing asset ratios and brought CARs to international levels by restructuring efforts such as capital injection and market-based non-performing asset disposal. Their financial positions are thus significantly improved. Secondly, risks of small- and medium-sized banking institutions were preliminarily disposed. Restructuring and reform of China Everbright Bank and Guangdong Development Bank went on smoothly; 82 UCCs phased out quietly while RCCs reported significantly improved performance, with CAR rapidly improved as a result of replacement of non-performing assets

by central bank bills. Thirdly, cumulated problems of securities companies were started to be tackled. In 2005 13 high-risk securities companies were closed.

During the process of risk disposal, a long-term mechanism for the financial risk management was established. The *Opinions on the Acquisition of Individual Creditor's Rights and Claims on Securities Transaction and Settlement Fund and the Supplementary Notice on Issues Related to the Acquisition of Individual Creditor's Rights*, which specify the scope and criteria for acquiring individual creditor's rights and further identify the market principle of risk premium, were promulgated and implemented. The Securities Investor Protection Fund was established and began to play its role. Insurance and safeguard mechanisms were in place. And deposit insurance system is being contemplated.

Financial Infrastructure Was Strengthened and Financial Ecosystem Improved

Secure and efficient performance of the payment system, which is a core piece of infrastructure in the financial system, is of vital importance for financial stability. Since 2005, major strides have been made in the development of a modern payment system in China with large-value and retail payment systems ("LVPS" and "RPS") successfully promoted and applied across the country, marking the establishment and continuous improvement of China's payment service network. With the launch of the contingency system for payment clearing, a simulation exercise of emergency switch between the LVPS national processing

centre ("NPC") and contingency centre were successfully undertaken in September 2005, after which the payment system has become more capable of responding rapidly to emergencies.

A greater attention has also been placed on other financial infrastructure and financial ecosystem was further improved. With the amendment of two important laws, the *Company Law* and the *Securities Law*, the financial legal framework was updated and enforcement was enhanced. Accounting standard was also improved, particularly with accounting principles for enterprises. Major breakthrough was made in the credit report system, with the national network of credit databases for basic business and individuals operated officially. Laws concerning anti-money laundering were developed and coordination system rolled out.

The Financial Industry Opened Wider to the Outside World

Since China's WTO accession, the government has continued to open up its market to honor its commitment to gradually open up the financial industry in accordance with the terms and conditions of WTO. By end 2005, there were 254 foreign banking institutions with a total asset of USD 87.657 billion, accounting for 1.89% of total assets of banking system. The 154 foreign banks have been authorized to conduct RMB business in 25 cities and 25 foreign financial institutions have invested in 20 Chinese domestic banks. By end 2005, there were 7 foreign-funded securities companies, 20 foreign-funded fund management companies and 32 QFIIs. In the insurance industry,

there were 17 wholly owned foreign insurance companies and 23 sino-foreign joint ventures. Total assets of sino-foreign joint venture and wholly owned foreign insurance companies in China reached RMB 40.18 billion and RMB 26.606 billion, 2.64% and 1.75% of the industry total respectively.

Issues in Maintaining Financial Stability

Sustained growth and healthy economy, increasing economic stability and better coordinated economic development have created a sound external environment for financial stability in China. However, the impact of global imbalances, the fluctuations of oil and other commodity prices, domestic economic and financial structural bottlenecks, increasing international competition in the financial industry and potential risks of financial innovation on financial stability still merit attention.

Firstly, global imbalances and price fluctuations of oil and other commodities. Global imbalances are closely-watched issues by all countries as it has led to excess liquidity, low long-term interest rates (i.e. flat yield curve) and rising commodities and asset prices. Adjustment of such imbalances (particularly if it happens in a drastic and disorderly manner) could exacerbate volatility in major currencies and result in a slowdown in the US economy and asset price correction which could hurt Chinese export and economic growth. In addition, fluctuating oil and commodity prices will lead to higher import cost and inflationary pressure in China,

which could affect the development of the country.

Secondly, structural bottlenecks in the economy. As a salient problem with the Chinese economy, structural bottlenecks mostly take the form of excessive growth in fixed asset investment, sluggish consumption and disequilibrium in the balance of payment. These problems hinder the healthy economic development by causing excess liquidity, higher inflationary pressure, asset prices and credit risks of banks and thus greater overall risks within the economic and financial system.

Thirdly, structural problems in the financial industry. Development of direct financing has been slow. Among the major direct financing channels, fund raising from the stock market shrank while corporate bond issuance remained small. In contrast, indirect financing is the dominant funding sources where businesses rely heavily on bank loans for financing. In addition, the small scale and inadequate coverage of insurance industry have also exacerbated financial structural problems, and the result is that the risks in the financial system are heavily concentrated on the banks. The concentration of financial system risks on commercial banks has undermined sound operation and sustainable development of banks as well as the prevention of systemic risks.

Fourthly, increasing competition in the financial industry upon the end of the grace period after WTO accession. Upon the end of the grace period, China's financial industry will be faced with a whole new dynamics of competition in an open market environment. In-

creasing competition challenges existing regulatory concepts and practice, and effectiveness of domestic financial industry and so calls for further reform to adapt to the new environment. Within the financial sector, domestic financial institutions need to bridge the gap between them and international competitors in areas like corporate governance, business mechanism, internal control, risk management, human resources and services to customers. Their ability to respond to interest and exchange rate fluctuations also needed to be strengthened. Also, the risks of small- and medium-sized financial institutions need to be further reduced. On the external environment, the financial ecosystem needs further improvement, reform of SOEs (which is closely linked to financial institutions) will need to be intensified, taxation system for financial enterprises enhanced, a country-wide credit system established and financial laws better enforced.

Fifthly, equal importance should be placed on financial innovation and risk prevention. Financial innovation is necessary for sustained and healthy development of the financial industry, as it promotes the development of capital market and boosts direct financing, diversifies the risks from the banking industry, provides more risk management tools for market participants and creates conditions for commercial banks to enhance credit, interest rate and exchange rate risk management capabilities. Chinese financial institutions are yet to become innovative, reflected as the lack of new financial products and a weak product innovation system. Financial institutions in China have to continuously reform and innovate

by expanding business scope, launching comprehensive business pilot programs, developing financial derivatives and improving services. Meanwhile, cross-industry, cross-market and cross-border systemic risks are difficult to prevent and monitor, and need special attention. While financial institutions enhance risk management, financial regulators need to improve their capability of risk monitoring and analytical power, encourage information disclosure, and promote regulatory coordination.

Reform, Opening Up and Innovation As the Drive Underpinning Sustained and Healthy Development of the Financial Industry and Guarantee for Financial Stability

2006 marks the beginning of the Eleventh Five Year Plan (11thFYP) and the end of the grace period since China's WTO accession. A complete understanding of the significance and urgency of reform and opening up, so as to respond to the new situation and challenges, is of vital importance to boost the overall competitiveness of the financial industry and provides a good start to the 11thFYP. The PBC will continue to work closely with other government agencies to implement the concept of scientific development and promote sustained and healthy development of the financial industry and maintain financial stability with reform, opening up and innovation.

Firstly, macroeconomic management will be further improved and become more forward-

looking, scientific and effective so as to ensure economic and financial security, efficiency and performance. With a view to policy stability and consistency, a prudent fiscal policy and monetary policy will continue to be implemented and macroeconomic management improved to promote sustained, healthy and stable economic and financial development. China will persist in macroeconomic management, optimize economic structures and resolve salient problems in the economy. Based on priorities, some areas will be boosted and some restrained. Guidance and targets will be provided for different regions and industries. Reform will continue to be the driving force to eliminate the factors that could disturb economic development. The market-based reform of interest rates will be continued and interest rate formation mechanism improved. The exchange rate regime will be further reformed so that the role of supply and demand in determining RMB exchange rate will be enlarged.

Secondly, the establishment of a deposit insurance system and a long-term mechanism for financial risk management should be accelerated. The development of a financial safety net will be sped up to protect the legitimate rights and interests of depositors, investors and the insurance policy holders. The securities investor protection fund and insurance protection system will be improved to prevent moral hazards. A deposit insurance system that covers all deposit-taking financial institutions will be established as soon as possible to better protect depositors and enhance the effectiveness of financial regulation. Pru-

dent regulation will be strengthened along with the central bank's function as lender of last resort.

Thirdly, financial reform should be pushed further to enhance overall competitiveness of financial institutions. Shareholding reform of SOCBs will be pursued unswervingly. The state will remain the major shareholder; ownership structure, corporate governance, internal control and management will be improved. The reform of JSCBs will be continued, adjustment and transformation of the function of policy bank will be accelerated, and operation of financial asset management corporations improved. Rural financial reform will be deepened with RCC system further improved and the reform of ABC and ADBC started. Financial innovation in the rural area will speed up with better services. Capital market will be boosted, with focuses on restoring core functions of the capital market in capital allocation, improving the quality of listed companies, comprehensive management of securities companies, market regulation under a strong legal framework and an open, just, fair and transparent market environment.

Fourthly, financial regulation will continue to be strengthened and coordination between different government agencies improved so that a sound regulatory environment be created for financial innovation. Innovation is a must for financial institutions wishing to survive competition, and a requirement for financial reform and development. As financial sectors become increasingly integrated, financial regulation needs to be further strengthened, co-

ordination between different regulatory authorities improved and information shared so that the regulatory environment for financial development and innovation could be improved.

Fifthly, the financial industry will become even more open while financial security is to be maintained. Further opening will help the better utilization of both domestic and international markets and resources. The financial industry will be opened further in an active and well-managed manner while foreign sharehold-

ing limits and restrictions on business scope and origin will be further relaxed. Financial resources of foreign financial institutions will be encouraged to industrial restructuring and upgrading, as well as balanced regional development in China, so that market opening could shift from quantitative expansion to structural optimization. Financial information will be better managed to ensure information security. Effective management over major financial institutions will be strengthened to ensure national financial security.

(By Wang Suzhen and Sun Tao)



Chapter II

Macro Economy

In 2005 the world economy maintained its strong growth momentum with a stable international financial market. The Chinese economy demonstrated a strong performance featuring rapid growth, high efficiency, stable prices and stronger dynamism along with well-implemented macro-economic management. All above-mentioned factors provided favorable international and domestic environment for China's financial stability. Meanwhile the impacts of such factors as global imbalances and structural problems in the domestic economy on China's financial stability need to be watched closely.

World Economy and International Finance

Stable world economy and international finance was a solid foundation for financial stability in individual economies. Similarly, risk factors including global imbalances, rising prices of oil and basic commodities, interest rate increase and excessive liquidity were the concern of all countries.

Fundamentals of World Economy and International Finance

In general, global economy and financial conditions remained stable.

Firstly, world economy grew rapidly at 4.8%. The US economy featured strong growth at 3.6% over the year; the Euro zone slowly recovered with an annual growth rate of 1.3%; the Japanese economy recorded strong

recovery, growing at 2.7%; emerging economies in Asia and Latin America maintained strong growth momentum; and middle-and east European economies also experienced steady growth.

Secondly, inflation rates rose slightly. Affected by price increases of energy and most non-energy mineral products, most industrialized countries, developing countries and emerging economies witnessed higher inflation rates to varying degree. However, the influence of energy price rise is yet to reach core CPI in these countries and regions.

Thirdly, international financial market remained stable overall with small risk premium and volatility. Despite the absence of major fluctuations on international financial market, market performances varied. Global stock market went strong (despite of fluctuations), and European and Asian markets were performing much better than that of America. In terms of bond market, long-term treasury bond yields of major countries fluctuated within a certain range while remaining low on the whole. On the foreign exchange market, the US dollar appreciated versus most currencies.

Fourthly, long-term interest rates in major industrialized countries and emerging markets remained low. Although short-term interest rates around the globe continued to rise, mainly driven by successive Fed rate rises, the imbalances between savings and investment, excess liquidity in the financial system and other factors dragged down long-term rates, providing lower cost funding for the world economy.

Factors Affecting Global Financial Stability

Some uncertainties still exist despite the steady growth of world economy and finance. Currently financial authorities in most countries are particularly concerned about the impact of the following factors on global economic and financial stability.

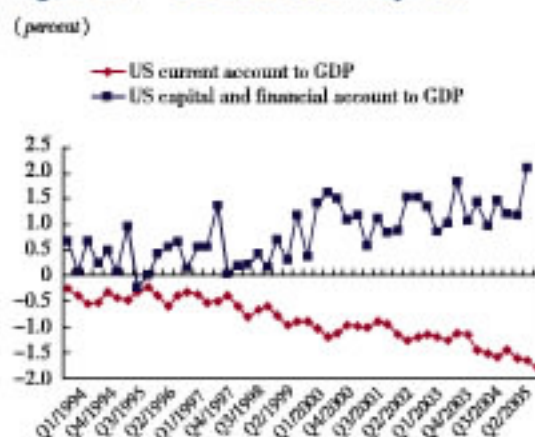
Global Imbalances

Global imbalances characterized by diverging growth rates among major countries, and global trade and current account imbalances remain serious problems. Among major industrialized countries, the US grew rapidly, and Japan recorded a stronger recovery while economies in the Euro zone recovered slowly. This lopsided pattern of growth is a risk factor to sustained and balanced development of the world economy. The Chinese economy grew at 10.2%, bracing global economic growth. The US economy and Chinese economy were the major engines of world economy in 2005.

In terms of growing trade and current account

imbalances, current account deficit of the US continued to expand, reached 6.4% of GDP in 2005 (Figure 2.1). Meanwhile trade surplus of Japan, Germany, oil exporting countries and some Asian emerging economies continued to expand—resulting in sharp increase of foreign exchange reserves (Table 2.1), and became the main source to make up the current account deficit of US. Continued global imbalances hurt not only the outlook of global economic growth but also normal economic and trade relations among countries.

Figure 2.1 US Balance of Payment



Source: International Financial Statistics, IMF.

Table 2.1 Emerging Economies and Developing Countries: Net Capital Inflow

(billions of USD)

	1995 – 97	1998	1999	2000	2001	
Change in Reserves	-103.9	-29.5	-101.3	-128.3	-128.1	
Current Account	-88.3	-49.6	42.9	128.6	90.5	
	2002	2003	2004	2005	2006	2007
Change in Reserves	-194.7	-351.6	-515.4	-580.2	-584.2	-562.3
Current Account	138.5	229.4	310.5	511.2	576.5	569.5

Note: Current account surplus and reserves of emerging economies and developing countries continued to increase (“ - ” refers to reserve increases in balance of payments); the figures of 2006 and 2007 are projections.

Source: World Economic Outlook, IMF, April 2006.

Global imbalances are rooted in low savings rates in the US and high savings rates in some other countries, including oil exporting countries and Asian countries. Although excessive savings by US corporate offset nearly half of the net debt increase by government and residents, and to a certain extent eased current ac-

count deficit, overall savings in the US remained negative and its economic growth highly dependent on other countries' savings as fiscal deficit continued to swell and personal savings rate dropped to negative between the second quarter of 2004 and first quarter of 2005 (Table 2.2).

Table 2.2 Flow of Funds between US and Other Countries and within US (to US GDP)
(percent)

	1952 - 82	1986 - 87	1952 - 2000	Q2 2004 to Q1 2005
Other Countries	-0.4	3.1	0.5	5.8
US Residents ¹	4.1	5.3	3.8	-3.3
US Companies ²	-1.7	-1.1	-1.3	1.7
Federal, State and Local Governments	-1.9	-5.3	-2.5	-4.2
Others	-0.2	-2.0	-0.4	0.0

Note: 1. US residents including residents and non-profit organizations;

2. US companies including non-agricultural and non-financial companies.

3. The combined percentage of US residential savings, corporate savings and government savings to US GDP equals to the percentage of other countries' savings to US GDP; US government fiscal deficit and residential debt increased between the third quarter of 2004 and the first quarter of 2005, with financing by other countries to the US accounting for 5.8% of US GDP.

Source: *Federal Reserve Flow of Funds*, quoted from *Global Financial Stability Report*, IMF, September 2005.

Adjustment of global imbalances will bring enormous impact. Although US has a mature financial market and financial globalization provides the country with more convenient financing channels and tools, the value of US assets for investment may eventually be questioned and challenged, and investors' willingness to continue to hold and purchase US financial products will be weakened, should its current account deficit continue to grow faster than GDP. Ceased capital inflow could result

in a weakened US dollar, shrinking consumption and investment, higher interest rates and financial market disturbances, which would jeopardize global economic and financial stability. The longer the global imbalances last, the greater the risks of sudden disorderly adjustment will be, which will severely damage the global economy.

In addition, as global imbalances exacerbate and developed countries become increasingly

concerned about competition from emerging economies, trade protectionism could once again re-emerged, along with trade frictions of all forms that have expanded from commodities trade to service and investment, sabotaging efficiency and flexibility of the world economy.

To address global imbalances is the shared responsibility of all countries requiring close coordination and concerted efforts by the US, Europe, Asia and oil exporting countries. The US needs to raise personal savings rate and reduce fiscal and trade deficit. Europe and Japan should continue to press ahead with economic restructuring to increase elasticity of the labor market. Asian countries need to increase public consumption (on pension, medical care and social safety net etc.), stimulate private consumption and make economic growth less dependent on export and investment. Oil exporting countries need to diversify their investment of petrodollars to avoid concentration in USD-denominated assets and increase investment in areas such as education and infrastructure.

Rising Prices of Oil and Other Commodities

Affected by demand side factors like larger holdings of strategic reserves by developed countries and increasing oil demand from emerging economies, low interest rate and excess liquidity, as well as speculation and supply side disturbances due to geopolitics and

broken supply chains etc., international oil price has soared since 2003, with WTI current month futures¹ closing at USD 61.04 on 30 Dec, 2005, a 44.9% increase over the year. IMF energy and non-energy price indices increased by 42% and 18% y-o-y respectively. Such price increases induced more pressure on global inflation and interest rates, and had some impacts on importing and exporting countries of these commodities, particularly oil. For oil importers, higher oil price leads to higher import cost, deteriorated terms of trade², depreciation pressure on the local currency and declining profit margins, falling consumption and asset prices, which in turn slows down economic growth. For oil exporters, oil price hikes bring in more export revenues; better terms of trade, increasing petrodollars, and appreciation pressure on the local currency, higher asset prices, increasing consumption and investment, and thus accelerate economic growth. Global interest rates were also lower as a result of larger supply of petrodollars. Heavy investment of petrodollars in US financial assets could support high consumption and low savings rate in US economy, which will exacerbate global imbalances and make adjustment of imbalances even more difficult.

Interest Rate Hike Cycle

Major economies in the world have entered a cycle of interest rate increases in 2005.

1 Refers to the month closest to delivery of a futures contract.

2 A recent IMF study suggests that US current account deficit directly caused by oil price hikes has accounted for more than 1% of US GDP since 2003. See *World Economic Outlook*, IMF, April 2006.

The Federal Reserve increased Fed Funds Target Rate to 4.25% through eight consecutive rate increase of 0.25 percentage points each. On December 1, ECB raised its main interest rate by 0.25 percentage points to 2.25% while Bank of Japan maintained its zero interest rate. The monetary authority of Thailand, Indonesia, the Philippines and others also increased official rates. Rate increases may slow down economic growth, change the direction that fund flows, reduce asset prices, increase interest rate risk and downgrade bank assets thus increasing systemic financial risk.

Excess Liquidity

Excess liquidity is a global issue. It leads to a flat yield curve (i.e. lower long-term bond yields), drives up prices of oil, other basic commodities, stock and real estates. Two major reasons for excess liquidity are the loose monetary policies in the US and Japan and high savings in Asian and oil exporting countries.

Excess liquidity is a global concern, with countries considering countermeasures that may squeeze global liquidity and lead to asset price adjustment. As the gap of GDP growth between different countries narrow gradually, monetary policy tightens globally and companies in G7 countries becoming less willing to save, pressure on interest rate hike will in-

crease and the direction of capital flow from European private capital, Asian foreign exchange reserves and petrodollar portfolios could change, leading to fluctuations of exchange rates between major currencies and foreign currency asset values. Research suggests that if the US dollar depreciates by 10% and results in liquidity squeeze globally, the wealth loss of foreign investors in the US stock and bond market could amount to 5% of these countries' GDP³.

China's Macroeconomic Performance

The Chinese economy grew in a sustained and healthy manner with greater stability in economic performance and enhanced coordination in economic development, creating a sound environment for financial stability in China. Meanwhile a number of deep-rooted structural and institutional problems, which affect economic development, persist.

The national economy maintained a sound momentum of steady and rapid development. Agricultural production was in good shape. Industrial production maintained steady and rapid growth. Businesses reported good profits. Industrial restructuring took positive turns. Corporate profitability continued to improve. Infrastructure for coal, power and transportation capacity was improved. Investment and

3 See Francis E. Warnock, "How Might a Disorderly Resolution of Global Imbalances Affect Global Wealth?", IMF Working Paper, WP/06/170.

net export demand remained strong. Consumption grew steadily. In 2005 GDP reached RMB 18.3 trillion yuan, an increase of 10.2% y-o-y. Residential income continued to increase rapidly together with rising employment; CPI fell slightly and production material prices stabilized. As foreign trade continued to expand rapidly, foreign exchange reserves made new highs. Financial system remained healthy and stable, while macroeconomic management has achieved positive effect. Reform in key areas continued. Fiscal revenue increased significantly, and people's living standards were raised further and new strides were made in social undertakings. China is accelerating its steps to change economic growth pattern in order to ensure that energy, resources and capital intensity is lower, knowledge and innovation are the primary driving forces and income distribution is becoming more equitable.

A sound monetary policy was further implemented. According to the overall plan of the CPC Central Committee and the State Council to strengthen and improve macroeconomic management, the PBC implemented a sound monetary policy, strengthened liquidity management within the banking system and policy coordination towards local and foreign currencies, adopted a variety of monetary policy tools such as open market operation, interest rate leverage and "window guidance"; maintained policy consistency and stability, focus on optimizing credit structure, create a stable monetary and financial environment for eco-

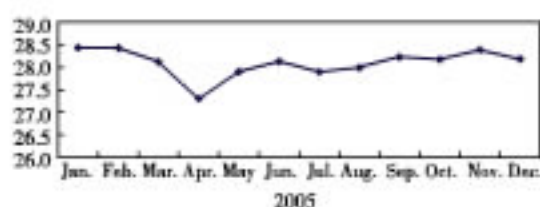
nomic restructuring and transformation of economic growth pattern.

RMB exchange rate regime was steadily reformed. After careful preparation and planning and with the approval of the State Council, the PBC announced that beginning from July 21, 2005 a managed floating exchange rate system based on market supply and demand and with reference to a basket of currencies was implemented and that RMB exchange rate was adjusted to RMB 8.1100 yuan per USD. The reform is of significant importance. Since July 21, the new exchange rate regime has run smoothly with RMB exchange rate stabilized in a reasonable equilibrium level. Business enterprises and commercial banks have become better able to hedge risk.

Favorable macroeconomic performance and sound macroeconomic policies have laid a solid foundation for financial stability. Meanwhile there were a number of salient issues with economic development, including excessive growth in fixed-asset investment, low consumption and imbalance between investment and consumption. Since 2002, y-o-y growth of fixed-asset investment has topped 20% (Figure 2.2) while consumption rate remained low. In 2005 China's final consumption accounted for 52% of GDP, much lower than 64%, Japan's low in the 1970s, and 70%, Korea's low in the 1980s. Higher investment and lower consumption exaggerated the imbalance.

Figure 2.2 Fixed-Asset Investment Growth Y-O-Y (2005)

(percent)



Source: CEIC.

Impact of International and Domestic Macroeconomic Performance on Financial Stability and Policy Response

Favorable macroeconomic environment, both international and domestic, facilitated financial stability in China. Meanwhile factors that affect China's financial stability need be watched closely and policies and measures need to be taken to safeguard it.

Global Economic and Financial Risks

As the Chinese economy and finance sector is becoming more open to the outside world, global financial risk will inevitably affect China's financial stability, particularly in the following ways.

First, global imbalances and potential adjustment will affect financial stability in China. Emergent situations, including regional conflicts, terrorist attacks, drastic fall in the supply of oil and other resources as well as strengthening trade protectionism, all could change the global asset allocation pattern, and trigger rapid adjustment of global imbalances. Such adjustment could cause huge fluctuations of major currencies, if they happen in a very rapid manner. An economic slowdown and asset price adjustment in US could have some impact on China's economic and financial stability.

Second, volatile energy prices such as oil price will affect financial stability in China. In 2005 China imported over 40% of its oil consumption. As domestic subsidies will not last in the long term, the impact of international oil price increase will affect production and eventually increase domestic inflationary pressure. In addition, changing supply and demand of oil and other resources will cause changes in production capacity, and thus affecting sustained and healthy development of the economy as well as the financial stability.

Third, the global trend of rising interest rate will exert twin effects on financial stability in China; on the one hand, rising rates in the US, Europe and Japan will help divert liquidity away from China; on the other hand, as the cycle of interest rate rise in US ends, and followed by rate hike in other major economies, the dollar might weaken and subsequent reduction of dollar-denominated international capital could increase capital inflow to China.

Fourth, international liquidity will pose threat to China's financial stability. As international liquidity flows to China via various balance of payment channels, inflationary pressure and asset prices could increase, adding potential systemic risk.

Structural Problems in the Economy

Structural economic problems are the major reason behind excessive growth in fixed-asset investment and external imbalance, and if left unchecked, could exaggerate economic volatility, undermine sustained and healthy development of the economy, push up real estate prices and increase potential inflationary pressure, jeopardize the quality of credit, increase financial risk.

The most outstanding consequence of structural economic problems is the excessive reliance of Chinese economic growth on investment and export, as well as the imbalances between investment and consumption. Such problems are connected with industrialization, urbanization and development of the market economy as well as the current economic growth pattern, economic structure and efficiency. Furthermore, the low interest rate environment as well as local governments' investment enthusiasm and banks' willingness to lend has exacerbated the imbalance.

Unbalanced growth of investment and consumption has become a major problem affecting coordinated and smooth economic development. On the one hand, low consumption leads to high savings and investment rates, making economic growth mostly depend on

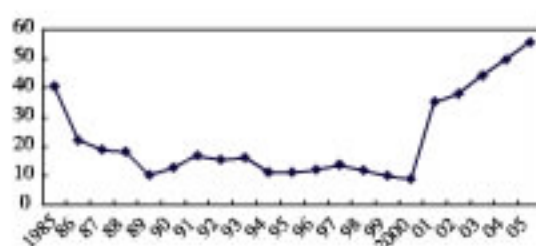
investment, and certain industries continued to expand aggressively, and thus obstacles the structural transformation of China's economic growth from sheer capacity expansion to one driven more by efficiency improvement. On the other hand, as consumption ratio (as % of GDP) continues to drop such that savings ratio being higher than investment ratio, trade surplus occurs. Moreover, the problem is self-perpetuating. While low consumption ratio results in high investment ratio and rapid capacity expansion, domestic demand will not be strong enough to digest all excess capacity which leads to more exports and trade surplus. Expanding trade surplus in turn causes excess liquidity and stimulates investment, and cuts the consumption ratio further, thus restraining the development of service industry. As the problem grows bigger, the economy moves further away from its equilibrium, making macroeconomic management and financial stabilization even more difficult.

Balance of Payment Surplus and Excess Liquidity

China has been experiencing continued balance of payment surpluses in recent years. While adding on to the accumulation of foreign exchange reserves, the surplus also has negative impact on the economy and finance system. Firstly, given the strong economic growth and investment demand, balance of payment surplus is becoming the funding source for investment through foreign exchange surrender, thus weakening the effect of credit policies and making macroeconomic management less proactive and effective. Sec-

ondly, with excess liquidity on the market, real interest rate becomes lower, fuelling investment and credit expansion, which in turn leads to potential rise in NPL and a more vulnerable banking system. Thirdly, the strong foreign capital inflow also lifted the prices of domestic assets (including stock and real estates), which in turn increases inflationary pressure. In case of the fall in asset prices after being overshoot, it could create a negative wealth effect on households and enterprises, which could add more non-performing assets to the banking system. Fourthly, balance of payment surplus could lead to increasing trade frictions. Finally, the balance of payment surplus could lead to stronger expectation for RMB appreciation, which in turn triggered domestic enterprises to borrow more short-term foreign debt to finance their activities (Figure 2.3) – which could increase related financial system risks.

Figure 2.3 Percentage of Short-Term Foreign Debt to Total Foreign Debt
(percent)



Source: SAFE.

Balance of payment surplus and excess liquidity are mutually reinforcing forces. The balance of payment surplus is an important contributor to excess liquidity; one direct outcome of rapid accumulation in foreign exchange reserves is increasing RMB equivalent of foreign exchange reserves in the balance sheet of the central bank. In turn, the central bank has to supply more base money passively to accommodate the inflow of foreign currency, which reduces the room for independent monetary policy operation and increases liquidity in the financial system. Excess liquidity in turn drives investment growth, and money and credit supply, thus exacerbating existing imbalances.

The ways through which balance of payment surplus and excess liquidity affect financial stability are as follows: Firstly, higher interest rate risk. Excess liquidity in the money market leads to lower interest rate, consistently falling current asset yield and inverted yield curve (i.e. long-term interest rates lower than short-term rates), which combine to erode banking system efficiency and profitability. Secondly, credit expansion and greater credit risk. To maintain their profitability, commercial banks are keen to lend out more money in face of this excess liquidity. In turn, return on assets of these projects may not be very high, thus raising the credit risk of banks financing them. Thirdly, excessive investment. Excess liquidity exacerbates overcapacity and triggers deflationary pressure and escalating trade frictions. Meanwhile, massive new capacity could cause profits to fall in related industries, thus threatening the credit

quality of loans to them. Fourthly, rising inflationary pressure and asset prices. Excess liquidity increases potential inflationary pressure and pushes up asset prices (including real estates), leading to an over-heated economy and lower efficiency on investment and in turn mounting financial risks.

Overall, excessive growth in fixed asset investment and enormous balance of payment surplus are intertwined and mutually reinforcing problems. Bloated investment represents greater demand on bank loans; excess liquidity in banks, which bolsters undue investment growth, is closely related to increasing "twin surplus" in the balance of payment and RMB equivalent of foreign exchange reserve; as investment expands, overcapacity emerges in certain industries, resulting in higher export and larger trade surplus. The consequences of these problems, if left unattended, will lead to grave results; imbalances in economic development will be exacerbated, particularly between investment and consumption; industries with overcapacity may embark on another round of expansion, creating more NPL and greater financial risks; bottlenecks in sectors like coal, power and transportation capacity, which have just been eased recently, may resurface. Pressure on natural resources and the environment may further increase; imbalances in the balance of payment and trade frictions may escalate, pressuring the RMB to appreciate. It will be difficult to achieve healthy and sustainable socio-economic development under such circumstances. As China is increasingly involved in global economic and financial activities, these issues will represent greater pressure and poten-

tially adverse impact on China's banking sector and financial stability.

To safeguard financial stability in China and promote smooth and healthy economic and financial development, proactive measures need to be adopted to accelerate economic restructuring, and allow macroeconomic management policies including monetary policies, exchange rate policies and fiscal policies to have their desired impact; Firstly, steps need to be taken to push forward economic restructuring and transformation of growth pattern. Consumption will continue to be encouraged, imports further increased and measures to stimulate domestic demand implemented to alleviate aggregate and structural problems and promote sustained and coordinated economic development. Secondly, open market operation will be strengthened to regulate liquidity in the banking system in a flexible manner. Thirdly, the role of fiscal policies will be fully utilized with greater efforts in transforming public finance and increasing spending on social development, education, medical services and social security and supply of public goods. Fourthly, the new RMB exchange rate regime will be given room to fully develop. Exchange rate policies will be deployed based on internal and external economic conditions to give the RMB exchange rate a bigger role in regulating economic behaviour. Potential impact of gradually increasing flexibility in RMB exchange rate on macro economy and financial stability will be monitored, and enhancing capability of key market participants, such as financial institutions, businesses and residents, to cope with exchange rate risks. Fifthly, implementation of the "go

abroad" strategy will be sped up. On the basis of ensuring adequate liquidity of reserves for international settlement, market-based, multi-tiered and diversified measures will be adopted to establish channels for overseas investment. Sixthly, monitoring and management of cross-border capital, especially short-term capital, will

be intensified with focus on capital flows in real estate, personal foreign exchange transactions, cross-border connected transactions and offshore accounts. Monitoring and warning systems related to cross-border capital flows will be established and improved.

Box 1 Paying Attention to Potential Financial Risks Resulted from Real Estate Market Volatility

Since 2004, the state has launched a series of measures including industrial policy, tax policy and credit policy in response to excessive increase in real estate investment and housing price. In 2005 y-o-y growth of housing area under construction, housing area completed and commercial housing area sold were all stabilized at around 20% (Figure 2.4); in 2005 purchased land area and developed land area also reached historic lows. In some months, the developed land area was actually declining (Figure 2.5).

Figure 2.4 Growth Rates of Housing Supply and Demand in 2005



Source: The PBC.

Figure 2.5 Growth Rates of Purchased Land Area and Developed Land Area in 2005

(percent)



Source: The PBC.

By the end of 2005, quality of real estate loans by 16 commercial banks⁴ had improved. The outstanding real estate loans of these 16 banks was RMB 1.0291 trillion yuan, an increase of RMB 39 billion yuan y-o-y; balance of NPL to real estate companies were RMB 91.6 billion yuan, down by RMB 18.2 billion yuan y-o-y; loans to real estate companies accounted for a smaller proportion of the portfolio of state-owned banks and joint stock banks; NPL ratio of 16 commercial banks to real estate companies stood at 8.90%, down by 2.19 percentage points y-o-y.

As personal housing loans accounted for more than 90% of personal consumption loans, it can be regarded as financing the demand in the real estate market. By end 2005, balance of personal consumption loans at 16 commercial banks were RMB 2.0258 trillion yuan, an increase of RMB 177.2 billion yuan y-o-y; balance of non-performing personal consumption loans stood at RMB 51.8 billion yuan, an increase of RMB 18.4 billion yuan y-o-y; NPL ratio stood at 2.55%, up by 0.75 percentage point y-o-y.

Given soaring housing price and significant growth in credit related to real estate, potential financial risks from real estate market volatility deserved close monitoring; First-

ly, risk of macroeconomic fluctuations. Re-adjustment on the real estate market will affect investment and consumption respectively through Tobin's Q effect and wealth effect, thus exerting negative impact on economic growth and financial stability. Secondly, risk of falling real estate price and real estate credit quality. While attaching high importance to the collateral value of real estate in their lending decisions, commercial banks are rather slack in examining the creditworthiness of the borrower. If the real estate enters into a downmarket, drastic fall in housing price could reduce the collateral value of properties held by banks substantially and the banks' proprietary capital. Reduction of bank capital will force the banks to cut their credit exposure to the real estate sector, which leads to further decline in real estate price. Thirdly, risk of credit losses. Given the high proportion of real estate loans and lack of financial products as asset-backed securities in domestic market, falling real estate price may transmit the risks of real estate market volatility to the banking system, leading to bad loans from banks offering financial services to real estate activities.

In short, considerable investment and speculative demand existed in the housing mar-

4 The 16 commercial banks include the "big four" (ICBC, ABC, BOC and CCB) and 12 joint stock commercial banks (Bank of Communications, CITIC Bank, China Everbright Bank, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Corporation, Evergrowing Bank and China Zheshang Bank).

ket, since a lot of housing need of the society remains unsatisfied. Therefore, macro-economic management policies need to be

consistent with controlling speculation on real estate and improving transaction systems regarding the real estate market.

(First by Yang Lihui, Zhao Zengde, Yan Xiandong, Liu Ke,
Wu Ge and Qian Shichun; Finalized by Sun Tao)



Chapter III

Banking Sector

A critical year for China's banking sector reform, 2005 ended with gratifying results; major headway was made in the shareholding reform of SOCBs; obvious effects were recorded in the RCCs reform; reform of banking institutions including small- and medium-sized JSCBs and city commercial banks went on smoothly; substantial financial risks in the banking sector were mitigated and the basis on which the industry may operate smoothly was consolidated. With the reform, China's banking system runs well, registering better business performance, improved asset quality and much higher CAR. Corporate governance was further improved and resilience to risks enhanced.

Recent Developments

Financial institutions and systems within the banking sector have been steadily improved. As of the end of 2005, banking institutions included 3 policy banks, 4 SOCBs, 12 JSCBs, 115 city commercial banks, 599 UCCs, 27,036 RCCs, 60 rural cooperative banks, 12 rural commercial banks, 4 AMCs, 59 TICs, 74 finance companies, 12 finance leasing corporations, 5 auto finance companies and numerous postal savings institutions.

Overall assets, outstanding deposits and loans grew steadily. As of the end of 2005, total assets of Chinese banking institutions within PRC reached RMB 37.5 trillion yuan, an increase of 18.6% on the year-on-year ba-

sis; total liabilities reached RMB 35.8 trillion yuan, an increase of 18.1% on the year-on-year basis; the total outstanding loans in both domestic and foreign currencies stood at RMB 20.7 trillion yuan, an increase of 12.8%; the total outstanding deposits in both domestic and foreign currencies stood at RMB 30.0 trillion yuan, an increase of 18.2%.

Comprehensive capacity in profit-making improved. In 2005 the banking sector featured much sounder performance. The overall profitability of 4 SOCBs and 12 JSCBs exceeded that in 2004 by a big margin, with substantial profits increase from domestic business; realized pre-provisioning profits reached RMB 257.3 billion yuan, an increase of RMB 47.02 billion yuan or 22.36% y-o-y; pre-provisioning return on equity reached 26.10%, with 23.73% for 4 SOCBs and 36.42% for 12 JSCBs.

"Double decline" of both outstanding NPL and NPL ratio was achieved, bringing much better asset quality. As of the end of 2005, according to the five-category classification, NPL of 4 SOCBs and 12 JSCBs stood at RMB 1.21966 trillion yuan, a decrease of RMB 498.58 billion yuan y-o-y; NPL ratio stood at 8.9%, a decrease of 4.3 percentage points over the end of previous year. It was the fourth consecutive year registering "Double decline" after 2002, 2003, and 2004. The decline can be attributed to two reasons: first, with tighter loan management, authorization and credit extension management and loan review, banks were

able to prevent new NPL; second, some banks disposed of large quantities of non-performing assets in the process of financial restructuring.

CAR increased rapidly and risk resistance capability became stronger. As of the end of 2005, net capital of 4 SOCBs and 12 JSCBs increased by RMB 673.698 billion yuan over the end of previous year, of which paid-in capital increased by RMB 157.200 billion yuan over the end of previous year. The number of SOCBs, JSCBs and city commercial banks meeting the new CAR requirement of CBRC went up from 30 at the end of 2004 to 53 at the end of 2005. The percentage of assets of banks meeting CAR requirement in the banking sector total increased from 47.53% at the end of 2004 to 75.1% at the end of 2005. Provision coverage of 4 SOCBs and 12 JSCBs was higher than that in 2004. As of the end of 2005, shortfall in provision decreased by RMB 322.303 billion yuan over the end of previous year, with provision coverage for 4 SOCBs standing at 21.48%, up by 11.66 percentage points over the end of previous year, that for JSCBs 53.39%, up by 8.13 percentage points over the end of previous year.

The banking system had excess liquidity. In 2005, 4 SOCBs and 12 JSCBs enjoyed sufficient liquidity. Except for ABC whose liquidity was lower than the 25% threshold in the second and fourth quarters (24.25% and 23.03% respectively), liquidity of other 15 commercial banks was above the threshold all the time.

Achievements of Banking Sector Reform

Major Progress in Shareholding Reform of SOCBs

In 2005 the pilot program on shareholding reform of wholly SOCBs progressed steadily. Upon completion of financial restructuring and shareholding reform in 2004, BOC and CCB continued to improve corporate governance in 2005 by enhancing internal control and risk management and accelerating the introduction of strategic investors and IPOs. CCB introduced Bank of America and Singapore's Temasek Holdings, and BOC introduced four strategic investors including Royal Bank of Scotland Group. CCB got successfully listed in Hong Kong on October 27. Pilot program on shareholding reform of ICBC was launched during the first half of 2005 and has run smoothly since then. On April 22, the State Council approved China SAFE Investments Limited ("China SAFE") to inject USD 15 billion into ICBC; at the end of June, ICBC disposed of its non-performing assets through market-based methods, and the financial restructuring was basically finished; on October 28, Industrial and Commercial Bank of China Limited was established with the MOF and China SAFE as its initial shareholders each holding 50% of the shares. ICBC has been implementing the shareholding reform by improving corporate governance and strengthening internal control since the recapitalisation.

Since 2005, three pilot banks, namely BOC, CCB and ICBC, have made significant progress in improving corporate governance, enhancing internal control and risk management systems. First, the identity of state-owner of pilot banks was explicitly highlighted. In performing their duties as shareholders, MOF and China SAFE have assigned directors and supervisors to the pilot banks according to the law, beginning to play a substantial role in SOCBs' corporate governance. Second, a basic framework of corporate governance structure was established. Benchmarking modern financial enterprise systems, mechanisms featuring elaborate division of duties, effective checks and balances and coordinated operation among the board of directors, board of supervisors and management of the pilot banks have been established and the governance system began to take effect. Third, internal control and risks management were enhanced. The three banks accelerated the implementation of internal control and risk prevention program such as data integration and internal credit rating and conducted vertical integration of internal control systems including audit, asset protection and credit extension. As a result of the proactive reform of risk management systems, a relatively independent internal control system and sound risk prevention system have taken shape. Fourth, internal resources were better integrated through reform and synergy. Having completed reform at the head office level, the banks provided their branches with detailed plans on various reform measures, demanding organization and management restructuring, thus deepening reform to the fundamental lev-

el. Fifth, accountability was established and the responsibility investigation was improved. While resolving NPA, each of the banks established a sound accountability system where noncompliant employees were held accountable and penalized so that losses were minimized and moral hazards prevented. Meanwhile senior managers were recruited with a view to building stronger teams. Sixth, while the state remained the controlling shareholder, strategic investors were introduced in the principle of reciprocity and win-win cooperation on management, technology and business so as to improve the banks' corporate governance framework and overall managerial skills. Seventh, financial innovation was pushed forward and service improved. The pilot banks steadily explored and pressed ahead comprehensive operation by adopting several measures aiming at improving business competitiveness and service levels. For instance, ICBC and CCB, two pilot commercial banks that set up fund management companies in 2005, formed joint venture fund management companies with established international institutions and launched their first fund product with the sizes of issuance standing at RMB 4.875 billion yuan and RMB 6.254 billion yuan respectively. Eighth, with successful public offerings and listings, the value of state-owned assets was well maintained and improved. CCB issued 30.5 billion new shares at HKD 2.35 per share on the Hong Kong Stock Exchange, raising HKD 71.58 billion (USD 9.23 billion). As the largest IPO ever managed by a Chinese business and in the banking sector around the world, the offering reached even exceeded international

banking average in terms of issuance price, P/B and P/E. As all CCB shares held by its sponsors including China SAFE were transferred into H shares upon listing, the bank became the first Chinese company that went public with full-circulation H shares, creating enormous added value for its state shareholders.

After restructuring, all three pilot banks enjoyed much better financial indicators including CAR, asset quality and profitability, and demonstrated strong financial sustainability. As of the end of 2005, CAR for BOC, CCB and ICBC stood at 10.42%, 13.57% and 9.89% respectively, all exceeding that required by New Basel Capital Accord. In terms of asset quality, NPL ratio of the three banks dropped to 5.41%, 3.84% and 4.69%; NPL provisioning coverage ratio stood at 81.07%, 64.33% and 101.23%; and block risk concentration stood at 3.31%, 6.9% and 5.48%, basically compliant with the supervision requirement. In terms of profitability, net return on total assets for the banks stood at 0.70%, 1.11% and 0.59% respectively,

close to international best average level.

The shareholding reform of SOCBs has significantly improved financial stability in China. By the end of 2005, the assets of SOCBs, the main body of China's banking sector, accounted for 52.5% of the banking institutions' total assets, indicating great influence on China's financial stability. With financial restructuring, SOCBs' NPA ratios declined dramatically while NPL provisioning coverage ratios increased rapidly and CAR up to international standards, which combined to mitigate existing financial risks. With enhanced governance, the structure and mechanism of modern corporate governance have been established within SOCBs, making the banks qualified players. As the banks went public, stringent accounting standards, regulatory standards and disclosure policies were upheld, thus operational risks of SOCBs were better monitored and disciplined by the market, resilience to financial risks was improved and international competitiveness was enhanced.

Box 2 Shifting Sovereign and Banking Sector Rating for China by International Rating Agencies

Credit rating represents comprehensive assessment of the ability of individuals, economies and financial instruments to undertake economic commitments and the credibility of each. Rating agencies vary in their rating scale and system. For instance, Standard &

Poor's rates "high quality" long-term bonds are AA+, AA and AA- while Moody's are Aa1, Aa2 and Aa3. The maximum rating that may be assigned to securities issued outside the US is the sovereign rating of the country where they were issued. While as-

signing ratings to companies, rating agencies mainly consider such factors as solvency. When it comes to sovereign rating, political, social, cultural and other qualitative factors need also be considered, such as “stability of political situation, social and economic cohesion, integration with the world economy”, etc.

Based on concerns about potential financial crises resulted from high NPL ratios and poor corporate governance with China's banking sector, international rating agencies rated the banking sector very negatively before 2003. Between late 2002 and early 2003, NPA of SOCBs was an issue followed closely by foreign media. A number of established financial magazines and newspapers, including *TIME Magazine*, *Business Week*, *Economist* and *Far Eastern Economic Review*, all had heavy coverage of NPA in China, estimating NPL ratios with SOCBs to be 50% or more and arguing that such issues as constantly high NPL, ill-defined government and business functions, structural problems and poor internal management might trigger financial crises any time. That S&P cut all banks on the Chinese mainland to junk status in November 2003 and caused quite a sensation.

The shareholding reform of SOCBs launched in 2003 recorded well-recognized achievements, and was followed by increasingly higher ratings by internationally established rating institutions for the banks under restructuring. With the reform, SOCBs have improved remarkably not only in fi-

nancial indicators but also in corporate governance, risk control and operational mode. As a result, many credit rating institutions raised the rating of BOC, ICBC, CCB and BOCOM. In September 2005, S&P announced that the credit rating of BOC, ICBC and CCB be raised from BBB- to BBB+ and for BOCOM from BB+ to BBB- based on expectations about government support, injection of foreign reserves and banking reform. S&P made a special mention that the adjustment for BOC, CCB and ICBC reflected improvement in the financial strength and risk management of the three banks that had happened as they were preparing for IPO. Later Fitch Ratings and Moody's also announced rating rises for BOC, CCB and ICBC.

The shareholding reform of SOCBs produced spill over effect on the reputation of other domestic banks. On the one hand, expectation of further banking reform and improvement in overall soundness and performance, certain rating agencies raised the rating of a number of banks yet to be restructured. In 2005 S&P raised the rating of ABC alongside the ratings for banks reformed; Fitch Ratings also raised the “support” rating of ABC to 1 (i. e. the probability of the government's future support of ABC is 100%). In its *Outlook of China's Banking Sector 2006*, Moody continues to hold a stable to positive outlook for the fundamentals of the industry, convinced of the momentum for further growth.

On the other hand, many rating agencies raised sovereign credit rating for China based on the achievements of its banking sector reform. In 2005 S&P announced official upward adjustment of China's sovereign credit rating in light of positive reform by the Chinese government of the financial industry and improved SOE profit margins. Fitch declared that it would raise the long-term foreign currency rating of China from A- to A, the 6th highest

grade/status in Fitch's rating system, thus bring China's foreign currency rating to the same level of Chile, Greece and Korea. In July 2006, S&P further raised China's long-term sovereign rating from A- to A in the belief that China had been working hard to strengthen its banking system to reduce future fiscal burdens while persistent market-oriented economic reform had generated brightful economic growth.

Continued Rapid Development of JSCBs

In 2005, JSCBs improved corporate governance and internal control regime through restructuring, capital injection and the introduction of foreign strategic investors, thus maintaining rapid development. By the end of 2005, total assets of 12 JSCBs stood at RMB 5.81252 trillion yuan, up by 23.7% over the end of previous year, total liabilities stood at RMB 5.60443 trillion yuan, up by 23.5% over the end of previous year; NPL ratio reached 4.22%, down by 0.74 percentage points; provision balance reached RMB 89.773 billion yuan; average CAR amounted to 7.42%, up by 0.83 percentage points y-o-y; annual realized profits reached RMB 44.556 billion yuan, up by 38.67% y-o-y.

The shareholding reform of BOCOM has begun to take effect, reflected in increasingly diversified ownership structure, corporate governance and major financial indicators approaching domestic average level. On June 23, 2005, BOCOM was successfully listed on

Hong Kong Stock Exchange.

Remarkable Results for RCCs Reform

Approved by the State Council, in 2003, eight provinces and municipalities, namely Jilin, Shandong, Jiangxi, Zhejiang, Jiangsu, Shaanxi, Guizhou, and Chongqing, launched pilot program of RCCs reform. In 2004, RCCs reform was expanded to 21 provinces, autonomous regions, and municipalities including Beijing, Tianjin, and Hebei. In 2005, pilot program of RCCs achieved deepening reforms, with stable development of various businesses, improved operation, enhancement of asset quality and improved capability in supporting agriculture and farmers.

First, RCCs reform was fully carried out in 29 provinces, autonomous regions, and municipalities nationwide with smooth progresses and impressive achievements.

Second, policy supports from central and local governments enabled RCCs to make positive

steps forward in shaking-off burdens and mitigating risks. By the end of 2005, NPL balance of RCCs nationwide stood at RMB 32.55 billion yuan, down by RMB 125.9 billion yuan y-o-y; NPL ratio stood at 14.8%, a decline of 8.3 percentage points over the end of 2004 and 22.1 percentage points lower than the end of 2002.

Third, Assets quality of RCC was improved by a large margin and their profitability went stronger. As of the end of 2005, there were 27,036 RCCs nationwide (lowered by 5,818 over the end of previous year) with a total asset of RMB 2,771.612 billion yuan, a total liability RMB 2,657.911 billion yuan, average CAR 8.97%, and profit of RMB 10.790 billion yuan for the whole year, a y-o-y increase of RMB 5.196 billion yuan.

Fourth, Efforts were made to integrate institutions, pilot program of founding rural banking institutions have been launched, and new steps have been endeavored in the field of ownership system and operation mechanism. New ownership systems such as joint stock mode and share holding cooperation mode were introduced; new ownership organization form such as rural commercial bank, rural cooperative bank, and prefecture city-level institutions were also established on a pilot basis. As of the end of 2005, 72 rural banking institutions were established in China, including 12 rural commercial banks and 60 rural cooperative banks, and applications for another nine rural cooperative banks have been approved. 519 prefecture city-level institutions have been founded.

Fifth, vigorous exploration has been made in management system to transfer business operation and risk management of RCCs to provincial governments. By the end of 2005, RCCs united at provincial level have taken shape in 25 provinces, autonomous regions, and municipalities nationwide.

Thanks to reforms, the capabilities of RCCs to support agriculture and farmers were greatly enhanced, credit extended to farmers and agriculture sector significantly increased, and services to farmers were further improved. Outstanding agriculture loans of RCCs nationwide reached RMB 1,007.1 billion yuan, an increase of RMB 449.2 billion yuan or 80.5% over the end of 2002, including RMB 798.3 billion yuan loans to rural households, 79.3% of agriculture loans, an increase of RMB 374.6 billion yuan or 88.4% over the end of 2002. More than 70 million rural households have received supports, which accounted for 32% of all rural households in China.

Formal Launch of Postal Savings Institutions Reform

In August 2005, Chinese government launched postal savings institutions reforms, of which reform of postal savings institutions management system and realization of standardized operation of postal financial businesses were core contents. At present, relevant parties are steadily pushing ahead postal savings institutions reform according to the master plan of postal system reforms.

The original mode of re-depositing all postal

savings institutions to central bank has been altered. Guided by relevant authorities, postal savings institutions have gradually realized independent determination of utilities and smooth transition. August 1, 2003 was taken as the demarcation line; current policies regarding re-deposit of postal savings at central bank remained unchanged before August 1, 2005, and utilization of new deposits were determined by postal savings institutions independently. Original deposits of postal savings at central bank would be drawn out in five years after August 1, 2005. As of March 21, 2006, three batches of deposits have been drawn out with a total of some RMB 62.2 billion yuan. The process was stable and orderly, casting no big impact on business operation of postal savings institutions.

We shall continue to expand the scope of utilization of postal savings deposits. Capabilities of independent use of postal savings funds have been enhanced together with the gradual drawn-out of old re-deposits. Postal savings institutions explored to introduce small-volume loans secured by pledge and improve the quality of their services to agriculture, farmers, and rural areas by taking advantage of rural financial reforms. In December 2005, CBRC approved postal savings institutions to launch pilot program of micro loans backed by fixed-term certificate of deposit in Shaanxi, Fujian, and Hubei to satisfy the capital demand of rural areas and rural households.

Sound Growth Momentum for City Commercial Banks

As of the end of 2005, 115 city commercial

banks had a total asset of RMB 2,036.69 billion yuan, 19.4% increase over the end of previous year; total liability of RMB 1,954.02 billion yuan, 18.6% increase over the end of previous year; NPL ratio of 7.73%, down by 3.96% over the end of previous year; owners' equity RMB 82.67 billion yuan, 43.58% increase over the end of previous year; a weighted average CAR of 5.13%, increase of 3.82 percentage points over the end of previous year; and profit of RMB 12.073 billion yuan for the whole year, an increase of 38.12% y-o-y.

In recent years, city commercial banks have played a positive role in providing financial services to urban citizens, meeting financing demands of SMEs, and pushing forward urban economic construction. In 2005, city commercial banks continued to bring into play their institutional advantages of flexible operation mechanism and relatively large number of outlets, attached great importance to risk prevention, strengthened business management, promoted reform and innovation, carried out merger and restructuring, explored road of development under new situation in an active manner, and achieved gratifying results in various aspects. As for internal management, some city commercial banks have adopted standard corporate governance framework and made beneficial efforts in introducing foreign strategic investors and advanced managerial expertise of foreign banks. As for merger and restructuring, some city commercial banks have carried out some actively endeavors. At present, over 40 city commercial banks and UCCs in seven provinces and mu-

nicipalities are planning to carry out merger and be restructured into new banks. As for risk disposal, city commercial banks have consecutively launched comprehensive disposal projects with major contents of assets spin-off and swap, recapitalization, corporate governance, and improvement of internal control mechanisms and achieved certain effects. They have gradually improved risk monitoring and warning system and vigorously explored various effective market-based disposal methods. After reform and development in the past year, CAR and liquidity ratio of some city commercial banks improved a lot and overall competitiveness is further enhanced.

Results of UCCs Restructuring and Reform

In 2005, relevant authorities, together with local governments, continued to push ahead restructuring of UCCs, deepen reforms of UCCs, and improve market exit mechanism. At present, some achievements have been attained in the compliant restructuring of rectified UCCs, classified disposal of unrectified UCCs, and market exit of closed-up UCCs. In 2005, 82 UCCs were cancelled via classified disposal, including 14 by restructuring, 9 by merger and restructuring of sole legal person entities, 2 by renaming and restructuring to RCC, 35 by acquisition by commercial banks and sole legal person entities, 21 by market exit, and 1 by revocation.

As of the end of 2005, there were 599 UCC legal person institutions with another 111 UCCs cancelled but not yet quitted. Among

599 UCCs, 328 were still in operation (including 66 sole legal person entities and retained institution after rectification and 262 unrectified institutions) while 271 have stopped operation for shake-up. 66 sole legal person entities and retained institutions had a total asset of RMB 143.295 billion yuan, a total liability RMB 138.196 billion yuan, including saving deposit balance of RMB 57.757 billion yuan; book owners' equity of RMB 2.957 billion yuan, actual CAR 3.72%, and an after-tax profit RMB 653 million yuan for the whole year. 262 institutions waiting for disposal had a total book asset of RMB 43.251 billion yuan, a total liability of RMB 45.945 billion yuan, including saving deposit balance of RMB 30.383 billion yuan.

Smooth Operation of Policy Banks

In 2005, three policy banks continued to carry out national industry policies, foreign economic and trade policies, and macroeconomic management policies and played important roles in promoting strategic adjustment of economic structure, alleviating bottleneck effects in economic development, protecting and enhancing the fundamental position of agriculture, stimulating development of agriculture and economy in rural areas, enhancing the international competitiveness of Chinese enterprises and exports, and accelerating the development of open economy. By the end of 2005, three policy banks had a total asset of RMB 2.93 trillion yuan, an increase of RMB 516.08 billion yuan or 21.4% y-o-y and a book profit of RMB 27.406 billion yuan for

the whole year, RMB 14.315 billion yuan more than the previous year. At present, all three policy banks are strengthening internal reform and risks control to improve assets quality. Meanwhile, relevant departments are studying next steps of reform plans for policy bank reform in accordance with the unified planning of the State Council.

Specialized Role of Financial Asset Management Corporations in Asset Disposal

In 2005, four AMC's conducted specialized and market-based disposal of NPA via various means with the policies and measures granted by the government, and continued to play positive roles in mitigating financial risks, promoting reforms of banks and SOEs, maintaining social credit order, and protecting state-owned assets. In 2005, four AMC's all achieved sound performance in asset disposal and business operation; first, disposal of claim assets of policy origin came to the final stage. As of the end of 2005, aggregate volume of disposed and strip-off assets of policy origin of four AMC's amounted to RMB 839.75 billion yuan (policy debt-to-equity excluded), an increase of RMB 164.69 billion yuan over the end of previous year; accumulated volume of recovered RMB 176.6 billion yuan in cash, up by RMB 39.6 billion yuan with an overall cash recovery ratio of 21.03%. Second, commercial acquisition and disposal businesses have been launched in an all-round manner. Following acquisition of NPL of BOC, CCB, and BOCOM in 2004, four AMC's acquired doubtful loans of ICBC with a total volume of RMB 459 billion yuan

through bidding in 2005. In addition, four AMC's also carried out some pilot programs of small-scale commercial acquisition, for instance, China Huarong AMC acquired RMB 400 million yuan NPL from CMB, China Great Wall AMC acquired RMB 200 million yuan NPL from Huaxia Bank, and China Cinda AMC acquired RMB 3 billion yuan NPL from Bank of Shanghai. As of the end of 2005, four AMC's had purchased a total volume of RMB 806 billion yuan NPL from commercial banks based on commercial principles, disposed of RMB 20.64 billion yuan, and recovered RMB 14.05 billion yuan in cash (the doubtful assets pack of CCB sold to China Orient Assets Management Corporation by China Cinda Assets Management Corporation excluded). Third, liquidation custodian business grew rapidly. China Huarong AMC continued with the disposal of all risk assets of Delong in the way that it provided custodian over some of the high-risk financial leasing companies, TICs and securities companies of Delong. China Orient AMC and China Cinda AMC put some high-risk securities companies and leasing companies under their custodian. At present, relevant departments are vigorously studying future reform plans of four AMC's.

Key Areas to Focus on in Developing the Banking Sector and Reform Measures

In 2005, reforms of SOCBs attained remarkable results and major financial risks in banking sector have been basically mitigated; howev-

er, there were still many problems to focus on, for example, long-term, complex and demanding nature of shareholding reforms of SOCBs, risk prevention and mitigation of small- and medium-sized financial institutions, imbalanced financial development between urban and rural areas, and in-depth conflicts of rural financial systems. The impacts of external environment on banking sector have become more and more extensive, and credit risks, market risks, operational risks faced by banks should not be neglected, because these are all major factors hindering healthy development of banking sector. Going forward, confronted with the increasing fierce international competitions after accession to WTO and new challenges facing China's banking sector in the socialist market economy reforms, banking sector should follow the specific goals of accelerating financial mechanism reform set forth in the *Eleventh Five-year Program for National Economic and Social Development of the PRC*, continue to adhere to the overall guideline of "market orientation, coordinated development, and cultivation both in and out", set the goal of modern financial institutions with "adequate capital, strict internal control, secure operation, and sound services and performances", and focus on the theme of "reform and innovation" to continue the deepening of banking reforms.

Deepening Shareholding Reform of SOCBs

Reform of SOCBs is a long-term endeavor of complexity and formidability. Financial condition and corporate governance of pilot banks achieved remarkable improvements through

shareholding reform, but these improvements were only skin-deep results for certain phase. From the internal perspective of banks, SOCBs still lagged behind of internationally advanced banks in terms of corporate governance framework, operation mechanisms, mode of growth, and risk prevention systems. From the external perspective of banks, China is at a critical stage of improving socialist market economic system; therefore, national economic and industrial structure keeps changing, SOEs are in the process of transformation and restructuring, construction of financial legal framework compatible with market economy is in need of improvement, social credit system has just been established, and financial and taxation system reform needs to be promoted. All these factors impose impacts on asset qualities, financial conditions, and future reform and development of SOCBs.

At present, reform of SOCBs is at a critical stage; therefore, we should fully take advantage of the sound economic environment and push the reform to a higher level in an unswerving manner. BOC, CCB, and ICBC should continue to improve corporate governance in accordance with the requirements of modern commercial banks and effectively establish a prudent business operation ideology with shareholders' value as priority. The theme of transforming business operation mechanism, strengthening internal control, and safeguarding against risks should be emphasized as always to prevent NPA from rising and operating profit from declining. Reform of branches should be continued to enhance the coordination of internal reform and

ensure effective operation of new mechanisms and systems in the overall framework. Implement the Concept of Scientific Development in an all-round manner, steadily promote pilot programmes of integrated financial business, boost the transformation of development and growth pattern, and continuously improve the capacity and efficiency of the services to national economic development. The supervision, promotion, and discipline functions of capital markets should be brought to full to propel pilot banks to strengthen information disclosure, enhance transparency, and

establish good images of public banks held by the national government. We should also actively promote reforms and improve fiscal and taxation system, incentive mechanism, and other complementary policies of SOCBs, explore strategies of managing state-owned financial assets in China's context, and continuously optimize external operating environment of SOCBs. We should accelerate the reform of ABC and do research in the reform plan of ABC in line with the master plan of socialist new villages construction and rural financial reform.

Box 3 Foreign Experience of State-owned Financial Assets Management Modes

In recent years, reforms of China's state-owned financial enterprises have recorded significant progresses, particularly, three SOCBs, namely BOC, CCB, and ICBC, carried out shareholding reforms in succession. After the restructuring and listing of state-owned financial enterprises, new situations such as diversified equity structure, corporate governance framework, and market discipline imposed new requirements on functions and duty performance of state shareholder. The topic of how to establish and improve the capital management system of China's state-owned financial enterprises has become an important research focus of people in all walks of life. Recently, some experts have researched on foreign

experience of state-owned capital management of financial enterprises in Singapore, Russia, and India and so on.

State-owned capital management of financial enterprises means that the state, as the ultimate owner, entrusts specific institutions to exercise the functions of investor in financial enterprises on its behalf. From the point of view of practices in various countries, there are two kinds of state-owned capital management systems of financial enterprises; one is a two-layer entrusted management mode, i. e., state – governmental departments – financial enterprises, where governmental departments mainly include MOF and central bank; the other is a three-

layer entrusted management mode, i.e., state-governmental departments-financial holding companies-financial enterprises, where governmental departments include both specific administrative departments such as MOF and central bank, and non-specific administrative departments such as special commissions established by the state or special board of directors founded within financial holding companies. In addition, some countries also make special institutional arrangements during special periods.

From foreign experience, it can be concluded that institutional frameworks of state-owned capital management in financial enterprises is closely related to political and economic systems and development levels of the countries; nevertheless, some common features can also be noted.

First, state exercises ownership separately on state-owned financial enterprises and non-financial enterprises to avoid related party relationship between financial enterprises and non-financial enterprises. For example, in Sweden, ownership of 34 state-owned non-financial enterprises is exercised by State-owned Enterprises Bureau under Ministry of Industry while ownership of state-owned financial enterprises by the Ministry of Finance; in India, State-owned Enterprise Administration Bureau exercises ownership on state-owned non-financial enterprises on behalf of the state while the central bank on financial enterprises.

Second, Effective "firewall" is established between owner's functions and public administrator's functions and market-based equity management has become an internationally prevailing trend. In order to make administrative authorities perform their duties better, some countries adopt more market-based mechanisms as follows to avoid contradictions and conflicts between owner's functions and such government functions as public finance: First, establishing principal-agent mechanism according to market-based principle to effectively promote the formation of sound corporate governance framework within state-owned financial enterprises; Second, exercising the rights of state shareholder via shareholders' general meetings and appointment of board directors; Third, conducting open evaluation of and effective supervision on operating performances of state-owned financial enterprises and utilization of state-owned capital; Fourth, carrying out equity management of state-owned capital in financial enterprises through holding companies with market-based means. Some countries found financial holding companies to perform the duties of investor, and such companies are concise and efficient with their priorities on monitoring appointment, operation, and development of board of directors in state-owned financial enterprises.

Third, the state carries out corporate-oriented restructuring of state-owned financial

enterprises to form a diversified ownership structure. Except for some policy financial enterprises wholly owned by state, governments of foreign countries usually restructure most of their state-owned financial enterprises into joint stock companies or limited liability companies with state holding controlling interests or participating in investments. Since 1980s, many countries have attained diversified equity structures of state-owned financial enterprises via shareholding restructuring.

Fourth, state conducts commercial management on state-owned financial enterprises via

holding companies and sets explicit operating goals. Maximum return on capital is where the ultimate interests of state-owned capital reside; hence, maximization of return on capital is usually the key or even the only operating goal of state-owned financial enterprises. Although operating goals of state-owned financial enterprises do not ice out certain social goals, state usually specifies these social goals through appropriate commercial or administrative laws and regulations; state-owned financial enterprises should not harm the equity value of state shareholder due to overburden of social goals.

Continue to Promote Reform of Small- and Medium-sized JSCBs

In 2005, small- and medium-sized JSCBs achieved sound overall development and obvious enhancement of overall quality and core competitiveness; however, some in-depth conflicts in development also showed up gradually; corporate governance framework is in need of further improvement; categories of financial products are far from enough, products show severe homogeneity and marketing means are monotonous, financial innovations and brand effects are not satisfying, competitiveness needs to be strengthened; a minority of small- and medium-sized JSCBs are weak in operating performance, profitability, and risk-resistance. Generally speaking, comprehensive development capabilities of small- and medium-sized JSCBs need to be further enhanced.

Going forward, we should start with such aspects as strengthening capital restrictions, perfecting corporate governance, transforming business operation mechanism, enhancing internal management, improving profitability mode, and preventing and mitigating risks, continue to promote reform and development of JSCBs, and actively carry out financial innovation so as to build small- and medium-sized JSCBs into modern commercial banks with sound corporate governance, prudent financial performance, sustainable development capability, and quality customer services and brands. First is to continuously improve institutional construction of corporate governance framework and internal control mechanisms and further perfect the governance framework of shareholders' general meeting, board of directors, board of supervisors, and management so as to realize clear division of duties, checks and balances, and mutual supervision

of decision-making, supervision, and implementation. Restrictions on both senior management and ordinary staff should be strengthened while relevant incentives should be in place. On the basis of improved corporate governance framework, it is necessary to enhance internal control and management of internal authorization and credit extension, and fully take advantage of the functions of internal audit and internal compliance checks, while bringing the functions of external audit to necessary extent. Second is to further consolidate the market-based and customer-oriented business operation conception and improve comprehensive services level and profitability. With the precondition of enhanced regulation and the base of standard management, we should make scientific planning, vigorously create a favorable external environment for financial innovation, actively support and guide small- and medium-sized JSCBs to strengthen innovations from various aspects of system, mechanism, and business flow, continue to enhance the services of small- and medium-sized JSCBs, and strengthen their profitability and core competitiveness in an all-round manner. Third is to enhance risk prevention and risk disposal and employ various means to reduce NPL while actively carrying out business innovation. It is essential to further emphasize the conception of prudent operation, adopt internationally prevailing prudent accounting standards, risks provisioning mechanism, and losses write-off system, continue to raise asset quality, reduce NPL ratio, and enhance the prudence of operation. Fourth is to accelerate the pace of restructuring of a few small- and

medium-sized JSCBs with certain problems and promote their prudent operation.

Further RCC Reform to Improve Rural Financial System

In 2005, rural financial reform attained remarkable achievements; however, some fundamental problems began to appear along the reform. First, although pilot reform of RCC achieved sound results at present, the reform needs to go deeper and fiscal sustainability of RCC needs considerable attention. Meanwhile, some provincial RCCs did not have a clear-cut division of duties and some RCCs still reflected problems of management exceeding authority, ambiguous management, and absence of management, which hindered the smooth operation of new system. Second, rural financial institutions showed universal deficiencies in corporate governance. Internal management, internal control, and supervision and checking mechanism which constrained the transformation need improvement. Third, rural financial institutions were weak in service and management, which together obstructed the competitiveness of rural financial institutions from comprehensive enhancement. Fourth, a huge amount of capital drained out of rural areas and financial supports to "agriculture, rural areas, and farmers" were severely restrained. Fifth, overall risks could not be neglected and the capability of preventing and guarding against risks was still relatively weak, which restrained the financial sustainability of rural areas. Sixth, the imbalanced financial reform processes, risk levels, staff qualities, and business operation environ-

ments between urban and rural areas in China also affected the financial stability in rural areas. The existence of aforementioned problems makes rural financial reform a complex and formidable task. In the long run, rural financial reform needs to mainly address the problem of imbalanced financial mechanism reforms between urban and rural areas, focus on such key issues as supporting economic development in rural areas and preventing systematic financial risks, bring the joint force of commercial financial institutions, policy financial institutions, and rural cooperative financial institutions into full play, accelerate the reforms of ABC, ADBC and postal savings, and continue to further reforms of RCCs.

Deepening of RCCs pilot reforms should base on concrete and delicate endeavors in aspects of preventing and mitigating risks, amplifying management mechanism and operation mechanism, improving governance and internal control, strengthening services to agriculture, and establishing long-term mechanism of risks prevention and mitigation; first, continue to further reform, earnestly carry out bill issuance and cashing business, adopt strict standards, procedures, and implementation, raise efficiency, and ensure the reform results of "money for mechanisms". Second, improve various internal control systems of RCCs, promote mechanism transformation of RCCs, bring the roles of shareholders and commune members into full play, and formulate a package of internal control systems with effective incentives, strict restrictions, clear-cut rights and duties, and explicit system of awards and penalties. Third, improve rural financial serv-

ices and enhance supports to agriculture. Continue to make more efforts to extend micro credit to rural households, further improve the system of mutually guaranteed loan for rural households, and explore new services to support agriculture so as to provide more improved and efficient financial services to agriculture, rural areas, and farmers. Fourth, actively make innovation of regulation measures and means, unify regulation standards, exercise classified regulation, reform regulation procedures, establish a regulation framework with off-site regulation as major means as well as appropriate separation of off-site regulation and on-site examination, and realize sustained regulation in an all-round manner. Fifth, get a better recognition of risks, research into overall risk situations, risk transfer, and major risk sources of RCCs, take effective measures to prevent risks in a proactive manner, strengthen risk disposal, and do researches to establish a long-term mechanism of risk prevention and mitigation.

While reform of RCCs goes deeper, it is necessary to further promote rural financial reform and perfect financial service network in rural areas so as to meet the demands of economic development in rural areas. The comprehensive goal of rural financial reform is: providing services to "agriculture, rural areas, and farmers", promoting coordinated development of urban and rural areas, focusing on solving such problems using "funding" and "risk compensation", reflecting localized and classified guidance in institutional network design and relevant policies, building a diversified and competitive rural financial sys-

tem, and earnestly improving rural financial services. The focus of rural financial reform is further deepening of reform of RCCs, establishing capital backflow mechanism in rural areas, perfecting the operational mechanism of ADBC, amplifying supports from commercial banks such as ABC to agriculture, and shaping a new pattern of clear-cut duties and responsibilities among policy financial institutions, commercial financial institutions, and cooperative financial institutions and their joint supports to economic development of rural areas.

Steadily Push Ahead Postal Savings Institutions Reform

At present, postal savings institutions reform has been formally launched. As of the end of 2005, outstanding deposit of postal savings institutions had exceeded RMB 1,300 billion yuan, 9.56% of market share in deposit market, after the four SOCBs and RCCs. Assets formed from independent utilization of postal savings capital had reached over RMB 530 billion yuan. Postal savings institutions have become an important component of China's financial service system by taking advantage of postal service network. However, along with the deepening of China's financial system reform and rapid development of postal savings business, the current management system of postal savings cannot adapt to the requirements of business development and professional financial management at all. In order to standardize the business operation of postal savings, prevent and mitigate financial risks, and actively ex-

plore capital utilization channels by creating new mechanisms, we should stick to the direction of financial system reform, accelerate the pace of establishing postal savings bank, and promote sustained and healthy development of postal savings business.

Properly Dispose of Risks of Certain Small- and Medium-sized Banking Institutions

Since 2005, the overall risks of China's banking sector have declined; however, considerably huge potential risks still exist in some small- and medium-sized banking institutions and the risks situation of city commercial banks, UCCs, and TICs are not at all satisfactory. Going forward, we should continue to focus on risks prevention and mitigation of small- and medium-sized banking institutions.

First, prevent and mitigate risks of city commercial banks to promote their healthy development. At present, some city commercial banks feature weak corporate governance, low CAR, insufficient provisions, low assets quality, weak innovation and development capability, single business category and profitability source, and lacking core competitiveness. In a relatively long period in future, city commercial banks should further improve legal person governance framework, strengthen capital restriction mechanism, specify market position, and accelerate business innovation. It is important to actively promote capital restructuring of city commercial banks, replenish capital via various means, and enhance risk resistance capability. We should keep in mind market demands and characteristics of

city commercial banks, speed up the business innovation pace of city commercial banks, stick to the market orientation of "base on urban residents, base on SMEs, and base on locality", and gradually realize the goal of "serving urban residents, serving SMEs, and promoting local economic development". Meanwhile, we should attach great attention to high-risk city commercial banks, vigorously explore effective market-based disposal modes, improve market exit mechanism, and prevent and mitigate risks of city commercial banks.

Second, continue to promote the overhaul of UCCs. In 2005, although the overhaul of UCCs has attained certain achievements for the period, some long-haunted questions and problems have not been fundamentally resolved. Most of UCCs ordered to stop operation for rectification or those licences revoked have not exited the market completely, and the task of risk disposal is still formidable; classification and disposal of UCCs which await disposal progresses slowly; a few rectified UCCs still show underlying risks. In the next phase, we should continue to push ahead the reform of UCCs. First, further perfect risk classification standards, enhance classification regulation, and guide rectified UCCs to realize sustained, smooth, and healthy development; Second, encourage commercial banks to carry out acquisition, merger, and restructuring of existing UCCs in accordance with market principles, and actively push ahead the classification and disposal of UCCs which await disposal; Third, encourage localities to realize the smooth exit of UCCs ordered to stop operation

for rectification or revoked through various means within the prevailing legal framework according to different situations of the localities; Fourth, continue to carry out risk monitoring and specialized treatment of cases in a careful manner to prevent and mitigate all potential risks.

Third, continue to progress with the liquidation and rectification of TICs. In 2005, the trust industry showed some improvements; however, the overall profitability of TICs is still in need of further enhancement. Some TICs did not appropriate sufficient indemnity provisions, a few TICs were engaged in illegitimate operations such as entrusted wealth management business with secured yield and appropriation of wealth management funds of customers, and great attention should be attached to operating risks. In addition, some TICs ordered to stop operation for rectification and those licences revoked have not exited the market, and the task of risk disposal is still huge. In the next phase, it is necessary to continue to push ahead liquidation and rectification of TICs and to promote healthy development of TICs. For a few TICs with high risk, various effective measures should be taken legitimately to properly dispose of the risks.

Defining the Role of Policy Banks and Reform Plans

Ever since their establishment, policy banks have made great contributions to national economic development in accordance with the needs of national policies by bringing the functions of policy banks to full. Successful

operation of policy banks also created favorable conditions for the reforms of SOCBs. At present, development of China's policy banks has entered a new phase with business scope of policy banks expanding continuously, traditional policy financial service field shrinking, and market-based operation trend strengthening. In order to adapt to socialist market oriented economy construction and national development strategy in the new phase, policy banks should carry out transformation and reform in terms of positioning and development direction by taking into consideration of rural financial system reform, grain distribution system reform, investment and financing system reform, and the new situation after China's accession to WTO. Policy banks should reverse their traditional positioning of dependence on fiscal subsidy and transfer themselves into development financial institutions that can satisfy demands of market economy, and are financially sustainable and possess certain competitive edges. In order to achieve this goal, first is to establish modern enterprise system and realize sustainable development of policy banks; second is "one bank one policy", i. e., design different reform plans for distinct situations of every bank and then implement such plans with goals in mind and in clear steps and phases; third is to establish management mode for development financial institutions and realize separate accounts and specialized accounting between designated projects of government and development projects of proprietary business operation.

Further Improve Operation Mechanism of Financial AMC

Financial AMCs have achieved gratifying results in assets disposal in the past few years, but they are also confronted with many problems and questions as follows, including development positioning of companies, flawed corporate governance framework and operation mechanism, and incompatible external environment; First, the goals set when companies were established cannot adapt to the demands of financial reform and development under new circumstances, and sustainable business operation needs to be further specified; Second, the ownership structure of wholly state-owned, on the one hand, obstructs, to some extent, expansion of businesses and introduction of strategic investors, and on the other hand, is not conducive to the improvement of NPA disposal capability; Third, the government style management mode and organizational structure divided by geological jurisdictions are not conducive to the commercial and market-based business operation and performance examination; Fourth, Measures for Financial Asset Management Corporations, as an administrative regulations, is limited by its level of legislation, and therefore can neither solve the conflicts between business measures of some AMCs and prevailing laws nor grant AMCs a special legal status and business operation rights, which makes AMCs incompetent in face of administrative interference and unfavorable external environment; Fifth, social credit environment needs further improve-

ment, some enterprises try to evade financial debts intentionally, which makes it harder for AMC to carry out their works.

In the next phase, AMCs should speed up the pace of reform and further improve operation mechanism. First, AMCs should ultimately develop into comprehensive AMCs with NPA disposal as major business and investment banking and asset operation and management functions as supplement through deepening institutional reform, improving operation mechanism and perfecting business functions. Second, AMCs should establish and amplify corporate governance framework and operation mechanism compatible to market-based operation. We should establish conditions to promote shareholding restructuring of AMCs, improve their corporate governance framework. We should do research to formulate equity assets disposal goals, track down all losses due to policy reasons, promulgate responsibility-bearing and verification and cancellation measures of losses of policy origins, reform the financial and accounting system of AMCs, realize the shift from examination on book value of acquired assets to recovery ratio of assets disposal targets, and establish conditions for AMCs to clear their balance sheet and income sheet. Third, further improve external regulation. We should learn from foreign experience, gradually establish a set of standardized regulation requirements and control criteria, and further improve regulation efficiency.

Promote Financial Innovation of Banking Sector in a Comprehensive Manner, Consolidate Achievements of Banking Sector Reform, and Enhance the Competitiveness of Banking Sector in the International Market

In 2005, national economy continued to maintain fast growth; industrial production, fixed assets investment, market sales, export and import all witnessed accelerating increase; and consumer price and manufacturer's price of industrial products were stable. However, there were still some conspicuous problems in the national economic operation such as fast-growing investment, capacity surplus in certain industries, climbing prices of energy and raw materials, and worsening imbalance of international balance of payment. Macroeconomic factors inter-wound with historical legacy problems of financial system makes the operation of banking sector face a more complex external environment and magnify the risks confronting banking institutions. First is the potential credit risks brought about by fast-growing investment, capacity surplus in some industries, regulatory policies in real estate industry, and climbing prices of energy and raw materials; second is the market risks brought about by RMB exchange rate fluctuation, monotonous hedging instruments for commercial banks, and interest rate liberalization; third is that since cases in banking institutions are still reported now and then, operational risks should not be neglected.

In the next phase, we should promote financial innovation in an all-round manner, consolidate achievements of banking sector re-

form, and enhance the competitiveness of banking sector in the international market. First, support commercial banks to innovate in service modes and raise service qualities. Actively encourage commercial banks to provide differentiated services to customers at different ends to meet the financial needs of various financial consumers. Second, encourage commercial banks to broaden business scope and carry out pilot programmes of comprehensive financial business. Comprehensive banking operation has been existing in China in the form of cross-sectoral sales of bank-securities and bank-insurance products. In the next phase, we should actively support commercial banks to broaden their business scope, study the general route for commercial banks to implement comprehensive business in a timely manner, and select banks with mature conditions to carry out pilot programmes of comprehensive business operation. Third, prudently encourage commercial banks to invest in and establish fund management companies. With the approval of the State Council, ICBC, CCB, and BOCOM have started their pilot programmes of establishing fund management companies by the means of direct investment. For the next step, commercial banks should abide by the principle of "different legal per-

son in separate industries", establish and improve the risk separation and related-party transaction control between themselves and their fund management companies, and prevent the spread of risks among different sectors in financial market. At the same time, regulation coordination and information communication should be strengthened. Fourth, enhance specialized regulation on pilot programmes of assets securitization. Approved by the State Council, CDB and CCB carried out pilot programmes of asset-backed securitization in 2005. In the next phase, we should continue to enhance regulation on pilot programmes of credit asset-backed securitization in commercial banks, guide the standard development of the industry through supervisory means, and promote and improve the behavior of specialized market. Fifth, encourage commercial banks to carry out RMB derivative product businesses. Derivative product is an important component of banks' intermediate business. In order to raise the proportion of RMB value-added businesses, in the next phase, we should encourage commercial banks to carry out RMB derivative product business and to gradually enhance their capability of conducting RMB derivative businesses.

(By Xiao Yuping, Chen Jianxin, Ouyang Changmin, and Lin Wenshun)



Chapter IV

Securities Sector

In 2005, the non-tradable state share reform of listed companies progressed smoothly; securities companies were undergoing an overhaul; problems left over from the past in the securities market were addressed step by step; new market structure and operational mechanism began to take shape, and investors' confidence was gradually restored.

Recent Developments

The stock market was basically stable, with declining funds raised in the domestic market. As of the end of 2005, there were 1,381 listed companies in the Shanghai and Shenzhen stock exchanges, with 16 newly listed companies and 11 de-listed ones. The total market capitalization and floatation of tradable shares stood at RMB 3.2 trillion yuan and 1.1 trillion yuan respectively, decreasing by 12.49% and 9.05% respectively over 2004. Since May 2005, when stock financing was suspended, Shanghai and Shenzhen stock exchanges raised total fund worth RMB 33.81 billion yuan, down by 58.7% over 2004.

The total assets of securities sector increased slightly, with the scale of securities investment funds growing rapidly. As of the end of 2005, the total assets of securities sector was RMB 801.1 billion yuan, an increase of RMB 116.4 billion yuan over 2004, equivalent to 17%. There were 115 securities companies, 13 less than in 2004. The assets of securities companies totaled RMB 307 billion yuan, RMB 22.4

billion yuan less than in 2004. There were 53 fund management companies, managing 218 securities investment funds, an increase of 10 and 57 respectively over 2004. Correspondingly, the funds under management reached 474.1 billion units, an increase of 1,307 over 2004, or 38.1%. There were 183 futures brokerage firms, with total assets of RMB 20 billion yuan, RMB 1.9 billion yuan less than in 2004.

Investment by institutional investors grew rapidly, with a more rational investors structure. Besides securities investment funds, QFIIs, social security funds, insurance companies and other institutional investors also developed by leaps and bounds. In 2005, there were five new-licensed QFIIs, and the quota for foreign exchange investment increased by USD 1.495 billion. As of the end of 2005, the total number of QFII reached 32, with their quota totaling USD 5.495 billion. QFIIs held securities assets worth nearly RMB 30 billion yuan, accounting for 90% of their total assets. The capitalization of stocks held by the National Council for SSF stood at RMB 20.52 billion yuan, an increase of 65% compared to the end of 2004. Insurance funds indirectly used in investment totaled RMB 106 billion yuan, up 57% over the end of 2004; while the insurance funds directly used in investment reached RMB 15.888 billion yuan.

Innovation of securities products starts up, with new products and businesses launched one by one. In 2005, there were 7 warranties with features of financial derivatives, with the total trading volume of RMB 218.8 billion yuan. As part of the pilot programs for innova-

tion, 11 securities companies issued 13 collective wealth management products worth RMB 14.5 billion yuan; 7 companies launched several special assets management products based on infrastructure, municipal construction and property management fee; margin financing and securities lending products and Stock Index Futures were being studied.

Securities Sector Reform Achievements

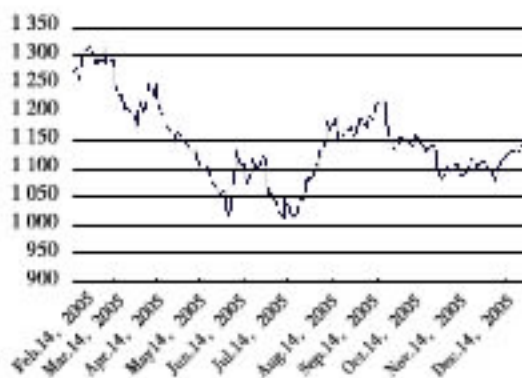
In 2005, with the continuous adjustment in securities market, its function of financing weakened, various problems were substantially exposed, and risks became more evident. Shanghai and Shenzhen stock indices reached their historical lows in July, with Shanghai Stock Exchange Composite Index even falling below 1,000 points in the process of exchange time (Figure 4-1). In order to solve problems existing in the securities market and promote its sound development, various reform measures concerning the capital market were introduced, which yielded positive results.

Non-tradable State Share Reform Progressed Smoothly

The Chinese securities market was born in a planned economy, therefore, shares were divided into tradable shares and non-tradable state shares in the A-share market. As of the end of 2004, the equity of listed companies totaled 714.9 billion shares, including 454.3 billion non-tradable state shares, which accounted for 64% of the total equity. State-owned shares took 74% of the non-tradable

state shares. As an institutional shortfall inherited from the past, non-tradable shares constrained the sound development of the capital market and fundamental reform of the state-owned asset management system in China in many ways. In addition, with the increase of IPOs, the adverse impact of this problem became more evident on the reform and opening up of the capital market and stable development, such as distorted pricing mechanism in the stock market, lack of common interests in corporate governance and impediment to the reform of state-owned asset management system.

Figure 4.1 Trend of Shanghai Stock Exchange Composite Index 2005 (Based on the closing prices)



Source: CSRC.

On April 29, 2005, non-tradable state share reform on trial basis was launched to solve this institutional bottleneck, which had restrained the development of the Chinese capital market.

During the pilot period, 46 listed companies underwent non-tradable state share reform in two successive batches. Basic principles, operational procedure and management approaches for the reform became clearer, laying a solid foundation to push ahead the reform from an experimental basis onto the next stage of practical implementation.

In mid-September 2005, non-tradable state share reform carried forward extensively. As of the end of 2005, 421 companies have either completed the reform or entered into reform procedures, accounting for 31% of the total number of listed companies, and 35% of the total capitalization in the Shanghai and Shenzhen stock exchanges.

The non-tradable state share reform has shown initial positive results. The market expectations were gradually stabilized; stock prices reached a rational level. Market discipline for listed companies and the basis of common interests for shareholders were reinforced. Various historical problems were addressed somewhat during the reform. Room for securities market reform and innovation was effectively explored.

Comprehensive Restructuring of Securities Companies Was Underway on All Fronts

As important intermediaries in the securities market, securities companies play an impor-

tant role in cultivating and developing the securities market. Due to systematic or institutional loopholes, while developing very rapidly, securities companies have many problems to be solved. In order to solve such problems, in July 2005, the comprehensive restructuring of securities companies was started.

The basic consideration to restructure securities companies is as follows: capture the critical opportunities of favorable macroeconomic conditions and the deepening reform of the securities market, concentrate on risk mitigation, day-to-day supervision and industrial advancement, with the purpose to better fend off risks, improve the system, combat criminal offenses, and with features of prevention and control with emphasis laid upon prevention. In the next two years, the objective is to basically resolve the current risks, put in place a new mechanism, effectively fend against new risks and lay a foundation for well-regulated, sustainable and stable development of securities companies.

Under the coordination by the State Council, relevant authorities closely worked with each other to adopt various measures and extensively implemented the comprehensive restructuring of securities companies.

The risk profile of securities companies was basically identified. Securities regulatory authorities have got a general picture of the risk profile of securities companies as a whole by asking companies to report their risks, conducting on-site inspection and auditing annual reports, and urged "problem-ridden companies" to restructure themselves according to

specified plans. As a result, the prevailing violations and misconducts were contained at the source and risks were mitigated. As of the end of 2005, the gap in clients' securities transaction and settlement funds was reduced by 61% compared to that at the end of 2003, misappropriation of clients' bonds down by 79%, misconducts in entrusted wealth management dropped by 70%, hidden operations down by 77%.

Securities investor protection fund was established. Concerned with potential adverse effects caused by the PBC's loan to repay the creditors' claims on securities companies and to cover the gap caused by misappropriation of clients' transaction and settlement funds, the

PBC worked with CSRC and other relevant authorities to forcefully set up a securities investor protection system, and put in place a long-term mechanism to mitigate risks in securities companies. On June 30, 2005, CSRC, the PBC and MOF jointly promulgated *Administrative Measures on Securities Investor Protection Fund*; on August 30, China Securities Investor Protection Fund Co., Ltd (Investor Protection Fund) was registered. Given that the expenditure exceeded income at the initial stage after the Fund's establishment, PBC made a loan of RMB 61.7 billion yuan as start-up capital for the Fund to make sure that the disposal of securities companies could properly proceed.

Box 4 Securities Investor Protection System

In recent years, risks accumulated in securities companies were increasingly exposed, and many securities companies were closed down, suspended or put under administrative custody due to misconducts, while the debts owed to clients and the gap in the clients' transaction and settlement funds were covered by the PBC's through loan. This government-led approach to expel poorly performing financial institutions out of market had played an important role in maintaining social stability and protecting the interests of small-and-medium value investors. But at the mean time, this approach might lead to moral hazards and bring about negative effects. In order to safeguard small-and-medium value in-

vestors' interests, to prevent moral hazards and to promote industrial self-discipline, the Securities Investor Protection System was established in 2005 when Southern Securities was suspended for risk disposal purpose.

On August 30, 2005, Investor Protection Fund was registered, signaling that the market-based risk mitigation mechanism for securities companies was initially established. The Fund is a wholly state-owned company, whose major responsibility is to raise fund in line with the principle of "taking capital from the market and using capital for the market", and repay creditors of securities companies being disposed of according to relevant state policies. Considering that

the Fund's expenditure was more than the income during the initial period of operation, the PBC lent RMB 61.7 billion yuan as the Fund's start-up capital to guarantee that the disposal of securities companies could proceed well.

Since the Fund was established, it had taken various projects to participate in mitigating risks of securities companies, gradually prepared and improved concerning rules and regulations, and conducted investor education, so as to help maintain social stability and protect the rights and interests of investors.

According to the *Administrative Measures*

on Securities Investor Protection Fund, sources of the Fund include commissions charged for transactions in exchanges, contributions made by securities companies, interest gains from frozen capital for subscription, and gains from bankruptcy liquidation of securities companies, etc. In the future, as the work unfolds, the Fund will do better in raising, operating and managing fund, identify sources for the protection fund, collect contributions from securities companies regularly, put in place an open and transparent fund operation information system, and forcefully undertake investor education, so as to maintain social stability and protect the interests of investors.

Risky securities companies continued to be disposed. After the 7 high-risk securities companies were disposed of in 2004, concerning authorities handled another 13 high-risk securities companies in a timely and prudent manner in 2005.

Forcefully restructured securities companies. Restructuring of securities companies is an important policy against certain market conditions. In 2005, all risks associated with securities companies were exposed. However, forced de-listing of securities companies, especially large-scale companies would dampen investors' confidence and hurt market stability given the market conditions at that time. After careful consideration, the principles were finally clarified that administrative guidance was integrated with market disciplines. the PBC worked with other relevant authorities and lo-

cal governments to steadily push ahead with restructuring of securities companies. Based on situations of individual securities companies, restructuring plans for China Galaxy Securities, Shenyin & Wanguo Securities, Guotai Jun'an Securities, Huaxia Securities and Beijing Securities were finalized, with the China SAFE, China Jianyin Investment Co., Ltd ("Jianyin") as platforms for restructuring. Methods for restructuring include capital injection by shareholders, liquidity support and partnership with strategic investors, etc. The restructuring of securities companies, on the one hand, mitigated risks and maintained the stability of the securities market; while on the other hand, laid a solid foundation for restructured securities companies to grow and for China's securities sector to improve its international competitiveness.

Box 5 Restructuring of Beijing Securities

Beijing Securities Company Limited ("Beijing Securities") was founded on September 9, 1997, whose registered capital once reached RMB 1.515 billion yuan after recapitalization. Beijing Securities has 27 outlets in 15 cities throughout China (including 10 in Beijing), employing 571 staff and serving 194,000 clients. Due to poor operation, and bear market, Beijing Securities experienced high liquidity risks and operational difficulties. As of the end of 2004, Beijing Securities had total assets of RMB 4.86 billion yuan, total liabilities of RMB 6.536 billion yuan, and net assets of RMB -1.676 billion yuan, resulting in a loss of RMB 3.191 billion yuan. In 2005, in order to mitigate risks, a decision was made to restructure the company. The restructuring scheme was as follows.

Establishing a New Company

First, Jianyin invested RMB 1.4 billion yuan to establish an asset management corporation. Second, Jianyin and the asset management corporation, with RMB 1 billion yuan and RMB 490 million yuan from the two companies respectively, jointly established a new securities company, accounting for 67% and 33% of the total equities.

Disposing of Assets

The asset management corporation acquired the account receivables and other NPAs as well as other related assets from Beijing Securities with RMB 910 million yuan at a premium, to cover the RMB 784 million yuan mis-

appropriations of clients' securities transaction and settlement funds, and repayment of debt.

According to fair value, the new securities company purchased part of operational securities assets from Beijing Securities with RMB 490 million yuan at a premium (including seats of 6 securities outlets, office equipment and trading system, as well as unfinished issuances and financial consultation projects of the investment bank division).

Equity Transferring

Jianyin transferred no more than 25% of its equity in the new securities company to foreign companies. 20% shares were sold to UBS at RMB 1.698 billion yuan (at a premium of RMB 1.4 billion yuan), and no more than 5% were sold to Internal Financial Companies at par value. Jianyin sold 42% of its shares in the new company to COFCO at par value, and 14% to State Development and Investment Corp. Jianyin, as a strategic investor, held the remaining 14% equities.

Jianyin sold equities of the asset management corporation to former shareholders of Beijing Securities at the nominal price of RMB 100 yuan. Given contingency debts and other potential historical debts owed by Beijing Securities after liquidation, the asset management corporation provided 33% of its shares in the new securities company as collateral, based on requirements of the foreign companies, so as to guarantee the stable operation of the new company.

Disposing of Branches

Beijing Securities had 27 outlets, 6 of which were sold to the new securities company at fair value, while the rest 21 were sold to a reputed and well-functioning securities company by Beijing Securities to ensure no changes to employees and clients and normal operation.

Closure and Liquidation of Beijing Securities

After the new securities company was set up, Beijing Securities should be closed down and

liquidated. China Cinda Asset Management Corporation was commissioned to establish a custody and liquidation work force for liquidation of Beijing Securities. If no conciliation could be reached with creditors, Beijing Securities would declare bankruptcy.

The restructuring of Beijing Securities is a pilot project when China's securities sector deepens reform and opening up. After restructuring, the risks were preliminarily solved, social stability maintained, but the long-term effects are still to be tested by the market.

The reform of fundamental systems in the securities sector was progressed extensively. First, push forward the reform of custodian system of clients' securities transaction and settlement funds. According to the PBC's requirements, securities companies that were restructured by using national public capital and resources should be the first to implement the third-party custodian system for securities clients' transaction and settlement funds. CSRC will push other securities companies to do the same in a step-by-step manner based on provisions in the Securities Law. At present, 36 securities companies are working on plans of or implementing the third-party custodian scheme. Second, regulate entrusted wealth management business by real-time monitoring over trading activities of the wealth management accounts. Third, promulgate and publicize *Guidelines for Proprietary Trading of Securities Companies*, and better regulate proprietary trading of securities companies. Fourth, work out a plan for reforming the system of

T-bonds repurchase in which old and new transactions are treated differently, reform the transaction settlement system of T-bonds repurchase, clarify the responsibilities and rights of clients, securities companies, and registration and clearing companies in T-bonds repurchase, and make institutional improvement to address the problem that securities companies misappropriate clients' T-bonds.

The supervision of securities companies was reinforced and tailored to their categories. According to the criteria and procedure issued by SAC to evaluate securities companies categorized as innovation pilot and compliance ones, securities companies can be categorized as innovation pilot companies, compliance companies, etc and be supervised accordingly. As of the end of 2005, there were altogether 15 companies of innovation pilot type, 15 of compliance type. With the two types together, there were 30, more than 1/4 of the total number of companies in normal operations. To be qualified, the 30 companies disposed of illegal oper-

ations, increased net capital, asked shareholders to replenish capital to the promised level, and improved internal governance and risk control. In 2005, the net assets of the 30 companies took 70% of the total sector, income 78%, and tax payment 58%.

Initial results have been achieved in the process of the comprehensive restructuring of securities companies in 2005. Long-term accumulated risks in the securities sector were mitigated preliminarily, widespread illegal behaviors were generally contained, the compliance awareness was strengthened, regulatory methods were improved, and the work concerning fundamental systems in securities sector made substantial progress. The aforesaid measures helped to lay a solid foundation for basically completing the work of comprehensive restructuring of securities companies in 2006, transferring to normal regulation, and putting the entire sector on the track of sustainability.

Orderly Enhance the Quality of Listed Companies

Listed companies are cornerstones for the development of the capital market, and their quality is the source of investment value in the capital market. Improved quality of listed companies would help to enhanced attractiveness and vitality, fully display the role of the capital market in resources allocation, protect the legitimate rights of investors, with small-and-medium value investors in particular, and promote the sound and stable development of the capital market in China.

For a long time, influenced by certain system-

atic factors, especially the existence of the division between tradable and non-tradable shares, a large number of listed companies suffered from problems in governance structure, compliance operation, poor profitability and other problems. Some listed companies only attached importance to IPO, but neglected reorganization; stressed fund-raising but ignored return on investment, resulting in low return for investors. These results dampened the investors' confidence and contained the sustainable development of the capital market.

To regulate operations of listed companies and improve their quality, in 2005, the State Council forwarded *Opinions on How to Improve the Quality of Listed Companies* issued by CSRC and made deployment to improve their quality.

Improve corporate governance to make listed company operate more in line with regulations. A sound corporate governance structure is a pre-requisite to improve the quality of listed companies. According to the new *Company Law*, CSRC timely issued a revised version of *Guidelines for Articles of Listed Companies and Regulations for Shareholders Meeting of Listed Companies* in time, which laid a solid foundation for listed companies to improve their governance structure, and their operations and management.

Clarify job responsibilities and regulate external guarantees provided by listed companies. On December 23, 2005, CSRC and CBRC jointly promulgated the *Circular on Regulating External Guarantees Provided by Listed Companies*, in which the internal decision-making

procedure and information disclosure responsibility concerning external guarantees by listed companies were emphasized, the requirements for approval and responsibilities concerning banking institutions in making loans guaranteed by listed companies were regulated, and the responsibilities and regulatory functions of concerning authorities in handling illegal guarantees by listed companies were defined.

Strengthen cooperation to straighten out cases in which big shareholders misappropriate listed companies' assets. CSRC and SASAC worked together to further straighten out cases whereby big shareholders, especially those holding state-owned shares misappropriate listed companies' assets. In 2005, misappropriation worth RMB 10 billion yuan was found out and handled. After the efforts of over one year, a comprehensive regulatory system for promoting compliance of listed companies was put in place.

Enhance coordination among regulatory authorities to improve the regulation over listed companies. In order to enhance regulation over listed companies, CSRC is now working hard to formulate *Regulatory Measures on Listed Companies* in accordance with the new *Company Law*, and revising relevant laws and regulations to protect legitimate rights and interests of investors and provide a legal framework governing compliance issues of listed companies. The coordination mechanism among securities regulatory authorities, public security and judicial departments was improved; the suspects of financial crimes were transferred to public security and judicial de-

partments timely; criminal behaviors were strictly investigated and punished, regulation over listed companies was improved; validity and authority of such supervision were enhanced; and the market and social stability were practically maintained.

Prudently dispose of operational risks of listed companies and improve the market exit mechanism for listed companies. In 2005, 36 high-risk listed companies were properly disposed of. Over 30 listed companies involved in the Greencool family, Hongyi family and other 20 families were looked into one by one. Risks were fended off and exposed in due course through restructuring and improved information disclosure. Throughout 2005, 11 companies were de-listed smoothly, and a pattern of "survival of the fittest" had taken shape.

In general, the undertaking to improve the quality of listed companies has successfully kicked off. The comprehensive regulatory system is being created, and the effectiveness of the regulation over listed companies has been improved.

Institutional Investors Continue to Grow

The capital market cannot develop without investors. It is of critical importance to foster investment philosophies, enhance external control and improve the market efficiency, as far as the cultivation of institutional investors is concerned. In 2005, institutional investors in the securities market continued to grow, and the investor structure improved. As a result, a diversified investor composition started to take shape.

Securities investment funds continued to grow. As of the end of 2005, 218 securities investment funds had been launched, with the net value of RMB 469.116 billion yuan, RMB 144.476 billion yuan more than that in 2004, up by 44.50%. In addition, the scope of investment for securities investment funds kept on expanding, including warrants, short-term financing bills, asset-backed securities and other financial instruments in the portfolio; the distribution channels were further explored to enable subscription and redemption of funds on the trading network in Shanghai and Shenzhen stock exchanges.

QFIIs progressed steadily on trial basis. There were 5 new-licensed QFIIs, and the total foreign exchange investment quota increased by USD 1.495 billion. As of the end of 2005, there were 32 QFIIs, with the approved foreign exchange investment quota of USD 5.495 billion. QFIIs' assets in securities approached nearly RMB 30 billion yuan, accounting for 90% of their total assets. In order to further attract QFIIs to invest in the domestic capital market, CSRC and SAFE worked together to improve the approval system for QFII, and relaxed the management of lock-up period for foreign investors making long-term investment in the domestic capital market.

Social securities funds, insurance funds, enterprise annuities and other institutional investors sped up their entry into the securities market. As of the end of 2005, the National Council for SSF held stocks worth RMB 20.52 billion yuan, an increase of 65% over the end of 2004. Insurance funds made RMB

106 billion yuan indirect investments in the market, up 57% over the end of 2004, while the direct investment totaled RMB 15.888 billion yuan. The initiative to allow enterprise annuities to invest in securities markets began to be implemented. Market entry by social securities funds, insurance funds, enterprise annuities and other pensions would primarily improve the unbalanced institutional investor base in the domestic capital market.

Securities investment funds, insurance funds, social securities funds, enterprise annuities and QFIIs constitute a more diversified mix of institutional investors, who will have greater influence on the market as they increase investment. The valuation and pricing capability of the securities market was obviously enhanced, and the investment philosophy positively changed, which would greatly support the smooth progress of the non-tradable state share reform of listed companies and maintain a basically stable securities market.

Legal Framework of the Securities Market Continued to Improve

Since 2005, the legal framework governing securities market has made important progress. On October 27, 2005, amendments to *Company Law* and *Securities Law* were adopted by the Eighteenth Meeting of the Standing Committee of the Tenth NPC (National People's Congress), and came into force on January 1, 2006.

As basic laws governing the securities market, the *Company Law* and *Securities Law* were amended, based on the experiences and devel-

opments of the securities market. The provisions concerning incorporation, shares transfer, public offering, listing, trading systems, etc were completely revised; the constraints over market development and innovation were relaxed; the accountabilities and credibilities of board directors, supervisors and senior executives were further enhanced; and the regulation over listed companies, securities companies and other market players were strengthened.

The amendments of these two laws have made several key institutional breakthroughs. Risk mitigation efforts in recent years showed that one of the major reasons of frequent risk occurrence in securities companies was illegal operation, misappropriation of clients' securities transaction and settlement funds by certain securities companies and some individuals. Confronted by this problem, the revised *Securities Law* stipulated: "Transaction and settlement funds of securities companies' clients should be deposited in commercial banks in separate accounts of each individual client in their own names. It is strictly prohibited to misappropriate transaction and settlement funds or securities of clients by any company or individual in any form." This provision provides a legal and institutional safeguard against misappropriation of clients' securities transaction and settlement funds.

Key Areas and Reform Measures to Focus on in Developing the Securities Sector

So far, great changes have taken place in both internal and external circumstances of

the capital market, and the market is in a critical transition phase. However, it should be noted that the Chinese capital market is "emerging and in transition". It takes a long time for market players and the market itself to grow mature. Therefore, we must be fully aware that the development of the capital market, even after the non-tradable state share reform, is a long-term and complicated process.

Be Fully Aware That the Development of Capital Market Is a Long-term Process, and Comprehensively Push Ahead Integrated Reform

A mature capital market needs certain fundamentals, including high-quality listed companies, sound corporate governance, market-based pricing mechanism, good regulatory framework, eligible intermediaries, and so on. Therefore, the development of capital market is a systematic project. Non-tradable state share reform can solve the longstanding institutional bottleneck constraining the market development; however it does not necessarily mean that other conditions for the capital market to function are improved alongside the reform.

Accordingly, more deep-rooted problems constraining the capital market should also be attended to, such as the structure of listed companies, poor pricing mechanism, lack of credibility on the part of intermediaries, unsound regulatory system, and other problems, so as to push ahead the integrated reform of the capital market.

Improve the Quality of Listed Companies and Optimize Their Structures

After the non-tradable state share reform, how to improve the overall quality of listed companies has become one of the major issues faced by the securities market. Since 2005, China has adopted several measures to improve the corporate governance and management of listed companies, enhance the profitability and sustainability of the remaining companies. However, there are still listed companies ill structured. Currently, there are only a few well performing listed companies, and there is an increasing gap between well performing and poorly performing companies. In addition, most listed companies are small in size, which has created many negative effects, such as huge fluctuation of stock price, small-scale A-share market, and huge fluctuation of stock indices.

Therefore, various means should be combined to attract quality-listed companies to get listed in the A-share market and improve the structure of listed companies gradually. On the one hand, institutional innovation should be introduced to M&A, thus providing market-based methods available for the M&A and restructuring of listed companies. The remaining listed companies can have their quality improved through M&A and asset restructuring. On the other hand, the listing system should be reformed. Quality companies are encouraged to get listed in the overseas and domestic markets at the same time; H-share companies are encouraged to get listed in the domestic market, so as to make listed compa-

nies better restructured in terms of quantity increase.

Improve the Pricing Mechanism of Securities Market to Better Allocate Resources

The major institutional factor that used to hamper the pricing capacity of the A-share market was the non-tradable state shares. After the non-tradable share reform, other constraints hampering the pricing mechanism still exist, such as underdeveloped share issuance mechanism, immature pricing mechanism for market-based issues; weak institutional investor base in terms of time of development, size, pricing capability, and analytical capability, monotonous trading system and lack of pricing-finding instruments.

After the non-tradable state share reform, the securities issuance mechanism should continue to be improved, sponsors and other intermediaries should take their due responsibilities, issuance be better regulated, and market discipline strengthened. More efforts should be made to improve the institutional investor base, optimize the investor structure, and increase the proportion of QFIs, insurance asset management companies and other specialized investment institutions. Active endeavor should also be made to reform the transaction mechanism, create more arrangement systems in terms of transaction in line with investment and financing demand and risk management demand. The product mix shall be further improved by launching stock index futures and other financial derivatives in due course, while considering CDR for companies both listed in the H-share and A-share markets. A

comparative stock-pricing mechanism between the domestic and Hong Kong stock exchanges

shall take shape by allowing cross-border arbitrage transactions.

Box 6 Strengthen Cooperation between Mainland and Hong Kong Securities Markets to Improve the International Competitiveness of Chinese Securities Market

Hong Kong securities market is an important part of Chinese securities market, and Hong Kong and mainland markets have their respective advantages; Hong Kong market is better regulated with more transparent rules and strong regulations; investors are more rational and mature; market discipline is strong; market pricing is more reasonable; resources allocation is more effective; there are more international investors; and these are helpful to large-scale financing. The advantages of mainland market include large number of investors, huge investment potential, large number of companies willing to go public and proximity of regulators with their regulated targets.

At present, strengthened cooperation between mainland and Hong Kong securities markets and the link built up gradually between them can not only take advantage of Hong Kong market in the undergoing reform of domestic securities market, but also contribute to the stability and development of Hong Kong. First, this can create more choices for Chinese enterprises and investors and facilitate their transactions. Second, if timely efforts are made to guide red-chip

or H-share Chinese companies into A-share market, it will improve A-share market structure, overall quality of listed companies and attractiveness for investors. Third, cooperation can fully leverage on the respective advantages of the two markets and make them complement with each other. Fourth, it is beneficial to improve the overall international competitiveness of Chinese securities market and make Chinese market hold the leading position when competing for the status of Asia financial center.

As for how to strengthen the cooperation, scholars suggest the following ways: first, direct more companies to get listed in mainland and Hong Kong markets through various approaches to make the two markets deeper and wider. For listed companies, they can realize dual listing by new stock issues (in H-shares or A-shares) or issuance of CDR. Second, try to establish a mutual transaction platform which Shanghai, Shenzhen and Hong Kong exchanges can trade in, and improve the pricing mechanism. Third, put in place a mechanism for qualified investors to make investment across different markets. Accelerate

the development of QFIs and QDIs, and allow capital to flow freely within certain scope, which are helpful to remove the price difference between the two markets gradually. Fourth, promote regulatory co-operation. Regulatory standards, accounting criteria and other experiences in Hong Kong market can be borrowed directly. At the same time, better leverage on the advantage of mainland regulators in getting

the first-hand materials in a timely manner. Fifth, promote the reform of capital accounts. The reform of capital accounts and foreign exchange management system in China can be expedited through simultaneous IPO both at home and abroad and through CDR as well as cross-border transactions, which is beneficial for the reform of the entire financial system in China.

Continue to Improve Fundamental Institutional Framework to Promote the Sound Development of Securities Companies

With the undertaking of comprehensive restructuring of securities companies, risks common for securities companies are initially mitigated, but the building of underlying institutional framework still needs to be further strengthened and implemented. The amended *Securities Law* stipulates that securities companies shall have in place a third-party custodian system for clients' securities transaction and settlement fund; however, only a small number of securities companies actually carried out such a system, with the majority not yet formulating or implementing such a scheme. With the development of new business, such as warrants, margin financing and securities lending, securities companies need to further improve their behavior in information disclosure, risk management and internal management. In a long time to come, developing seller side business and expanding profitability channels will be another major task for securities companies.

In order to further consolidate the positive results from the comprehensive restructuring, more efforts should be made to improve the infrastructure construction related to the securities sector based on the new situation. According to the regulations in the amended *Securities Law*, it should be urgent for all securities companies to thoroughly execute the third-party custodian system for clients' securities transaction and settlement fund, so as to put in place an effective and closed management system for clients' securities transaction and settlement fund. Under the precondition of risk control, it is necessary to establish an institutional arrangement suitable for the sustainable development of securities companies. On the one hand, securities companies should be encouraged to make innovations, create a profit-making model based on seller side business, and diversify profit sources; on the other hand, restrictions on net capital for individual business shall be applied more rigorously according to net capital regulatory requirements. With the development of new business, such as warrants, margin financing and securities lending, securities companies should

be encouraged and supported to leverage on the capital market to enhance information disclosure, improve corporate governance, strengthen risk management and boost the risk resistance capability.

Strengthen Regulation and Improve the Regulatory Performance and Law-enforcement

At present, bottlenecks constraining the development of the capital market are phased out, and the capital market is in a critical phase. The amendments of the *Securities Law* allow the securities regulatory body to resort to more means and raise more requirements for its performance. As non-tradable state share reform comes to an end, in a market where all shares are tradable, irregularities such as insider trading and market manipulation will become more imperceptible and complicated in form, which creates new challenges for the securities regulatory body.

In order to improve regulatory means and levels, there needs to further improve securities law enforcement, enrich securities regulatory methods and strengthen regulatory coordination mechanism, mete out harsher punishment for violations and irregularities, severely punish securities companies and individuals involved, especially those crimes committed by companies in embezzling clients' assets and by big shareholders of securities companies in misappropriating assets of securities companies, in which case criminal responsibilities will be exerted. Punishment should be severe enough to be deterrent. Taking the opportunity of implementing *Securities Law* and *Company Law*,

regulatory departments should formulate and revise other related laws and regulations, so as to improve the legal environment of the securities market gradually.

Further Open the Securities Market and Improve the Services of Securities Sector

The opening up of the financial sector to foreign investors is an important part of the basic state policy of reform and opening-up. After China's accession into the WTO, China has made some progress in the opening up of the securities sector; however, the level is still low in general and far behind that of the banking and insurance sectors.

After the smooth restructuring of securities companies, large-scale restructured securities companies and other well-performing domestic securities institutions have taken up the major portion of domestic securities sector, and have a leading role in terms of market share. When domestic securities companies try to maintain the leading role in domestic securities market, it should be considered, when conditions permit, to introduce foreign strategic investors to partner with domestic companies. Through further opening up, more capital and especially more advanced management expertise can be introduced to help improve the corporate governance, and enhance the management of securities companies, so as to render higher-quality services for companies and investors for their respective financing and investment activities, and promote the sustainable, rapid and healthy development of the Chinese economy.

(By Li Yan and Meng Hui)



Chapter V

Insurance Sector

In 2005, the insurance sector was evidently stronger as a whole. With improved ability to forestall risks and broadened line of services, it played an important role in promoting reform, ensuring the healthy economic development, maintaining social stability and improving people's welfare.

Recent Developments

In 2005, the insurance sector continued its growth momentum, and made further progress in development, opening up, and supervision, etc.

More insurance institutions emerged. The year 2005 witnessed a steady increase of participants in the insurance market, including 22 new companies. As of the end of 2005, there were 93 insurance institutions, including 6 insurance groups and holding companies, 35 property insurance companies, 42 life insurance companies, 5 reinsurance companies, and 5 insurance asset management corporations.

The premium income grew steadily. In 2005, the premium income totaled RMB 493.128 billion yuan, up 14% over the previous year, including RMB 123.116 billion yuan worth property insurance premium income, RMB 324.686 billion yuan worth life insurance pre-

mium income, and RMB 45.326 billion yuan health and incident insurance premium income.

Claims and benefit payments increased somewhat. In 2005, various claims and benefit payments totaled RMB 113.67 billion yuan, an increase of 13% over the previous year, including RMB 67.29 billion yuan for property insurance claims, RMB 31.08 billion yuan for life insurance benefit payments, and RMB 15.31 billion yuan for health and incident insurance payments.

The assets available increased in amount, so did the return on capital utilization. As of the end of 2005, the total assets of domestic insurance companies stood at RMB 1.529869 trillion yuan, up 27.03% over the previous year, with the total assets for property insurance companies of RMB 173.028 billion yuan, assets for life insurance companies of RMB 1,340.087 billion yuan, assets for reinsurance companies of RMB 29.687 billion yuan⁵. The balance of insurance funds stood at RMB 1,410.011 billion yuan. The investment yield in 2005 was 3.6%, up 0.73 percentage points over that of 2004.

Insurance intermediaries developed rapidly. As of the end of 2005, professional insurance intermediaries increased to 1,887 (out of which 1,800 are in operation). There were 120,650 cross-sector insurance intermediaries, employing more than 1.4 million insurance

5 Because the premium income from property insurance and life insurance and that from reinsurance may overlap and due to the consolidation of balance sheet during financial calculation, the sum of assets in property insurance companies, life insurance companies and reinsurance companies is larger than the total assets for insurance companies.

salesmen. In 2005, premium income via intermediaries stood at RMB 359.7 billion yuan, accounting for 73% of the total premium income.

The sector was further opened up to foreign insurers. As of the end of 2005, there were 40 foreign-funded insurance companies, including 23 Sino-foreign joint venture insurance companies, and 17 solely foreign-funded insurance companies. In 2005, foreign-funded insurance companies earned RMB 34.12 billion yuan from premiums (including a group insurance policy of RMB 20 billion yuan sold by Generally China Life Insurance Co., Ltd. to Sinopec), up 304.55% over the previous year. Foreign-funded insurance companies accounted for 6.92% of the total premium income of the industry, with foreign-funded life insurance companies earning RMB 32.44 billion yuan and foreign-funded property insurance companies earning RMB 1.68 billion yuan.

The supervision system continued to improve. In 2005, CIRC steadily progressed with reform of insurance contract clauses and premium rates and establishment of an actuary system. As a result, the binding of solvency supervision was reinforced notably. At the same time, CIRC strengthened law-enforcement and inspections on vehicle mortgage insurance, universal insurance, "underground insurance policies" and other priority areas, to strengthen the construction of a system of acting in good faith. Therefore, market conduct supervision yielded good results.

Insurance Sector Reform Achievements

In 2005, domestic insurance sector explored more channels of investment, made efforts to experiment on integrated businesses, and made new progress in services innovation, structure adjustment and risk prevention.

Explore Investing Channels of Insurance Funds

In 2005, the insurance regulatory authority and other relevant authorities worked together to explore more channels of investment. In February, CIRC issued *China Insurance Regulatory Commission Notice on Certain Issues Regarding Stock Market Investments by Insurance funds*, *Notice Regarding Certain Issues in Stock Investments by Insurance Institutional Investors*, and *Guidelines On Registration and Clearance for Stock Investment by Insurance Institutional Investors*, in which stipulations were elaborated for operational issues for insurance funds making investment in the stock market, hence making it possible for insurance funds to invest directly in the stock market. In August, the promulgation of the *Provisional Measures for the Administration of Bond Investments of Insurance Institutional Investors* not only broadened the investment scope of insurance companies to financial bonds issued by commercial banks, short-term corporate financing bills and financial bonds issued by international development institutions and other innovative products, but also raised the proportion for investment in corporate bonds from

20% to 30% in the total assets. On September 1, CIRC issued *Implementing Rules for the Tentative Measures for the Administration of Overseas Utilization of Foreign Exchange Insurance Funds*, which stipulated that the field of insurance funds, excluding structured deposits, can be extended to MBS, money market funds and stocks issued by Chinese enterprises in overseas stock exchanges and other overseas financial instruments. As of the end of 2005, the State Council approved that insurance funds could be invested indirectly in infrastructure and the Bohai industry investment fund.

As the insurance funds was gradually allowed to make investments, the investment portfolio of insurance companies was notably improved (Table 5.1). This on the one hand improves the utilization efficiency of insurance funds and is good for the sound development of the insurance sector, and on the other hand, can bridge the insurance market to the capital market, hence supporting the reform of the Chinese capital market and promoting the coordinated development of the insurance market, capital market and money market.

Table 5.1 Investment Portfolio of Insurance Funds in 2005

	Balance at the end of the period (100 million of RMB yuan)	Increase y-o-y (percent)	In the balance of funds (percent)
Bank deposits	5,168.88	1.93	36.66
Bonds	7,424.55	53.82	52.66
T-bonds	3,591.76	37.17	25.47
Financial bonds	1,806.04	75.98	12.81
Corporate bonds	1,206.05	88.52	8.55
Subordinated bonds	820.70	51.28	5.82
Securities investment funds	1,107.15	66.16	7.85
Securities purchased under agreements to resell	27.80	-21.48	0.20
Stocks (equity)	158.88	3,422.59	1.12
Others	212.84	22.08	1.51
Total	14,100.11	30.82	100

Source: CIRC.

Pilot Programs for Integrated Financial Services Made Steady Progress

In 2005, CIRC worked with other related authorities to promote the integrated financial services on pilot basis, and some large-scale domestic insurance companies got actively involved in cross-product-line and cross-sector integrated services.

Insurance companies were engaged in cross-product-line integrated services on a pilot basis by setting up subsidiaries. Ping An Insurance (Group) Company of China Ltd ("Ping An") set up Ping An Life Insurance and Ping An Property Insurance to independently undertake life and property insurance. PICC Holding Company established a joint venture called PICC Life Insurance Company Ltd, to conduct integrated financial services covering such product lines of life insurance, health insurance and insurance brokerage,

etc.

As for the cross-sector integrated financial services, with the increasing investment made by the insurance sector in the capital market, the cooperation between the banking and the insurance sectors were being transformed from the loose business alliance to capital alliance. Ping An based itself on its subsidiaries (Ping An Trust and Investment, Ping An Securities, Ping An Bank, Ping An Asset Management, etc) to continue to explore models for integrated financial services. China Life Insurance (Group) Company ("China Life Group") made RMB 5 billion yuan worth investment in listed banks (including CCB and BOC). In October 2005, China Life Insurance Company Ltd. ("China Life") purchased CCB shares with USD 250 million. When BOC went public in Hong Kong, 78,842 H-shares were allocated to China Life and its parent company China Life Group.

Box 7 Case Study: Cooperation between Banks and Insurance Companies

Bancassurance is a product that combines the banking and insurance services as well as banking and insurance capital against the backdrop of economic globalization and financial liberalization, and has become an important approach for the banking and insurance sectors in developed countries to tap new markets and increase profits. Many large international banks or insurance companies have started bancassurance.

HSBC: Triple-win through bank-insurance cooperation

In 1974, HSBC set up a wholly owned subsidiary insurance company—HSBC Insurance Holdings (AP) Co., Ltd (previously named "Swire Life Assurance Company Limited, Carling Ford Insurance Company Limited), through which close bank-insurance cooperation was created on the basis of equity. HSBC then made reasonable division of responsibilities in the bank insurance

business, attached importance to brand-building, improved service quality, strengthened internal control and risk management. HSBC's bank-insurance cooperation achieved a triple-win situation; first, value for clients was continuously improved; second, the income structure of HSBC was optimized gradually; third, HSBC Insurance increased its market share and became moderately successful.

Credit Suisse Group: Flawed Bank-insurance Cooperation

In 1997, Credit Suisse Group and Winterthur Group announced their merger. After that, Credit Suisse quickly became a multi-play financial conglomerate providing commercial banking, investment banking and insurance services. The interaction between the two entities was very high in early stage after their merger, and Winterthur's profit increased substantially. But after 2000, under the influence of global economic downturn, weak stock markets and other factors, Winterthur suffered huge losses in equity investment. In addition, Winterthur provided some products with guaranteed minimum return, which exacerbated its financial situation, and required subsequent funding from Credit Suisse. These adversely affected the overall financial status of the Credit Suisse, putting pressure on it.

Allianz: Bank-insurance Cooperation Suffered Setbacks

German Allianz Group ("Allianz") is one

of the largest insurance groups in the world, while Dresdner Bank is the third largest bank in Germany. In 2001, Allianz purchased the majority shares of Dresdner with 24 billion Euros, boosting its total assets to 1 trillion Euros. However, because of lack of experiences in banking management and blocked initiative for bank-insurance cooperation, instead of making economic profits for Allianz, Dresdner caused Allianz to suffer great losses.

The Insurance Services Were Deepened and Service Scope Widened

In 2005, the insurance sector deepened its services and broadened the service area in the following aspects. First, it actively conducted agricultural insurance pilot programs with the agricultural insurance premium income growing by 84.26% y-o-y to reach RMB 729 million yuan, and the payment for agriculture insurance increasing by 94.79% y-o-y to RMB 558 million yuan. The agricultural insurance gradually played its role in stabilizing farmers' basic life standard, enhancing the ability of recovering reproduction after disaster and preventing and reducing risks in agriculture. Second, agricultural medical insurance was developed and started to provide the pension insurance for the farmer. Farmer's cooperative medical insurance was extended to 68 counties (county-level cities and districts) in 8 provinces (autonomous regions), covering 17.65 million farmers. The pension insurance for the farmer was launched in 53

counties (county-level cities and districts) of 18 provinces (autonomous regions). Third, insurance companies fully displayed the functions of guarantee and compensation of insurance, and launched over 200 liability insurance products tailored to new risks emerging in the economic and social

development. In 2005, the total premium income from liability insurance stood at RMB 4.531 billion yuan, up 35.71% y-o-y. Liability insurances played a key role in settling civil disputes, easing social problems and maintaining social stability.

The Unbalanced Development Was Somewhat Changed and the Structure was Optimized Gradually

In 2005, the insurance sector accelerated restructuring and achieved initial results. First, the business structure adjustment sped up. Property insurance companies slightly changed their strategy of over-emphasis on motor insurance, with the share of non-motor insurance in the total property insurance business up 2.3 percentage points over the previous year. Life insurance companies gradually changed their management philosophy to pay more attention to the embedded value and long-term stable and smooth development. As a result, the standard premium grew rapidly, 10 percentage points higher than the growth of scale premium; share of single payment policies increased in new life insurance business, with new life insurance installment premiums totaled RMB 46.612 billion yuan, up 25.78% y-o-y, accounting for 20.95% of new life insurance premiums, up 1.94 percentage points. Second, the regional unbalanced development was slightly improved. The development in middle and western areas noticeably accelerated, with Guizhou, Sichuan, Hubei, Shaanxi, and Shanxi growing by over 17% on average.

Third, the investment portfolio was changed. The proportion of bond investment in the total insurance asset investment for the first time exceeded that of bank deposits, to 52.3%, making insurance companies the second largest institutional investors in the bond market.

The Risk Control Mechanism Was Gradually Improved

In order to improve the capability in fending off risk, CIRC promulgated a series of new policies in 2005, including *Guidance for Regulating the Corporate Governance Structure of Insurance Companies (Provisional)* to improve the risk control capacity and management of insurance companies; *Administrative Measures on Non-life Insurance Reserves (Provisional)* and *Measures on the Administration of Insurance Terms and Rates of Property Insurance Companies*, to scientifically measure, analyze and evaluate the solvency of property insurance companies, improve actuary techniques and protect the interests of the insured; *Life Experience Table for Life Insurance in China (2000-2003)*, in which a new life experience table was compiled to improve the pricing ability and risk management level of life insurance companies. In addition, CIRC also issued the *Regulations on the Ad-*

ministration of Reinsurance Business in order to regulate the reinsurance market, and *Notice on Developing Custody of Insurance Funds*, in which the independent third-party custody system was introduced, to prevent risks that might arise after the insurance investment portfolio became more diversified and improve the safety of funds utilization. At the same time, the last line of defense to forestall risks – the policyholder protection fund was officially launched in China in 2005.

Key Areas and Reform Measures to Focus on in Developing the Insurance Sector

Insurance sector becomes more and more important as the economy develops and society advances. At present, the Chinese economy develops very fast, with the living standards improving continuously, which has brought about huge opportunities for the development of the insurance sector. In 2005, the insurance sector developed very stably in general, but certain deep-rooted problems that have been accumulated for a long time are not completely solved, while new concerns emerge. The insurance sector should speed up reform and development so as to meet the requirements of the national economic development.

Speed Up the Development to Provide More Diversified Services for the Economic Development

In recent years, the Chinese insurance sector has witnessed rapid development, with the annual growth rate of premium income during

the “Tenth Five-year Period” over 25%, and the overall strength obviously strengthened, therefore, it has been playing a more important role in the financial system. But the sector is still at its initial developing stage, because it started late with very poor fundamentals. The key indicators are far below global average and lag behind those of other financial sectors in China. In 2005, China insurance penetration (the percentage of national premium income in relation to GDP) was 2.8%, and insurance density (per capita premium income) was RMB 379 yuan, while the world’s average insurance penetration was 7.52%, and average insurance density USD 518.5. The total insurance assets only accounted for around 3% of the financial assets, far below the 20% average among developed countries.

There is still a large room for the development of the insurance sector in the perspective of the huge demand from the rapid development of national economy for the insurance sector, and the position and function of the insurance sector in the financial system. So the sector should develop faster and provide more services for the economic development. In terms of agricultural insurance, while improving services, the enthusiasm of the central government, local governments, insurance companies and farmers shall be put into full play, and a multi-layer, multi-channel agricultural insurance system should be established. In terms of catastrophe insurance, due to frequent occurrence of natural disasters that inflict upon lives and properties, we should explore ways to set up a catastrophe insurance system with financial support from the national

revenue. In terms of insurance companies' engagement in the social security system, insurance sector shall draw upon its advantages in human resources, wide coverage, risk management, investment management and other techniques to actively participate in the establishment of urban and rural commercial pension schemes and health insurances to satisfy the demand of the general public for safety environment. In terms of liability insurance, on the one hand, the sector should guide policyholders to improve risk management and reduce accidents probability through differential premium rates; on the other hand, timely payment should be made after accidents, and insurance should be incorporated into the accident relief system to maintain the social stability.

Solve the Historical Problem of Interest Spread Loss and Strengthen Asset-liability Management

At present, there are limited medium-and-long term bonds in the financial market available for insurance companies, far less than satisfy-

ing the companies' need for asset and liability match. This is especially true for life insurance companies whose performance is marred by asset-liability mismatch. As the insurance funds have more channels to make investment, insurance companies pay more attention to asset-liability management to fend off market risk. In addition, the historical legacy of interest-spread loss in China Life Group should be urgently addressed.

To solve the aforesaid problems, first, relevant authorities should cooperate closer to improve the funds utilization efficiency through supporting policies and broadening the investment channels. Second, investment products in the financial market should be enriched, with the medium-and-long term bonds in particular. Third, insurance companies should improve asset and liability management, and emphasize asset and liability match in funds utilization. Macroeconomic variables such as exchange rate and interest rate shall be taken into full consideration in product pricing.

Box 8 Interest Spread Loss in Life Insurance Companies

The price of insurance policies are based on interest rate and other related assumptions and sell policies to the applicants. Life insurance companies collect premiums. Then life insurance companies utilize partial premium income and make benefit payment to the insured with return on such funds utilization. When the return on investment is lower than the pre-set interest rate for insurance policies, interest spread loss incurs.

Spread loss is one of the major risks faced by life insurance companies, which makes the insurance companies' reserve inadequate and then reduces capital, impairs solvency, and even might lead to bankruptcy in more serious cases. The fundamental reason for such spread loss is that when designing insurance products, life insurance companies failed to take into full consideration of the impact of macroeconomic variables.

As for the damages resulted from interest spread loss, the Japanese lessons are worth learning from. In the 1980s, Japan gradually rose to be the largest creditor country in the world, and there appeared bubbles in this process. During this period, Japanese life insurance companies competed on scale, and substantially raised the previous average interest rate of 4% set in insurance contracts. By 1985, the pre-set interest rate for new insurance policies with a maturity of 10 years or less reached 6.25%. With the burst of bubble, Japan entered an era of deflation with the interest rate plummeting. Even after the zero interest rate policy is adopted, the capital market remained bearish. In the 1990s, Japanese life insurance companies were mired in interest spread loss. As of March 2000, 15 large-scale life insurance companies in Japan suffered a total loss of 1.5 trillion Japanese yen. Between 1997 and 2000, Nissan Mutual Life Insurance, Toho Mutual Life Insurance and Daihyaku Mutual Life Insurance declared bankruptcy because of interest spread loss. The subsequent bankruptcy of Japanese large life insurance companies dampened directly the confidence of the public in the insurance sector, and triggered the massive withdrawals. From April to June 1997, withdrawal amount for personal life insurances reached 23.7 trillion Japanese yen in 44 life insurance companies, up 21% than the previous quarter, including 10% withdrawal ratio among big companies, and 70%-80% among small companies. This

caused more insurance companies to go bankrupt and triggered serious crisis in the insurance sector.

The development of China's insurance sector started late and is still at the initial developing stage with limited experiences, and also suffered from interest spread loss. In the early 1990s, life insurance companies priced their policies mainly with reference to bank deposits interest rates, and the pre-set interest rate was as high as 8% or more, and a lot of insurance policies had a maturity of 20 years or even longer. When pricing their products, these companies were lacking in experiences and mechanism to manage risks, and didn't take into consideration the influence of macroeconomic variables, which caused their expected return on investment to drop, and huge pressure on capital accumulation and interest spread loss to incur.

After the interest spread loss occurred among Chinese life insurance companies, positive and effective measures were taken to mitigate the risk. First, CIRC issued *Emergent Circular for the Adjustment of the Pre-set Interest Rates of Life Insurance Policies*, in which it was stipulated that the annual compound interest rate for life insurance policies shall not be over 2.5%; second, related authorities cooperated with each other to increase channels available for insurance funds utilization and improve the return on investment; finally, the insurance reform was deepened, and the interest

spread loss was solved partially through restructuring and subsequent IPO, recapitalization, improvement of profitability, introduction of foreign investment, etc. Till

now, the spread loss issue has been by and large solved for the insurance sector, except for a few companies.

Improve Property Insurance Market Environment, and Promote Proprietary Innovations

In 2005, the property insurance business maintained its growth momentum, while high concentration risk on products with large payment (such as motor insurance), which led to fierce competition deserved to be closely monitored. Some insurance companies committed irregularities and strived for market share by lowering premium rates. This, coupled with lack of stringent underwriting system and underwriting management, increased costs of these companies. While compared to their costs, the prices of the insurance companies' products are very low, and the premium income couldn't even cover the risks.

In order to further improve market environment, promote the healthy development of the property insurance business, more attention should be paid to the following aspects. First, regulatory authorities should strengthen supervision, with more emphasis laid upon insurance companies involved in vicious competition, and handle irregularities more seriously. Second, insurance companies should raise awareness of and implement the concept of compliance and doing business in line with laws and regulations. Third, insurance companies should improve actuarial techniques to reasonably price their products, develop un-

derwriting system and underwriting management system. Fourth, insurance companies should endeavor to improve innovation capabilities, accelerate the adjustment of product structure and cultivate new businesses for growth. Market segmentation should be made according to different consumer bases, and new and marketable products shall be developed to satisfy the diversified needs in society.

Speed Up the Reform of Reinsurance Companies to Improve Their Competitiveness

In 2005, the premium income from direct insurance businesses approached near RMB 500 billion yuan, but the reinsurance premium only stood at about RMB 20 billion yuan, accounting for only 5% of the total, far below the average of 20% of developed countries. The development of reinsurance falls far behind, leading to the accumulation of risks, thus constraining the rapid and sound development of the insurance sector in China.

According to the estimation of CIRC, by 2010, the premium income will reach RMB 1 trillion yuan, providing large space for the development of reinsurance business. At present, global reinsurance giants are coming to China to tap the market in a flurry. As of the end of 2005, Swiss Re, Munich Re and Cologne Re had set up subsidiaries in China to directly compete with Chinese reinsurance

companies, while Chinese reinsurance companies cannot be compared to them both in terms of capital strength and management. Besides, according to China's WTO commitments, China will terminate compulsory reinsurance, which will put more pressure on operations of domestic reinsurance companies.

Accordingly, domestic reinsurances should speed up reform, make clear development strategies; improve corporate governance, establish a sound internal control mechanism,

reinforce the independence, professionalism and authoritativeness of internal auditing, and put in place and improve the risk control system; extensively learn from the experiences of the international reinsurance market, introduce advanced overseas management expertise and technologies to improve the competitiveness and become more prepared for international competition, and provide reinsurance protection for the development of the domestic insurance market.

Box 9 The Development of the Global Reinsurance Sector

Reinsurance is the "insurance for insurance", and refers to operations of transferring part of an insurance company's underwritings to other insurance companies. Reinsurance can diversify insurance risks, expand the underwriting capacity, guide the market innovation, and is the "safety valve" and "regulator" for the insurance sector. When catastrophes occur, reinsurance business can share the losses to make sure the original insurers can weather through crises. It is reported that Hurricane Andrew in 1992 caused a loss of USD 20 billion for the insurance sector, out of which reinsurance sector shouldered 30%. In 2005, Hurricane Katrina inflicted a loss of USD 135 billion. Loss payment from global insurance companies totaled USD 45 billion, including USD 20.7 billion to USD 24.0 billion shouldered by reinsurance companies.

As of December 31, 2004, the total capital

of global reinsurance sector was nearly USD 380 billion, with 150 major reinsurance companies, and the main source and target in regional term of premiums are US and Europe. Europe is the net payer for reinsurance risks. According to net premium income, the world's top five reinsurance companies in 2004 were Munich Re, Swiss Re, Lloyd's of London, Hanover Re and Allianz (please refer major indices to Table 5-2). According to Swiss Reinsurance, the global reinsurance premium income in 2004 was about USD 167.8 billion, including premium income from non-life reinsurance of USD 134.4 billion, premium from life reinsurance of USD 33.4 billion, accounting for 80% and 20% respectively of the total. The global top 10 reinsurance companies took up 52% of the non-life reinsurance market, and 87% of the life reinsurance market (Table 5.3).

Table 5.2 Related Indices of the World's Top 5 Reinsurance Companies in 2004

Rank	Company	Net Premium Income (million of USD)	Market Share (percent)	Adjusted Equity (million of USD)	Comprehensive Cost Ratio (percent)
1	Munich Re	24,729.0	14.5	35,708.0	96.5
2	Swiss Re	15,628.2	9.1	10,803.1	103.9
3	Lloyd's of London	7,653.1	4.5	26,236.6	96.4
4	Hanover Re	5,638.2	3.3	4,958.1	96.8
5	Allianz	5,058.8	2.95	64,625.1	84.9

Source: Calculations based on data from S&P and A. M. Best.

Table 5.3 Development of Reinsurance in the World 1990-2004

Year	Non-life Insurance			Life Insurance		
	Total Premium Income (million of USD)	Reinsurance Premium Income (million of USD)	of Reinsurance (percent)	Total Premium Income (million of USD)	Reinsurance Premium Income (million of USD)	of Reinsurance (percent)
1990	537.4	59.8	11.1	673.9	7.3	1.1
1995	745.0	89.9	12.1	1,056.4	11.1	1.1
2000	758.2	94.5	12.5	1,370.6	20.0	1.5
2001	814.0	108.1	13.3	1,300.8	22.4	1.7
2002	927.1	124.6	13.4	1,388.0	25.0	1.8
2003	1,060.3	141.1	13.1	1,529.1	29.4	1.9
2004	1,187.2	134.4	11.3	1,702.5	33.4	2.0
Underwriting proportion of top 10 reinsurance companies in 2004			52	87		

Source: Swiss Reinsurance.

Regulate the Development of Insurance Intermediaries to Upgrade Their Professionalism

In 2005, the insurance intermediary market developed very rapidly, and the market order was improved; however, there were still some problems needed to focus on: first, insurance salesmen need to be better managed; second, the professionalism of intermediaries' employees is low, due to therefore, the professional-

ism shall be improved; third, professional intermediaries, compared to insurance salesmen and cross-sector insurance intermediaries, develop slowly on a small scale.

To promote the rapid development of insurance intermediary market, insurance intermediaries should actively explore reasonable marketing model based on their operational and management characteristics, and strengthen

management over insurance salesmen; adjust the internal structure to promote the rapid development of professional intermediary agencies; streamline the market segmentation, innovate the organizational form, provide specialized services and improve resources allocation efficiency in the insurance market.

Increase the Channels for Insurance Funds Utilization and Improve the Utilization Efficiency

Underwriting and funds utilization are the two pillars of insurance companies. As the competition among insurance companies becomes fiercer, the underwriting margin falls, therefore, funds utilization is increasingly becoming an important source for insurance companies to make profits. From 1999 to 2005, the annual return on investment averaged at 3.48%, and in 2005 3.6%, pretty low compared to that of developed countries. The major reasons are as follows. First, China's insurance sector is still at its initial developing stage, with low ability in funds utilization, and poor adaptability to the changes in the external macro-economic policies. Second, there are limited channels for insurance investment. In the past and for a long period of time, insurance funds could only be invested in bank deposits and T-bonds. Although the channels were expanded in 2005, there is still a large space for expansion. Third, there are limited financial instruments available for medium-and-long term investment, thus cannot meet the demand of insurance companies for investment.

As the transition period after China's WTO accession is to be concluded, the funds utilization

efficiency will become the key factor that influences the competitiveness of Chinese domestic insurance companies. Therefore, relevant authorities shall expand investment channels, and develop more financial products available for insurance companies to make investment. At the same time, the insurance sector should actively participate in the product innovation in the financial market, improve the funds utilization efficiency as soon as possible and narrow the gap with the developed countries.

In addition, more channels for investment, though beneficial for raising the return on investment, can also pose challenges for insurance companies in terms of risk management capability. In order to strengthen the management of risks associated with insurance funds, regulations regarding risk control shall be issued in a timely manner, reinforce the supervision over insurance investment, gradually establish and improve the custody system, improve the management of connected party transactions in insurance investment, and promote the transparency of insurance funds management. Insurance companies shall speed up the reform of funds utilization management system, set up a specialized, market-oriented, and well regulated insurance funds management system, as well as improve the risk control capability.

Further Improve Regulatory Ability, and Corporate Governance of Insurance Companies, Strengthen Information Disclosure

At present, the risk prevention system for China's insurance sector has taken shape and good results have been yielded. But some in-

insurance companies are still not well prepared for risk management. They expand businesses too fast and tie up substantial funds, which result in poor solvency. In the next step, while continuing to strengthen risk prevention, improve supervision of market behaviors and corporate governance, the insurance sector shall strengthen regulation on companies' solvency. A financial system in line with features of the insurance sector and international standards shall be put in place and the solvency supervision indicators system shall be improved.

At present, many insurance companies have initially established their corporate governance framework, and made progress in optimizing shareholders' structure and strengthening the building of Board of Directors, but Board of Directors and Board of Supervisors of certain companies still need to be improved, with the system of accountability for risks to be established, risk management to be strengthened, and information disclosure to be strengthened. Therefore, insurance companies should focus on consolidating the results of joint stock reform of the state-owned insurance companies, make more efforts to improve corporate governance, put in place a coordination and balance mechanism among the power body, decision-making body, supervisory body and practitioners; they should also introduce overseas advanced experiences and techniques, improve risk management, strengthen internal control, improve and carry out the system of accountability for risks; lay more emphasis on trans-

parency of the entire industry and strengthen information disclosure according to such features of the insurance sector as high specialization, complex insurance contract terms, and asymmetric information.

Improve the Service Quality of Insurance Companies and Strengthen Credibility Construction

Currently, there is a phenomenon in the insurance market that values policy selling more than service quality. Some insurance companies failed to attach importance to honest operation; instead, they cheat or mislead clients by taking advantage of the complexity of the insurance clauses and lack of insurance knowledge on the part of the applicant. When accidents covered by the insurance policy actually occur, they are reluctant to settle claims.

With the aim to improve the insurance service quality, strengthen the credibility, the insurance sector shall launch new services and comprehensively improve the service quality; strengthen integrated governance and punish the dishonest conduct harshly, and take practical measures to fight against such cases as misleading and difficulty of claim settlement; press for honest, faithful and standardized service, make more efforts to create a culture of credibility, so as to lift the image of the insurance sector, win the trust from the public; put in place a rapid processing mechanism for insurance-related disputes to earnestly guarantee the interests of the insured.

(By Xu Zhong, Wang Shaoqun
and Chen Min)



Chapter VI

Pilot Programmes of Integrated Financial Services

In October, 2005, the Fifth Plenary Session of 16th CPC Central Committee adopted the *Proposal of the CPC Central Committee for Formulating the Eleventh Five-year Plan for National Economic and Social Development of the PRC*, which comes up with a suggestion of “pushing forward pilot programmes of integrated financial services in a steady manner”. Pilot programmes of integrated financial services is the natural choice of China’s financial industry in this broad environment of deepening reform and further opening up to the world. At present, the conditions to push forward pilot programmes of integrated financial services in China have been met. The next step is to further strengthen financial regulation coordination and information sharing, enhance risk control capabilities of financial institutions, choose an integrated financial services mode in line with China’s national conditions, fend off any possible cross-sector and cross-market risks arising from integrated financial services, and maintain financial stability.

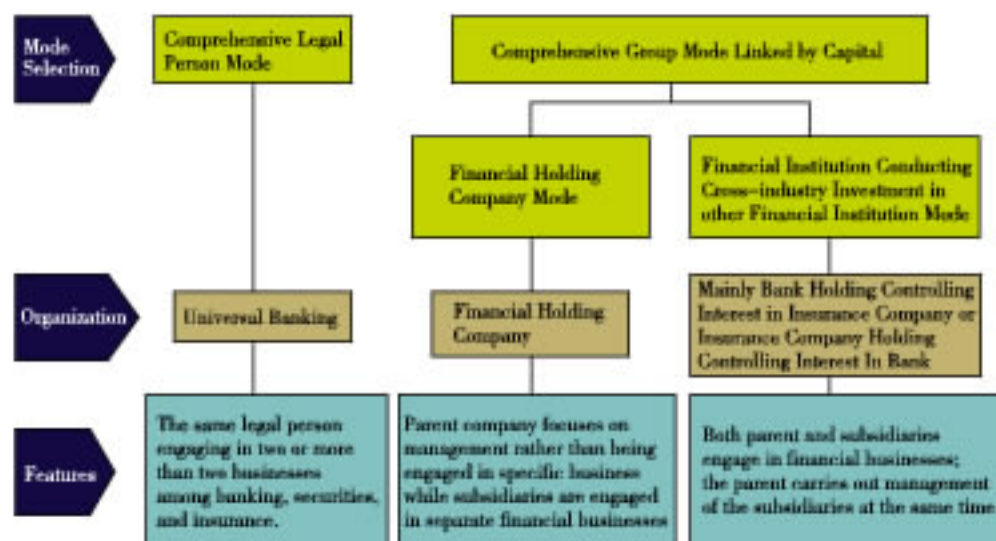
Retrospect and Status Quo of Integrated Financial Services in China

Integrated financial services refer to the financial mechanism in which banking, securities and insurance industries can deal in cross-industry businesses. Integrated financial services have two major forms (Figure 6.1). First one is comprehensive legal person mode,

meaning that the same legal person deals in two or more than two businesses among banking, securities and insurance. This mode requires financial institutions to have relatively strong legal conception, sound heritage of credit culture, and consciousness of self-discipline. The second is comprehensive group mode linked by capital, which can also be classified into two categories: (1) financial holding company, which does not directly engage in financial businesses but has controlling interest in commercial bank, security company, or insurance company; (2) one financial institution, mainly commercial bank or insurance company, acts as investor to conduct cross-industry investment and establish financial institutions of other industries.

Integrated financial services are not new in China. Since 1978, China’s financial industry has made its endeavor in diversifying business operation, which was generally referred to as “mixed operation”. In 1978, after the Third Plenary Session of CPC Central Committee established guiding principles of economic and financial reforms, China witnessed diversification of financial institutions and financial businesses. CITIC founded in 1979, BOCOM restructured in 1986, and CITIC Industrial Bank newly established were all once authorized to deal in diversified businesses including banking, insurance, securities, trust, and so on. As a result, SOCBs also once set their feet in various financial businesses and invested in non-bank financial institutions and non-financial enterprises.

Figure 6.1 Integrated Financial Services Mode



The principle of "segregated industry operation and supervision" was primarily established between 1993 and 1997. In 1993, China's financial order experienced serious problems due to unfavorable financial ecosystem, insufficient regulation, lack of talents, unhealthy internal control mechanism, and faulty accounting standards. Mixed operation was regarded as one of the reasons giving rise to the situation. In November, 1993, the Third Plenary Session of 14th CPC Central Committee passed *The Decisions of the CPC Central Committee on Several Issues Regarding the Establishment of Socialist Market Economic System*, demanding "segregated regulation of banking and securities industries". In December, 1993, the State Council promulgated *Decisions on Financial System Reform*, which prescribed that "SOCBs should not invest in non-financial enterprises. Insurance industry, securities industry, trust industry, and banking

industry shall have segregated business operation." *Commercial Bank Law* and *Insurance Law* promulgated in 1995 and other financial laws all abided by the principle of "segregated industry operation and supervision".

The structure of segregated industry operation and supervision of financial industry was improved between 1997 and 2002. In December, 1997, faced with the grave situation of Asian financial crisis as well as China's chaotic financial order and increasing financial risks, the CPC Central Committee and the State Council summoned National Financial Work Conference and distributed the *Notice of the CPC Central Committee and the State Council on Deepening Financial Reforms, Rectifying Financial Order, and Preventing Financial Risks*, which demanded "to explicitly define business scopes of various financial institutions and take resolute measures to re-

verse the mixed operation” and pointed out that “the segregated business operation principle of banking, trust, insurance and securities industries should be strictly followed under present circumstances in China”. In 1998, CIRC was founded to form a segregated industry regulation system with the PBC, CSRC, and CIRC exerting regulations on banking, securities, and insurance industries respectively.

During 2002 and 2003, the system of segregated industry regulation was finally established; meanwhile, financial industry began the pilot programmes of integrated financial services. In December, 2001, China acceded to WTO. In February, 2002, the CPC Central Committee and the State Council held the Second National Financial Work Conference, which requested to further improve modern financial institutional system, market system, and regulation system in the new era, enhance China's financial competitiveness in an all-around way, and emphasize that “enhancement of supervision efficiency is the most important mission.” Against this background, CBRC was duly founded in April, 2003, signifying the final formation of China's financial administration system consisting of “the PBC, CSRC, CIRC, and CBRC”.

In the process when segregated regulation system was gradually formed and established, in 21st century in particular, the limitations of segregated operation have begun to show. Petitions for and dynamics of integrated financial services are growing day by day with the deepening of the opening up of China's economic and financial sectors and the development of financial globalization and liberalization. Since the

professionalism and efficiency of supervision and regulation have witnessed obvious improvement, financial industry began pilot programmes of integrated financial services and explored cross-industry institutional innovation and product innovation in order to boost competitiveness and satisfy the demand of the society for diversified financial services. In 2002, CITIC Holdings Ltd was established with the approval of the State Council. Confronted with new circumstances, the Third Plenary Session of 16th CPC Central Committee adopted the *Decision of CPC Central Committee on Issues Regarding Improvement of the Socialist Market Economic System* in October, 2003, requiring to “establish and improve a mechanism of organic combination and coordinated development among money market, capital market, and insurance market” and “establish and improve a coordination mechanism between regulatory authorities of banking, securities, and insurance industries and macro economic control and regulation authorities such as the central bank and the MOF so as to strengthen financial regulation.” On October 11, 2005, in order to boost financial institutions' competitiveness in international market, fend off financial risks, and promote stable development of financial industry, the Fifth Plenary Session of 16th CPC Central Committee passed the *Proposal of the CPC Central Committee for Formulating Eleventh Five-year Plan for National Economic and Social Development*, which explicitly required to “push forward pilot programmes of integrated financial services in a steady manner.”

Since 2005, as policies governing pilot pro-

grammes of integrated financial services gradually turn out to be luminous, pilot programmes of integrated financial services in China have been progressing steadily with the joint efforts of governmental guidance as well as voluntary momentums of the market. First, the State Council and financial regulatory authorities have consecutively approved cross-industry investment of some financial institutions. On February 20, 2005, with the approval of the State Council, the PBC, CBRC and CSRC jointly promulgated *Administrative Rules for Pilot Incorporation of Fund Management Companies by Commercial Banks*, which allows commercial banks to invest in and establish fund management companies. In August 2005, China Galaxy Financial Holdings Limited was established with the approval of the State Council. In April 2006, the State Council agreed insurance companies to invest in non-listed bank equities and securities companies. In May 2006, the State Council agreed in principle that commercial banks may establish and invest in financial leasing companies and that AMC's engaging in risk disposal

of securities companies may establish securities companies and acquire security assets. Second, some large state-owned energy, power, and transportation groups under direct leadership of the central government, some state-owned assets investment and management companies owned by local governments and joint-stock private enterprises have voluntarily expanded their businesses to financial industry, invested and controlled financial institutions of various industries with the purpose of leveraging financial profits and obtaining financing facilities. Third, financial institutions have expedited innovation of financial products and engaged in cross-industry and cross-market financial businesses in many fields, including cross sales of bank-securities and bank-insurance products, entrust financing, credit assets securitization, enterprise annuity management and investment, etc. Fourth, relevant government departments have also strengthened supervision, regulation, and risk analysis of integrated financial services. In 2005, the PBC conducted a survey of integrated financial services in China.

Box 10 Developments of Integrated Financial Services in China

In recent years, great attention has been given to the development of integrated financial services. In order to obtain a better understanding, the PBC carried out a series of surveys on 506 legal person financial institutions and their top 10 shareholders (3515 enterprises altogether) in China. The survey demonstrates that integrated financial services are relatively common in China. If

absolute controlling is defined as directly or indirectly holding of over 50% shares of financial institutions while relative controlling is defined as holding less than 50% shares of financial institutions but possessing actual controlling powers in human resources, finance, and operation decision-making, by June 30, 2005, out of 3515 sampling enterprises, 530 non-financial enterprises have

invested in more than two types of financial institutions with 46 possessing controlling positions, 230 financial institutions have invested in financial institutions in other industries with 66 possessing controlling positions, and three financial holding companies were incorporated. The 115 enterprises in aforementioned three categories have already become de facto financial groups (Table 6.1), and these enterprises are mainly located in developed regions such as Beijing, Shanghai, Jiangsu, Guangdong, etc. The details are as follows.

First type is the group integrating non-financial and financial entities, formed from large non-financial enterprises. Major reasons for non-financial enterprises to pursue controlling interests in financial institutions are: offering diversified services so as to reduce operational risks, investing in financial industry so as to meet capital and other financial demand incurred by business expansion. Among these groups, minority of them have integrated financial resources within the group, i. e. the groups establish holding companies to manage financial assets; but majority of them choose to establish "financial management department" within the group to manage financial assets, forming a direct mixed operation of non-finance and finance.

Second type is the financial group guided by local governments, transforming from state-owned assets investment and management companies. In recent years, almost all local

governments began to integrate local resources. Many local State-owned Assets Supervision and Administration Bureaus began to establish state-owned assets investment and management companies so as to realize the controlling interests in local banks, securities companies, insurance companies, fund companies, and so on.

Third type is the financial institutions, which make cross-industry investment in financial institutions of other financial industries. At present, many large financial institutions, particularly some commercial banks and insurance companies, demonstrate strong inspiration of diversifying their businesses. Some commercial banks and insurance companies have already begun or are being vigorously engaged in pilot programmes in this regard, wishing to enter other financial fields by cross-industry acquisitions.

Fourth type is a large number of private enterprises and listed companies holding over 5% equities of financial institutions. In this survey, it is discovered that 176 enterprises have invested in two or more than two financial institutions at the same time and have all possessed over 5% shares. These enterprises include some renowned private enterprises and listed companies. Although these enterprises do not have controlling interests in the financial institutions, they can still exert material impact on those financial institutions as a large shareholder. Some of them may even be transformed into financial groups in the future.

Fifth type is more foreign investment in terms of joint-venture with some possessing controlling interests in domestic financial institutions. At present, some foreign financial groups have penetrated into banking,

securities and insurance industries in China by establishing branches, subsidiaries, or joint-venture companies, and investing in financial institutions, to achieve their strategic deployment.

Table 6.1 Basic Organizational Forms of Integrated Financial Services in China

Category	Sub-category	Number
Industrial-Financial Conglomerate	Large Groups in Energy and Transportation Industry	17
	State-owned Assets Investment Companies Owned by Local Governments	24
	Joint-stock Enterprises	5
	Subtotal	46
Financial Institution Investing Financial Institutions in Other Industries	Commercial Banks	6
	Insurance Companies	5
	Securities Companies	23
	TICs	27
	AMCs	2
	Finance Companies	2
	Futures Brokerage Companies	1
	Subtotal	66
Financial Holding Companies		3
Subtotal		115

Necessity and Feasibility of Steadily Pushing Forward Pilot Programmes of Integrated Financial Services

Necessity of Steadily Pushing Forward Pilot Programmes of Integrated Financial Services

Pushing forward pilot programmes of integrated financial services is an inevitable choice of China's financial industry in the environment

of both external pressure and internal momentum.

First, it is the requirements on China's financial industry to meet external challenges and promote international competitiveness. At present, most large multi-national financial institutions in the world are engaged in integrated businesses. Year 2006 is the last year of the transition period after China's accession into WTO; China's financial industry is opening

wider to the world. Although foreign financial institutions have to abide by basic principle of segregated operation, they can still compete with domestic financial institutions in an all-round way by taking advantage of the integrated services advantages of their parents in business support, data information, and customer resources; and China's financial institutions will face tougher competition. Thus, it is necessary for China's financial institutions to conduct integrated financial services with the purpose of enhancing international competitiveness and meeting the challenges actively.

Second, it is the requirements on China's financial industry to satisfy the demand for diversified financial services. Since reform and opening up, China's economic development and national income have witnessed continuous growth; relationship between banking industry, securities industry and insurance industry have become closer and closer; inter connections between money market, capital market and insurance market are enhanced day by day; and both enterprises and households have strong demand for diversified financial services. Therefore, financial industry must expedite innovation of financial services and products, improve efficiency and quality of financial services, and meet demand of customers for diversified financial services to the largest extent through integrated services.

Third, it is for the purpose of dispersing risks and fully taking advantage of the resources allocation function of financial market. Due to historical legacy problems as well as under-developed financial market, financing struc-

ture in China is mainly indirect financing with commercial banks playing a dominant role. Direct financing lags far behind indirect financing, which, on the one hand, gives rise to the over-dependence of enterprises on banks and over-concentration of whole society's financing risks in the banking system, and on the other hand, the dependence on banking industry to evaluate market risks and allocate capital is not conducive to the optimization of resources allocation and overall stability of financial system. Hence, offering integrated financial services is conducive to reduce proportion of indirect financing, make further use of resources allocation function of market, promote coordinated development of direct financing and indirect financing, realize organic combination of financial markets, and maintain the stability of financial system.

Feasibility of Steadily Pushing Forward Pilot Programmes of Integrated Financial Services

Integrated financial services are closely related to financial reform, financial opening up and financial stability, and also constrained by many factors. At present, China's financial sector has met basic conditions to carry out pilot programmes of integrated services.

First, professionalism of financial regulation has been enhanced by a relatively large margin so as to meet the regulation requirements for integrated financial services. In the prevailing segregated industry regulation system, financial regulation authorities ensure the healthy development of China's financial industry by improving various regulation provisions and rules, strengthening regulation measures and

methods, accelerating risk mitigation and disposal, and continuously enhancing professional capabilities of financial regulation. Confronted with the trend of integrated financial services, financial regulation authorities have formulated relevant regulation provisions on cross-sector financial products, including credit assets securitization, financial derivatives, and entrust financing products in their respective regulatory areas. The PBC has strengthened coordination and cooperation with various regulation authorities to conduct a trial functional regulation in such areas as commercial bank are establishing fund management company and accumulated some experience for regulation system of integrated financial services.

Second, further deepening reforms of financial institutions have laid a sound micro foundation for pilot programmes of integrated financial services. Along with the further deepening of financial reform, financial institutions now feature generally better operating results, obviously improved asset quality, well-controlled financial risks, and drastically lowering NPA ratios; financial institutions' capabilities to resist risks are further strengthened, modern corporate governance structure is almost established, risk management and internal control mechanism have shown relatively large improvement, and a batch of teams of senior and professional talents have been organized. In particular, SOCBs, after three years' reform, are now in relatively sound status in terms of financial conditions, corporate governance, risk management and internal control mechanism, asset quality and profitability, which have laid a sound micro foundation for inte-

grated financial services.

Third, a preliminarily established financial market system provides guarantee for pilot programmes of integrated financial services. The width, depth and openness of financial markets are improving day by day with increasing kinds of products, rising liquidity, and strengthening basic resource allocation function of the market. Money market, bond market, stock market, insurance market and foreign exchange market, etc, all have made great strides forward, the number of financial instruments is growing, and financial innovation is rapidly progressing, which altogether provide sound market operation conditions and guarantee to carry out integrated financial services.

Fourth, financial ecosystem is getting improved and almost all external requirements on pilot programmes of integrated financial services are satisfied. Financial ecosystem, including accounting standard, credit environment, and financial safety net, is gradually perfecting. Financial laws such as *Commercial Bank Law* and *Securities Law* have left aside space for integrated financial services, and the ecosystem conditions needed for pushing forward pilot programmes of integrated financial services are basically met.

The Way Forward

Integrated business, while adding driving force and vitality to the development of China's financial industry, also brings about uncertainties undermining financial stability,

which makes characteristics of financial risks more complex in that cross-industry, cross-market, and cross-border systemic features begin to show up. It's becoming more and more formidable to fend off systemic financial risks and maintain financial stability. In view of the current economic and financial situations, it is not yet the proper time to carry out integrated financial services in an all-round manner; rather, we should first begin with some pilot programmes with steady progress, and attach great importance to the following aspects.

Enhance Financial Regulation Coordination and Information Sharing, Further Improve the Effectiveness of Financial Regulation

The Third Plenary Session of 16th CPC Central Committee required to "establish and improve coordination mechanism between regulatory authorities of banking, securities and insurance industries and between such regulatory authorities and the central bank and the MOF"; the fifth plenary session of 16th CPC Central Committee requested to "establish and improve coordination mechanism between regulatory authorities of banking, securities and insurance industries and between such regulatory authorities and authorities of macroeconomic regulation and control". In the process of steadily pushing forward integrated financial services, the PBC and other financial regulatory authorities should follow the spirits of the third and fifth plenary sessions of 16th CPC Central Committee, establish and improve coordination mechanism of financial regulation, harmonize regulation policies and measures, enhance information sharing and prevent

cross-industry and cross-market financial risks.

Improve Corporate Governance of Financial Institutions, Strengthen the Capabilities of Risk Control

Financial institutions which offer integrated financial services need to conduct product innovation, institution innovation and service innovation; therefore, they will be confronted with complex cross-industry and cross-market operations and risks thereof. Hence, financial institutions must attach great importance to innovation and risk control capabilities, improve corporate governance, enhance innovation capabilities, strengthen risk control capabilities, and focus on talents reservation while exploring more extensive spectrum of operation measures and products and conducting integrated services.

Improve Related-party Transaction Control and Prevent Cross-sector and Cross-market Risk

In a financial conglomerate engaging in integrated services, it is very easy for risk of one subsidiary to transfer to other subsidiaries within the conglomerate via related-party transactions, which shall give rise to cross-sector and cross-market risk. Therefore, related-party transaction control is the core to prevent risks of integrated financial services. At present, no effective mechanism and measures of related-party transaction control have been adopted by financial conglomerates in China. In the process of steadily pushing forward pilot programmes of integrated financial services,

regulation system with related-party transaction control as the core and internal control

mechanism of risk management within financial institutions should be established.

Box 11 Risk Disposal of Delong Conglomerate and Its Implication

Delong Group is a conglomerate that controlled over 200 industrial enterprises and 13 financial institutions through complex capital maneuver and a series of illegal operations with Delong International Strategic Investment Co., Ltd ("Delong International") as the parent holding controlling interest in Xinjiang Delong (group) Co., Ltd ("Xinjiang Delong") and Xinjiang Tunhe (group) Co., Ltd ("Xinjiang Tunhe Group"). According to preliminary investigation, total assets of all non-financial enterprises in the Delong conglomerate reached RMB 22.225 billion yuan while total liabilities amounted to RMB 17.876 billion yuan; after deducting minority shareholders' equity of RMB 394.4 million yuan, losses of equity of holding financial institutions, losses of related-party transactions, and other contingent liabilities losses caused by guarantee and pledge of Delong conglomerate, the net assets were over RMB -7 billion yuan. Actual losses of 13 financial institutions in Delong conglomerate were estimated to be more than RMB 20 billion yuan after creditor-debtor relations among themselves are excluded.

In April 2004, risks of Delong conglomerate erupted with the continuous 10% slump (maximum limit of slump) of three listed companies' stock prices controlled by De-

long conglomerate, namely, Hejin Investment Company, Xinjiang Tunhe Company, and Hunan Torch Company. The PBC, government departments concerned, and local governments, according to the uniform arrangement of the State Council, strengthened communications, obtained a clear risk status of Delong conglomerate, drew up a general plan, specified risk disposal principles of Delong conglomerate, shouldered respective responsibilities, made relevant policies, and guided China Huarong Assets Management Corporation to provide custody to Delong conglomerate enterprises and dispose risks of the Delong conglomerate.

After the custody of over one year, disposal of valid assets of industrial enterprises of Delong conglomerate has completed. The equities of two listed companies, Tianshan Ltd, Co and Tunhe Ltd, Co, originally held by Delong conglomerate were transferred, and debt restructuring has witnessed positive progress. Two financial institutions in Delong conglomerate, Deheng Security company and Hengxin Security Company were closed down and liquidated; other five financial institutions in which Delong used to hold equities, namely Changsha City Commercial Bank, Zhuzhou City Commercial Bank, Kunming City Commercial

Bank, Nanchang City Commercial Bank, and Eastern Life Insurance Company, existed from Delong via equity transfer; Jinxin Trust Company, Islam Trust Company, Xinjiang Financial Leasing Company, New Century Financial Leasing Company suspended business operation for rectification; and Nanjing International Trust and Investment Company was revoked and liquidated.

The business expansion of Delong with characteristic of “capital maneuver” is the fundamental reason for the risk eruption. The “capital maneuver” of Delong mostly followed the way of illegally controlling an enterprise (financial institution in particular)—obtaining funds through illegal means—manipulating the stock price in capital markets to seek profits, which supported the dramatic expansion of the conglomerate itself. Moderate capital operation is one of the feasible means for enterprises to develop; however, if one enterprise does not take industrial development as the foundation, over-dependence on capital maneuver, trying to obtain funds via various illegal means, the enterprise is bound to pay lots of interests and bear high financial costs, which shall place the enterprise in a “capital-shortage” status with high liabilities. This financing structure with huge risks brings about a very fragile financing

chain to enterprises’ operation; the whole conglomerate will not be able to sustain if there is any problem with any link of the financing chain. Thus the eruption of risks of Delong conglomerate is inevitable.

The case of Delong conglomerate also reflects, to some extent, the flaws of the current regulation system. Under present segregated industry regulation system, it is hard to exercise effective regulation on cross-market and cross-industry business operation. The Delong conglomerate, directly or indirectly, held controlling interests or invested in many banks, securities companies, and TICs, frequently transferred capital among various financial institutions and non-financial institutions via means of capital maneuver, and involved in the risks between different financial institutions and between financial institutions and non-financial institutions together by the financing chain and a great number of related-party transactions. When any financial institution or industrial enterprise has any problem and the financing chain of the group breaks, the single risk of an individual institution will spread within the conglomerate and influence the whole conglomerate. If such risk cannot be controlled in a timely manner, it may lead to systemic risks of the financial system.

Strictly Formulate Information Disclosure Rules and Strengthen Market Discipline

Due to the complexity of related-party transac-

tions and equity structure of financial conglomerates, regulatory authorities usually couldn’t get acquainted with their business operations and accurately judge the overall risks

of the conglomerate. Therefore, strict accounting standards and regulatory requirements should be implemented carefully and information disclosure rules should be strictly formulated and implemented to make information more transparent, which could make regulatory authorities, customers and investors have an accurate judge of capital status, profitability and risk status of financial conglomerates and their members so as to strengthen market supervision and discipline on integrated financial services.

Select Integrated Financial Services Mode in Accordance with China's National Situations

From the viewpoint of financial development in China, financial holding company in the form of "parent holding controlling interests while subsidiaries engaging in segregated industry businesses" has advantage in assets allocation, risk management, customer information and resources sharing, and so on; which

can effectively prevent the transfer of financial risks among different industries and is compatible to current financial regulation system in China, and is a suitable mode to China's national situations. Besides, some large financial institutions have already had certain capabilities in capital operation, risk management, cross-sales, and business integration; some of these financial institutions with certain requirements may also conduct integrated business via cross-industry investment in financial institutions in other industries. In view of the case of Delong conglomerate; at present, it is not wise to allow non-financial groups to directly or indirectly hold controlling interests in many financial institutions. As for the existing non-financial groups holding controlling interests in financial institutions, it is necessary for them to establish independent financial holding company to take the responsibility of holding and managing various financial assets.

Box 12 Integrated Financial Services Modes and Regulation Systems in Major Countries

Due to different national conditions and historical traditions, the integrated business modes in different countries vary from one another; therefore, financial regulation systems of various countries also experience corresponding reforms and improvement to comply with their integrated business modes. Major modes are listed below.

Germany: comprehensive legal person mode and integrated regulation system. Traditionally, continental countries in Europe,

represented by Germany, adopt comprehensive legal person mode with the organizational form of universal banks, which can deal in both commercial banking and securities business (insurance excluded) without setting up special subsidiaries. Besides, banks can also conduct non-financial investment. In face of such a comprehensive business mode, Germany passed *Regulation Act of Integrated Financial Services* in May, 2002, amalgamating regulatory authorities of banking, securities, and insur-

ance industries into Federal Financial Supervisory Authority (BAFin). BAFin is responsible for integrated regulation of banking, insurance, and securities businesses as well as cross-sector financial businesses. BAFin is in close cooperation with Bundesbank, the central bank, in order to avoid redundancy and enhance regulation efficiency; BAFin doesn't have branches in various regions; the responsibility of daily financial regulation is taken by the branches of Bundesbank, which report the statistics and results of examinations to the head office and BAFin.

U. S. A. : financial holding company mode and functional regulation system. U. S. promulgated *Financial Services Modernization Act* in 1999, which prescribed that bank holding companies with sound management and capital status or foreign banks with relevant conditions may transform to financial holding companies. Financial holding companies may conduct an extensive series of businesses with "financial-in-nature", including securities and insurance businesses conducted by subsidiaries. Financial holding companies can also be engaged in non-financial businesses as long as Federal Reserve believes that such business is in close relation or complementary to financial businesses of the financial holding companies. Compatible with the mode of financial holding company, U. S. exercises an umbrella-shape regulation system comprising leading supervisor and functional supervisors. FRS, as the regulation coordina-

tor of financial holding companies, is responsible for integrated regulation of financial holding companies and coordination of various functional supervisors to fend against systemic risks. Meanwhile, original supervisory authorities conduct functional regulation according to different financial services. U. S. 's financial holding company mode is not only conducive to enhance financial institutions' business operation efficiencies and competitiveness, but also helpful to the control of systemic financial risks. The umbrella-shaped regulation system of leading supervisor and functional supervisors adapts to the new form of financial holding companies, while retaining the traditional functional regulatory authorities, which is an innovation of regulation system maintaining the pattern of segregated supervision system.

U. K. : financial institution's cross-industry acquisition of financial institution of other industries mode and integrated regulation system. In 1986, U. K. implemented the "big bang" financial reform, which altered the segregated industry business operation system. Commercial banks were transformed to financial conglomerates by merging and acquiring such financial institutions as securities brokers, and began to provide integrated financial services including banking, securities, insurance and trust businesses. In order to comply with this integrated financial services mode, the supervisory responsibilities of the Bank of England were transferred to the Financial Services Author-

ity (FSA) by the *Bank of England Act* 1998 in June, 1998; thus, FSA began to take responsibilities for integrated regulation on all financial institutions and the whole financial markets. In order to maintain financial stability, the Bank of England, FSA, and the HM Treasury signed a memorandum of understanding to specify their responsibilities allocation, and strengthen coordination and cooperation in areas of information gathering, information exchange and policy making. Besides, the Standing Committee on Financial Stability consisting of representatives from the three parties was established to discuss issues of significance relevant to financial stability every month. The governor of the Bank of England and the president of FSA also are the members of Councils of the other party; an exchange mechanism of employees between two organizations was also established to tighten the connection and strengthen the cooperation.

Japan: a comprehensive business mode with characteristics of both U. S. and U. K. and integrated regulation system. In 1992, Japan promulgated *Financial System Reform Act* and some other relevant laws and regulations to allow financial institutions to con-

duct banking, securities and insurance businesses via their subsidiaries. In 1997, *Anti-monopoly Act* was amended and *Financial Holding Company Act* and *Bank Holding Company Establishment Act* were adopted to permit the establishment of financial holding companies, which made integrated business mode of Japan's financial institutions bear features of both U. K. and U. S. In accordance with such integrated business mode, the financial regulation system of Japan also experienced some changes. In 2000, Financial Supervisory Agency and the Financial Planning Bureau of the Ministry of Finance were merged into the Financial Services Agency to exercise integrated regulation on various financial institutions and financial markets. At the same time, Japan's central bank and supervisory authorities strengthened cooperation in regulation. In order to perform the obligation of maintaining financial stability, Bank of Japan may sign on-site examination agreement with any financial institution that opens settlement account at Bank of Japan, conduct off-site regulation on relevant financial institutions, and provide results of on-site examination or information for Financial Services Agency to coordinate their actions.

(By Tao Ling and Qin Guolou)



Chapter VII

Financial Market

China's financial market continuously developed in a diversified manner, system construction of various markets has attained remarkable achievements, market operation mechanisms have been improved, market functions have been better utilized, and the basis of stable operation of the market has been increasingly intensified. The sustained and healthy development of financial market provided an effective financing channel and risk management fashion for market participants as well as a stable platform to implement macroeconomic and financial management.

Recent Developments

In 2005, the financial market continued to maintain a sound development tendency. Money market trading was active and has adequate liquidity; bond market featured abundant product categories and good issuing conditions; stock market developed smoothly in the reform process and the market confidence strengthened; foreign exchange market saw the acceleration trend of innovation and the RMB exchange rate formation mechanism was further improved; futures market functioned in a smooth manner in general and market operational capability were better utilized; gold market witnessed expanding trading volume and its trading function was continuously strengthened; and insurance market maintained healthy and stable development trend.

With adequate capital in the market, various

sub-markets of money market played a positive role for the effective transmission of monetary policy, for the successful realization of macroeconomic management and regulation goals, and for the maintenance of overall financial stability. First, trading volume of interbank borrowing market decreased moderately. In 2005, aggregate trading volume of national interbank borrowing market reached RMB 1.3 trillion yuan with a daily trading volume of RMB 5.09 billion yuan, a y-o-y decline of 11.83% compared with 2004. Second, repo market featured active transactions and trading volume increased along with the development of its corresponding spot market. In 2005, trading volume in bond repo market reached RMB 18.4 trillion yuan, a y-o-y increase of 31.5% compared with 2004. Bonds under the repo transaction were mainly treasury bonds and policy-related financial bonds, and there was an obvious characteristic of shortening trading term structure in the repo market. Third, business of commercial bill financing, which became an important short-term financing method for enterprises, developed rapidly and gradually. Bank's acceptance bill continued to be the most important tool in the bill market. Along with the increasingly fierce competition in the market, some commercial banks strengthened their efforts of intensive operation and management in bill business by means of separating bill business from other businesses within their systems.

Bond market maintained the healthy development tendency with more and more products innovated and bond issuance scale rapidly ex-

panded. First, the primary market witnessed the increasing number of bond types and rationalized term structure. In 2005, the aggregate bond issuance volume amounted to RMB 4.1 trillion yuan, or a y-o-y increase of 67.2%. Structure of issuers was further diversified and there were more types of bond products and credit rating. Second, trading volume in the secondary market increased by a large margin and market interest rates were declining. In 2005, trading volume of spot transaction in bond market was RMB 6.3 trillion yuan, a y-o-y increase of 122.6% compared with 2004. The yield curve of treasury bond showed a downward trend in general; yield of mid- and long-term bonds decreased noticeably, resulting in the flattening of the yield curve. Third, the quantity of investors in bond market continued to increase quickly. At the end of 2005, there were 5,508 participants in interbank bond market, an increase of 1,525 compared with the end of 2004; of which, the number of non-financial enterprises and investors with collective fund increased by a relative large margin. Fourth, transaction of accounting treasury bond at counters of commercial banks increased moderately. In 2005, the transaction of accounting treasury bond at counters in commercial banks featured a stable business; the number of branches carrying out this business rose gradually and their trading volume also increased compared with the previous year. A total of 78,000 deals were registered for the whole year, a y-o-y increase of 22.5%; trading volume reached RMB 6.57 billion yuan, a y-o-y increase of 5.7%.

The reform and development of stock market

achieved remarkable progress shoulder by shoulder. Although financing volume and trading volume of stock market in 2005 was lower than those of 2004, mechanism of stock market recorded significant changes, some deep-seated contradictions and structural problems affecting the stability and development of the market were gradually resolved; market confidence was boosted; and stock market realized a stable development in its reform. At the end of 2005, there were altogether 1,381 listed companies in Shanghai Stock Exchange and Shenzhen Stock Exchange with the total number of stocks as 1,464 and the negotiable and the total market capitalization as RMB 1.1 trillion yuan and RMB 3.2 trillion yuan respectively. In 2005, total trading volume of A-share in both stock exchanges reached RMB 3.1 trillion yuan, an increase of 24.9% compared with 2004; of which, trading volume of Shanghai Stock Exchange was RMB 1.9 trillion yuan, 61% of the total, while that of Shenzhen Stock Exchange was RMB 1.2 trillion yuan, or 39% of the total. Warrant products newly introduced with the non-tradable share reform featured active transactions; trading volume of warrants in both stock exchanges reached RMB 218.8 billion yuan.

Well-developed Foreign exchange market quickly accelerated market innovation; the RMB exchange rate formation mechanism was further improved. First, the RMB exchange rate went strong since the reform of exchange rate regime. Before the reform of RMB exchange rate regime, the daily weighted average RMB/USD exchange rate in the interbank foreign exchange market was around 8.2765

yuan to one USD. On July 21, 2005, the RMB/USD exchange rate was adjusted to 8.11 yuan to one USD; the RMB exchange rate climbed slowly afterwards within a range of fluctuation of 426 bps and the rate was concluded at 8.0702, the highest of the year, at the end of 2005. Second, trade of foreign exchange pairs was introduced and transactions of USD were relatively active. The interbank foreign exchange market formally introduced bidding transaction of eight foreign exchange pairs on May 18, 2005; the aggregate trading volume of them amounted to USD 52.133 billion in the whole year, or a daily trading volume of USD 328 million. Three most actively traded foreign exchange pairs are EUR/USD, USD/HKD, and USD/JPY, accounting for 41.6%, 25.6% and 23.2% of the total trading volume respectively. Third, foreign exchange forward transaction was introduced and USD continued to be the major trading target. The interbank market formally launched foreign exchange forward transaction on August 15, 2005; 277 deals were reported in the year, including 263 in USD and 14 in JPY.

Futures market generally operated soundly and continued to play its proper role. First, the market featured stable operation in general. In 2005, the aggregate trading volume of domestic futures market amounted to RMB 13.4 trillion yuan, a y-o-y decrease of 8% compared with 2004; 323 million deals were reported for all kinds of futures, an increase of 6% compared with 2004. Second, new products were successfully introduced to and traded in the market with active transactions. Funds were

transferred from actively traded products in the past to new introduced products. New futures commodities listed in 2004 such as corn, cotton, and fuel oil recorded fast increase in trading volume and became major active forces in the market. Third, market shares were concentrated to large companies. In 2005, of the total trading volume of RMB 13.4 trillion yuan in domestic futures market, top 20 futures brokerage companies accounted for 55.7%, featuring an evident trend of market share concentration to large companies.

Gold market featured a rising trend in both trading volume and price; spot trading increased in a stable manner while margin trading developed rapidly; a diversified structure of market participants was taking its shape and the market demonstrated a sound operation tendency. First, Au and Pt's trading was active with their prices keeping climbing. In 2005, trading volumes of Au and Pt both recorded their historically high point since the establishment of the market. Trading volume of Au for the whole year reached RMB 106.98 billion yuan and that of Pt was RMB 9.87 billion yuan, or a y-o-y growth of 46.3% and 53.6% respectively. Meanwhile, the price of Au kept rising, showing a trend almost in step with that of the international market. Second, spot trading was stable and margin trading developed quickly. For the six trading species in Shanghai Gold Exchange, spot trading is the major trading means, and Au (99.95) and Au (99.99) are the earliest and most actively traded with their trading volumes accounting for 82.08% of the total. Two margin trading products, Au (T + 5)

and Au (T + D) developed rapidly and met the demand of enterprises for productions and utilization to evade price risks; Au (T + D) has reported particularly active trades and has been gradually recognized by the market. Third, a diversified structure of various participants has gradually taken shape and the capabilities of participants to play their roles properly in the market have been strengthened. By the end of 2005, Shanghai Gold Exchange has had 128 members, including 16 commercial banks, 31 gold producers, and 81 gold users and other enterprises.

Insurance market continued its healthy and stable development with increasing number of market participants, steadily rising premium income, rapidly expanding assets scale, increasing fund investment channels, and deepening asset management reforms. First, insurance business maintained healthy and stable growth. At the end of 2005, total assets of insurance companies reached RMB 1529.869 billion yuan, an increase of RMB 324.01 billion yuan compared with the beginning of the year. The premium income of 2005 was RMB 493.128 billion yuan, a y-o-y increase of 14%. Second, the scale of insurance funds expanded rapidly and the market function of financing was enhanced day by day. At the end of 2005, the balance of utilized insurance funds amounted to RMB 1410.011 billion yuan, an increase of RMB 335.72 billion yuan compared with the beginning of the year. Insurance institutions, as important institutional investors, played an important role in maintaining the stability of capital market by increasing investment in funds and direct

investment in stock market. Third, the number of participants in insurance market increased continuously and the market became more competitive. At the end of 2005, there were 93 insurance institutions, 1,887 professional insurance intermediaries, and over 120,000 insurance proxies in China. The number of foreign insurance institutions was on a stable increase with their market shares expanding. Fourth, the reform of insurance asset management was further deepened, which steadily increased investment returns. The pace of insurance asset management reforms was obviously accelerated in 2005; professional management mechanism was gradually improved; and investment channels were broadened, all of these laid a foundation for increasing insurance assets investment returns.

Financial Market Development Promoted Financial Stability

Financial market construction, which is a complex and systematic project, features a close and complementary relationship with financial stability. Sustained and healthy development of financial market can safeguard financial stability while a stable financial environment also creates conditions for further development of the market. The development of financial market mainly includes innovation of financial products and market mechanism, and wider opening to the outside world.

Financial Product Innovation Was Conducive to Financial Stability

China's financial products featured relatively

quick innovation with fruitful results, therefore it promoted financial stability.

The Innovation of Financial Products

First, short-term financing bills were introduced to the money market. Since the successful issuance of the first batch of enterprise short-term financing bills in May 2005, the financing bill market has witnessed stable operation, sound development tendency, and increasing issuance scale. By the end of 2005, 58 enterprises had issued 76 batches of short-term financing bills with an aggregate face value of RMB 139.25 billion yuan. The introduction of short-term financing bills in the interbank bond market was a significant breakthrough in China's financing aspect, and was conducive to increase financing channels for enterprises, and optimize the financing structure in China.

Second, financial bonds, bond forwards, and asset-backed securitization products were initiated in the bond market. The issuance of ordinary financial bonds was conducive to broaden direct financing channels for financial institutions, enrich credit rating of the market, and further enhance market efficiency; asset-backed securitization was of great and realistic significance to China in developing financial market, maintaining financial stability, and meeting challenges resulting from financial opening-up to the world; and the introduction of forward transaction of bonds was such an important milestone in the development of the financial market in China that it signified the beginning of financial derivatives market in China and was of tremendous importance to

maintaining financial stability, promoting the development of spot transactions in the bond market, and formulating and implementing monetary policies by the central bank.

Third, warrant products were introduced in the stock market; trading of warrants was active and investors showed relatively high enthusiasm. In 2005, the aggregate trading volume of warrants in Shanghai Stock Exchange reached RMB 176.307 billion yuan and that of Shenzhen Stock Exchange was RMB 42.546 billion yuan. The introduction of warrant products enriched China's financial derivatives, stimulated transactions in the market, provided a financial instrument for resolving the non-tradable share issue, and also presented an instrument of wealth management and risk prevention for investors.

Fourth, the innovation in foreign exchange market was accelerated, and the foreign exchange-pair business and foreign exchange forward trading were introduced in interbank market in succession. It provided market participants with a tool to manage exchange rate risk, cultivated the capabilities of market participants in risk pricing and risk elusion, promoted the functions of price discovery and effectively allocating foreign exchange resources, and laid a solid foundation for the development of other foreign exchange derivative instruments in the future.

Fifth, innovation in the insurance market sped up, and various kinds of products such as accident insurance, disaster insurance, and agriculture insurance were introduced to the market and became a new growing point of the in-

insurance industry. Product innovation promoted the stable and healthy operation of the insurance market, stimulated structural optimization of the insurance market, and played a positive role in enhancing social security and improving social management.

The Positive Impact of Financial Product Innovation on Financial Stability

Innovation of financial products can moderately separate, transfer, and disperse risks and solve the problem of imbalanced financing structure in China with the precondition of adding no risks to the market as a whole. In China, the proportion of indirect financing is too high and credit risk concentrates in the banking industry. In 2005, such financial innovation products as short-term financing bills and credit asset-backed securitization products were introduced in succession, raised the proportion of direct financing to the total financing, and gradually alleviated to some extent enterprise's credit risk in the banking system. The financing structure of domestic non-financial institutions (citizens, enterprises, and government agencies included) featured obvious changes in 2005; the share of corporate debt rose noticeably while that of loans and treasury bonds experienced a decline. The proportion of loans, stocks, treasury bonds, and corporate debts of domestic non-financial institutions in the whole year was 78.1:6.0:9.5:6.4; the ratio of that in 2004 was 82.9:10.8:1.1:5.2.

Innovation of financial products further improved the market operation mechanism to safeguard financial stability and promoted the

effective allocation of financial resources by the market. The process of financial products innovation is, in nature, a process of replacing original low efficiency and low transparency financing methods with standardized, high transparency, and high liquidity ones. Take short-term financing bill as an example, when an enterprise borrowed money from banks as a method of financing, since the internal approval process of banks was not transparent and the force of market mechanism to ensure timely pay-off of loans by the enterprise was weak, it was difficult to avoid moral hazards of the borrower; but in an open market with strict requirement of information disclosure, the obligation of the issuer to pay both the principal and interests was under supervision of all holders of financing bills in the market; and the possibility of malicious contract breach was relatively low.

Innovation of financial products can enhance financial institutions' competitiveness and profitability, therefore strengthen their capabilities to fend off risks. In 2005, the shareholding reform of SOCBs was at a critical stage and the period was also of great importance before the all-around opening up of China's banking industry; the rapid development of China's banking institutions, commercial banks in particular, was the key precondition to maintain financial stability. Since the establishment of short-term financing bill market, intermediary businesses of banking institutions in China have grown quickly; particularly, the professional services such as bond underwriting and financial consultation not only met the demand of enterprises to lower fi-

nancing costs and diversify financing channels as well as increase the revenues and profits of commercial banks, but also facilitated the transformation of commercial banks from traditional mode to intermediary business mode and enhanced their competitiveness in the opened market in the future.

Innovation of financial products can strengthen the capabilities of institutional investors to identify and fend against risk and reduce the possibility of systematic risk. The introduction of innovative products, especially, short-term financing

bills secured only by credit of enterprises without any collateral in particular, propelled institutional investors to strengthen their research and enhance their capabilities of judging and identifying risks while pursuing higher returns. When risk exposes in the market or accident occurs, institutional investors will voluntarily establish risk emergency disposal mechanism to protect their rights and interests under the precondition of compliance with relevant laws and regulations, so that a fair and efficient market operation mechanism will be gradually formed.

Box 13 Steadily Pushing Forward Credit Asset-backed Securitization

Credit asset-backed securitization is the activity whereby credit assets with foreseeable cash flow are sold in the financial market in the form of securities. Securitization is a major means and successful experience of developed countries to resolve and disperse bank credit risk. At the end of the second quarter of 2006, the balance of U. S. assets-backed securities (ABS and MBS included) reached USD 8.2 trillion, accounting for 31.1% of the outstanding balance of the whole U. S. bond market; it was the largest category of bond products, leaving the second largest corporate debts (19.7%) far behind. China's pilot program of credit asset-backed securitization was formally launched on March 21, 2005 with the approval of the State Council. On December 15, 2005, the first batch of ABS of RMB 4.17727 billion yuan was issued by CDB and MBS of RMB 3.019 billion yuan

issued by CCB; on April 25, 2006, the second batch ABS of RMB 5.82 billion yuan was issued by CDB. Those issuances were successful and the securities were traded in the national interbank bond market. The issuances marked the success of China's pilot program of credit assets-backed securitization and laid a solid foundation for the further development of asset-backed securitization.

First, a policy framework of credit asset-backed securitization in line with China's realities has been primarily established. The PBC and CBRC jointly promulgated the *Administrative Rules of Pilot Program for Credit Assets Securitization*; CBRC promulgated the *Measures on the Administration and Supervision on Pilot Program for Credit Asset-backed Securitization by Financial Institutions*; the MOF issued the *Provisions*

on Accounting Involved in the Pilot Program for Credit Asset-backed Securitization; the MOF and State Administration of Taxation issued the *Notice Regarding Certain Taxation Policies of Credit Asset-backed Securitization*; the Ministry of Construction issued the *Notice on Relevant Issues Concerning Mortgage Right Change Registration of Individual Mortgage-backed Securitization*; the MOF and the Ministry of Labor and Social Security also issued circular to approve National Social Security Fund to invest in asset-backed securitization products. These documents have established a primary policy framework for carrying out credit asset-backed securitization in China as well as laid down a solid foundation for credit asset-backed securitization legislations in the future.

Second, a set of supervision and regulation mechanisms to effectively fend off risks has been primarily in place. The *Administrative Rules of Pilot Programs for Credit Assets Securitization* made principle provisions on risk management during key periods in credit asset-backed securitization process. According to these principles, CBRC promulgated the *Measures on the Administration and Supervision on Pilot program for Credit Asset-backed Securitization by Financial Institutions* to prescribe relevant market access criteria and procedures for financial institutions to act as sponsors and trustees, formulate specific business rules for financial institutions' participation in credit asset-backed securitization, and put

forward relevant risk management requirements. The PBC made provisions on information disclosure of credit asset-backed securitization as well as registration, custody, trading and settlement of ABS in the interbank bond market, and guided the National Interbank Borrowing Center and China Government Securities Depository Trust and Clearing Co., Ltd to establish mechanisms conducive to the prevention of ABS risks in technical system.

Third, it provided a mode to learn from and an issuance and trading platform for the securitization development in the future. CDB and CCB, when designing their programs of credit asset-backed securitization, both took into consideration China's realities and adhered to the international standards by forming basic assets pool with credit assets and mortgage loans and engaging trust companies as trustees and issuers of ABS. The mode not only conformed to the international practices, but also was the reasonable choice in the current legal framework in China, realizing risk separation and limited recourse by legal means and providing an exemplar for asset-backed securitization development in the future. The National Interbank Borrowing Center and China Government Securities Depository Trust and Clearing Co., Ltd have designed a comprehensive bond business system to support the issuance and trading of ABS, which successfully supported the issuance and trading of

the first batch of ABS; at present, the system is operating in a stable manner and is able to support larger scale of issuance and trading of ABS.

Credit asset-backed securitization, as an important instrument to link the credit market and the financial market, is conducive to improving banks' operational mode ameliorating the width and depth of China's bond market, and of great realistic significance to the stable development of banking industry and the maintenance of financial stability as a whole. First, it is conducive to the improvement of credit term structure of banks. In recent years, there were obvious signs that banks began to have more long-term assets and short-term liabilities, which gave rise to the problem of credit mismatch. Securitization of part of the mid- and long-term loans can improve the present situation of mismatched credit, enhance the liquidity of bank assets, and accelerate the turnover of credit assets. Second, it is conducive to raise CAR of banks. After credit asset-backed securitization, credit assets will be transferred out of the balance sheet in the form of "sold in real sense"; and it is an effective way to raise banks' CAR by market operations. Third, it is conducive to disperse credit risk. Credit asset-backed securitization can bring the investors' role of jointly identifying risks and determining fund prices to the full, therefore, to some extent, disperse credit risk used to concentrate in banks to the financial market and

is conducive to the maintenance of financial stability. Fourth, it is conducive to the development of capital market. Credit asset-backed securitization turns credit assets lacking liquidity to negotiable securities with relatively high liquidity and therefore provides a new trading product to the securities market. It effectively reduces the proportion of indirect financing, and is helpful to stimulate the development and improvement of multi-layer capital market. Fifth, it is conducive to the financial opening-up process. China's financial industry is about to open to foreign financial institutions in an all-round manner. Given the rich experiences of foreign financial institutions in asset-backed securitization business, it can be estimated that assets securitization business will be a key area for foreign financial institutions to compete in Chinese market.

At present, China's credit asset-backed securitization business has just started and is still at the trial stage. We should carefully summarize our experiences gained from pilot program, abide by the principle of prudence, always attach great importance to the mechanism construction and risk prevention, push forward the expansion of pilot program of credit asset-backed securitization in an earnest manner, further bring the function of securitization technology in China's economic and financial sector to full, and promote steady development and overall stability of China's financial system.

Institutional Innovation Offered Regulatory Authorities a New Platform to Strengthen Regulation

Along with the gradual establishment of socialist market economy system in China, management and operation of financial market should also employ a market-oriented ideology to continuously relax control and shape a benign development mechanism led by the market. A series of institutional innovations have won favorable conditions for further enhancement of regulations.

Institutional Innovation

First, introducing the issuance filing system and gradually relaxing issuance control. In 2005, the issuance process of short-term financing bills adopted the issuance filing system, which was the first introduction in terms of bond issuance methods in China and was a positive exploration of relieving issuance control in the market of institutional investors. Since the implementation of the filing system, short-term financing bill market has maintained a tendency of sustained and rapid development.

Second, improving the market maker system and effectively enhancing the market function. Market maker, as a core force to stabilize and activate the market, plays an important role in market price discovery. The introduction of market maker system in the interbank foreign exchange market, which increased the liquidity of the market, was a complementary policy of China to further develop the interbank for-

eign exchange market and improve the RMB exchange rate regime. By the end of 2005, 13 domestic and foreign banks had been approved as market makers of RMB trading in the interbank foreign exchange spot market.

Third, pushing forward the non-tradable state share reform and further improving and developing the stock market. At the end of April 2005, CSRC announced to formally launch pilot program of the non-tradable state share reform with the approval of the State Council. By the end of 2005, altogether 421 companies had completed their non-tradable state share reform or started the non-tradable state share reform procedures, accounting for 35% of the total market capitalization of both Shanghai and Shenzhen Stock Exchanges. The steady progress of the non-tradable share reform will gradually rectify the institutional flaw hindering the development of the stock market for years and play a very positive role in the development of the stock market.

Institutional Innovation Was Conducive to the Enhancement of Financial Regulation

The PBC has been adhering to the principle of market-oriented operation in a series of institutional construction in the interbank market.

First, emphasizing that investment risk should be evaluated and born by investors, relaxing administrative control on issuance and trading, leaving problems which could be solved by the market to the market, squaring administrative organs from making material judgements on issuers and making them fully play their roles

of “referee” in formulating market operational rules and conducting supervision and regulation. For instance, the filing and registration issuance system was adopted in issuance management of short-term financing bills to exercise balance management for issuance scale; and the approval procedure for corporate bonds’ trading and turnover was simplified by shifting from the pre-event approval approach to the verification approach, making it convenient for corporate bonds to access to the interbank bond market.

Second, attaching great importance to the enhancement of such market discipline mechanisms as information disclosure and credit rating; strengthening information disclosure requirements on issuers and relevant intermediaries as well as standardizing credit ratings of corporate bonds; encouraging intermediary agencies such as credit rating institutions and underwriters to strengthen their self discipline; effectively fending off risks, enhancing the market transparency, and implementing effective market discipline on issuers and relevant intermediaries.

Third, strengthening the market infrastructure construction, which was also one of the most important aspects of ensuring financial market stability. At present, trading in the interbank bond market depends primarily on the trading system of the National Interbank Borrowing Centre, and bond custodian settlement is done on the book keeping system of China Government Securities Depository Trust and Clearing Co., Ltd. In October 2005, the PBC organized, guided, and promoted the connection of

the two systems, which primarily realized “direct processing” of bond trading and settlement in the interbank bond market. This progress, which simplified former trading and settlement procedures, reduced operations of redundant data input, lowered operational risk, raised the market operation efficiency, strengthened the real-time and pre-event monitoring of the market, and improved risk control measures, was conducive to maintain market stability and provided a necessary technical platform for the product innovation in the future.

The Opening Up Strengthened the Financial Market Stability

China has been strictly performing relevant commitments since the accession to WTO. Financial service industry was opening wider and wider; the geographical presence and businesses of foreign financial institutions were expanding; and the competitive atmosphere in the market was gradually intensified. The opening-up process strengthened the financial market stability.

Opening Up

By the end of 2005, 25 foreign financial institutions have become shareholders of 20 Chinese banks with a total investment of near USD 20 billion, or about 15% of the total capital of domestic banks. 32 foreign institutions were granted qualifications of QFII and 40 foreign insurance companies were authorized to carry out businesses in the domestic insurance market.

When fulfilled its commitments of accession to

WTO in steps and phases, China also paid close attention to amending and improving relevant laws, regulations, and market rules and took measures to accelerate the pace of opening-up of the financial market to the outside world. In April and May 2005, Pan-Asian Bond Index Fund and ABF China Bond Index Fund were authorized to join the interbank bond market in succession, which was another new measure of the capital market opening-up after the trial implementation of QFIIs system. In October 2005, some international development institutions were, for the first time, authorized to issue RMB bond in China, indicating another important step forward in the opening-up process of China's financial market.

The Opening Up Process Promoted Financial Stability

The wider opening of financial market not only further promoted the development of, but also strengthened the stability of the financial market.

First, it is conducive to the stable and healthy development of China's financial market. In 2005, China introduced foreign bond issuers and traders in succession in the financial market for the first time; improved its financial legal system and regulation system and pushed ahead reforms of the financial system and institutions. At present, Chinese financial institutions enhance stronger competitive capabilities while foreign financial institutions have become an organic part of China's financial system via standardization and development. As a result, the participation of foreign finan-

cial institutions enhanced competition in the market and propelled Chinese financial institutions to accelerate reforms and raise service efficiency; meanwhile, the joint ventures and cooperation between foreign and domestic financial institutions also introduced to China advanced corporation governance mechanism and mature managerial expertise. Currently, China's financial market is confronted with challenges of opening-up and is accumulating experiences to deal with foreign competition and impacts. Financial market was contributing to the stable and healthy development of China's financial system by enhancing competition in the market and speeding up the introduction of technologies and experiences from those mature financial markets.

Second, it is conducive to the stable operation of China's financial market in the later transition period after accession to WTO. At the end of 2005, there was only one year left before the end of the transition period. Judging from the real situation of the market development, China was opening its financial market in steps and phases, improving institutional construction of the financial market, and maintaining the stable operation of the financial market. At the end of 2005, the number of QFIIs approved reached 32, with foreign exchange investment quota of USD 5.495 billion approved, securities assets held by QFIIs amounted to near RMB 30 billion yuan, accounting for 90% of their total assets thereof. This was conducive to the further opening-up, carrying out relevant commitments for WTO accession while considering real situations of the financial market, avoiding enormous fluc-

tuation after the termination of the transition period and enhancing the stability and risk-resistance capability of the financial market.

Finally, it is conducive to improve the discipline mechanism of the financial market. The healthy development of the financial market attracted a number of noted foreign intermediaries, which became the bridge connecting domestic and foreign markets. On the one hand, foreign intermediaries played an important role to assist the successful overseas investment and listing of domestic corporations and provided conditions for the domestic financial market to learn from foreign advanced practices, and establish and improve market discipline and incentive mechanism such as information disclosure and credit rating; on the other hand, the competition and cooperation brought with these foreign intermediaries raised the crisis awareness of domestic service intermediary, and was helpful to promote such domestic institutions to learn the sophisticated expertise and technology from international peers, and to elevate their competitive capability and service level.

Key Areas to Focus on and Reform Measures to Carry out in Developing the Financial Market

In 2005, China's financial market witnessed notable development in the process of innovation. The market was running in a stable manner with financing structure further optimized, thus creating a stable market environment for the sustained and healthy development of the

financial industry. Meanwhile, following aspects would still need special attention and active counter-measures so as to promote the healthy and stable development of the financial market.

First, financing structure was imbalanced in the context of direct and indirect financing proportions, of which the proportion of indirect financing was too high. Moreover, stock was the main direct financing instruments, while the issuance scale of corporate bond was very small, and no ordinary corporate bond based on enterprise credit has been issued. Such a financing structure with indirect financing as the main body led enterprises to a high level of indebted operation, worsened the mismatch problem of assets and liabilities of banks, increased the risks in the process of opening up of the financial industry, forced banks to bear risks which should be born by the financial market, and thus harmful to the efficiency enhancement of the macro financial management and the development of emerging industries. To solve this problem, we must further optimize the social financing structure, strengthen the development of direct financing, with the corporate bond market in particular, improve the structure of the stock market, cultivate institutional investors and promote the comprehensive, coordinated and sustainable development of the financial market.

Second, the financial products were not rich, and so were the available risk management tools. In recent years, the credit mismatch problem of commercial banks was outstand-

ing, i. e. short-term deposit and long-term loans' issue. The short-term trend of deposit and long-term trend of fund utilization were intensified. According to a survey regarding the mismatch problem of deposits and loans in 8 major commercial banks in China, at the end of 2005, the ratio of deposits payable within 1 year to loans receivable within 1 year reached 4.05, and that of loans receivable over 1 year to deposits payable over 1 year reached 4.82. Such term mismatch of deposits and loans in commercial banks might lead to liquidity risk, interest rate risk and credit risk. To mitigate such mismatch risk, we must expedite the innovation of financial products, develop financial derivatives market, and actively study and develop some financial derivative products suitable for the market development, so as to provide commercial banks with effective methods in managing interest rate risk and credit risk.

Third, the functions of market discipline and incentive mechanism have not yet been fully exerted. Strengthening the basic market discipline and incentive mechanism such as credit rating and information disclosure was of extreme significance in aspects of cultivating honest and standardized market players. The further financial reform and the rapid development of financial market raised new requirements for credit rating as well as opportunities

for its development. The credit rating sector of China was still at its initial stage, requiring constant improvement. Thus we need to further enhance the quality of credit rating agencies, establish a scientific and qualified rating system, build a market environment favorable for the healthy development of credit rating, further improve the quality of information disclosure in financial market's transactions, timely and accurately reflect market risk and maintain the fairness and transparency of the market operation mechanism.

Fourth, certain market laws and regulations were not fully in place, relevant regulation systems need further improvement, and the ecosystem of financial market needs to be further optimized. We need to reform and improve market access, issuance, trading and relevant systems, build a sound basic system regarding laws and regulations, accounting, auditing and taxation, thus further optimize financial ecosystem and further open up to the outside world. We also need to strengthen the monitoring of the financial market operation and the forward-looking analysis of risks, continuously improve the professional level of regulators, strengthen the coordination in the financial market regulation and promote the standardized operation of market players.

(By Ma Jianyang, Wang Wei, Liu Ying, Yang Jinmei, Cai Guoxi,
Wen Jiandong, Zhang Tiantian, Hong Bo and Wang Suzhen)



Chapter VIII

The Study and Design of Establishing Deposit Insurance System in China

Deposit insurance system is a fundamental institutional arrangement of the banking sector in market economies. As a key component of national financial safety net, its basic elements include: deposit-taking financial institutions participate in deposit insurance and pay the assessment according to stipulated standards; deposit insurance institution is responsible for the operation of the deposit insurance system; in the event of any deposit-taking financial institution's failure, deposit insurance institution should make timely compensation to depositors according to stipulated standards and participate in or organize liquidation per law. The essence of such a system is to share the losses of any deposit-taking financial institution's failure among government, shareholders and depositors, protect depositors' interest, enhance public confidence in the banking system, and maintain the stability of financial system, through establishing market-oriented risk compensation mechanism. At present, China's economy has kept the sustainable, rapid and healthy growth. The banking system is operating stably; and the legal, economic and regulatory environment continues to be ameliorated. Thus the internal conditions and external environment for establishing deposit insurance system are basically sufficient. And it is of important and realistic relevance to seize the opportunity to establish deposit insurance system combining both our country-specific features and international experiences.

Necessity for Establishing Deposit Insurance System

The implicit full-coverage deposit guarantee has been existing in China for a long time under which the state actually acts as the deposit insurer for the public. This has been important for protecting depositors' interest and maintaining social stability in the past. However, with the development of market economy, the disadvantages thereof become more and more apparent. Particularly, the implicit full-coverage deposit guarantee is likely to cause moral hazard and is not in the interest of long-term financial stability and should be transferred into an explicit deposit insurance system as soon as possible.

First, deposit insurance system helps to raise public confidence in banking system and therefore avoid bank run or systemic financial crisis. In recent years, although China has not witnessed large-scale and intensive eruption of financial risks, there did exist cases of bank run on small-and-medium sized financial institutions, which threatens the stability of banking system and the society. Deposit insurance system will substantially strengthen depositors' confidence and effectively prevent bank run or systemic financial crisis caused by a single financial institution's failure or financial incident, therefore maintain financial stability.

Second, deposit insurance system will protect the interests of small-and-medium depositors effectively. At present, China's financial mar-

ket remains to be improved in a variety of aspects, such as fewer financial products, undiversified investment channels for residents, and limited financial assets that are mainly savings. Therefore setting up a deposit insurance system with scientific compensation limit will protect the interests of many small-and-medium depositors and ensure that they are timely compensated in case of any financial institution's failure.

Third, a scientifically designed deposit insurance system will give full play to market discipline and prevent moral hazard. Under the current implicit deposit guarantee system, the government makes full-amount compensation to natural person's deposits when the financial institution fails, while institutions' deposits can only be compensated after the liquidation and depend on residual properties thereof. The implicit guarantee mechanism not only increases the financial burden of taxpayers, but also weakens market discipline by financial institution's expectation that the government will pay for its failure, thus causing moral hazard. It also leads to unfair treatment between individual creditors and institution creditors. In an explicit deposit insurance system, the losses of any bank failure will be shared jointly by the bank shareholders, government and depositors. This will not only reduce government's burden, but also prompt market players to be more risk-sensitive (particularly for depositors with large-value deposits), promote depositors to prudentially choose depository institutions and products, and pay attention to and monitor the management situation of financial institutions. This

would undoubtedly enhance market discipline. Meanwhile, compulsory membership and differentiated premium based on different risk profile of deposit-taking financial institutions would restrict the risk-taking behaviors of high-risk institutions and effectively prevent moral hazard.

Fourth, deposit insurance system will promote financial structural reform and fair competition among financial institutions. In the past, most institutions are owned by the state. The government takes major responsibility in case of operational problems. With deepening financial reforms, the ownership structure of China's financial institutions became diversified. SOCBs have introduced foreign strategic investors. City commercial banks and RCCs have substantially increased their stakes from the private and foreign capital sector. In a socialist market economy, all financial institutions are independent players facing fair market competition. It is therefore theoretically contradictory if the state continues to bear the loss of any financial failure. Accordingly, in the ongoing process of financial reform, it is necessary to establish deposit insurance system with a market-oriented risk compensation mechanism to change depositors' historical reliance on government guarantee, handle troubled financial institution with market forces so as to further the reform of banking sector, solve de facto unfair competition problem among different financial institutions, promote healthy development of small- and medium-sized banks, and create a well-structured deposit-taking financial sector.

Fifth, the establishment of deposit insurance system is the key step to standardize the market exit mechanism for financial institutions. With the absence of deposit insurance system, China has long adopted administrative order to force financial institutions to exit the market. Although this administration-driven closure policy can take advantage of the administrative resources of government in asset liquidation, investigating into the responsibilities, and re-locating staff of failed institutions, as too many compulsory administrative measures are adopted, not only market mechanism's fundamental functions in risk diversification and transferring are destroyed, which will further lead to risk concentration and weakening risk awareness of investors, but also put the government at the center of conflicts in practice. There's no legal basis for the full indemnification of individual debt while the compensation ratio for institutional debts extremely lower. Actually, such treatment generally prolongs closing process of financial institutions. As a result, these institutions do not actually exit the market, affecting financial and social stability to a large extent. The establishment of deposit insurance system and the adoption of market risk compensation mechanism will force troubled financial institutions to exit the market, and minimize their negative impact on the financial system.

Sixth, it is practically urgent to establish a deposit insurance system. In October 2004, the PBC, the MOF, CBRC and CSRC jointly issued *Opinions of the Purchasing of Individual Creditor's Claim and Clients' Securities Transaction and Settlement Funds* (hereinaf-

ter referred to as the "Opinions"). While it provided for uniform regulation in terms of treatment of individual creditor's claims and protected the interests of small and medium investors, it has not fundamentally resolved the problem and has triggered moral hazards due to loopholes in policy. The *Supplementary Notice on Issues Concerning the Opinions of the Purchasing of Individual Creditor's Claim* (hereinafter referred to as the "Supplementary Notice") promulgated on January 27, 2004 relieved to some extent the above-mentioned contradiction and uncertainties after September 30, 2004, due to ambiguous purchasing policies of individual creditor's claims. However, the explicit long-term mechanism to tackle similar future issues is still unavailable.

In recent years, reforms of SOCBs, JSCBs and city commercial banks have sped up and reform of RCCs is basically completed with better performance on average. The state also made huge investment in this regard. After the reform, whether these financial institutions can go on the track of virtuous cycles depends not only on their internal control system and business management, but also on the existence of a sound external environment and institutional design that will drive them to strengthen internal risk control. An important step of external institutional design is the establishment of a deposit insurance system. Therefore, a prompt establishment of deposit insurance system has a crucial significance in consolidating the success of current banking reform and finally obtaining the goal of financial reform.

The Feasibility of Establishing Deposit Insurance System in China

A sound macroeconomic environment, an effective financial regulation regime and a stable banking system are needed for deposit insurance system's efficient operation. At present, China's economy has maintained fast and healthy growth. Its banking system is operating stably. The legal, economic and regulatory environments continue to be ameliorated. Both the internal and external conditions are now matured for the establishment of a deposit insurance system, as is reflected in the following.

First, the financial legal system has become more sophisticated. A series of laws and regulations including the *Law on PBC*, *Law on Banking Regulation*, *Law on Commercial Banks*, *Company Law*, *Guarantee Law*, and the *Enterprise Bankruptcy Law* (to be implemented) have provided strong legal support for the launch and operation of a deposit insurance system.

Second, rapid and healthy macroeconomic performance in recent years and the stable financial system have provided a sound macro environment for the establishment of such a system. Economic performance is cyclical. The cost and effectiveness of establishing deposit insurance system at different stages of the economic cycle thus can vary. Establishing the deposit insurance system at a time of financial crisis is more costly and is likely to worsen the crisis if improperly designed. As

the operation of a deposit insurance system requires accumulation of capital and some cost shall be covered by the banks, therefore, the favorable timing for introducing the deposit insurance system is when the economy moves upward. It will be too late to do so if economic slowdown has brought about a lot of troubled banks. The cost of establishing such a system will be huge for the sake of maintaining social stability.

Third, banking reform, including SOCBs and RCCs, deepened and made great headway. Losses caused by historical reasons have been dealt with, which laid a good internal foundation for establishing a deposit insurance system. SOCBs have gradually set up standard corporate governance after capital injection and restructuring with obviously improved financial indicators and asset quality and with continuously ameliorated internal control mechanism. Some JSCBs are already listed. City commercial banks and UCCs are going through restructuring. Reform of RCCs is conducted all over the country and their business operations have achieved better performance in general. Overall speaking, problems of the deposit-taking financial institutions are gradually being resolved with no systemic financial risk at present.

Fourth, the accounting standards of the Chinese banking sector are upgraded step by step and are more in line with international practices. For the banking institutions, the accounting industry's compliance profile proves to be improved with more reliable accountant's report, better and more transparent informa-

tion disclosure. Capital market played a key role in encouraging listed banks to operate prudentially. At present, BOCOM, CCB and BOC have been listed in Hong Kong. ICBC will be listed on the international capital market after shareholding reform and will apply international accounting standards and standards for financial regulation. With the further improvement of mainland capital market, banks listed in mainland China will also be put under greater scrutiny in terms of accounting standards and information disclosure.

Fifth, the regulatory framework has evolved with more matured regulatory philosophy and models introduced. Regulatory tools are more standard-based to encourage commercial banks to strengthen capital adequacy, establish and improve governance structure, and improve risk management. The financial safety net has begun to play its role initially.

International experience indicated that deposit insurance system is established in countries either following banking crisis or at a time of basic completion of bank restructuring and under relatively stable economic environment. Meanwhile, corresponding infrastructures need to be improved. In general, the conditions are basically sound in China to establish deposit insurance system.

Several Key Aspects to Study in the Establishment of Deposit Insurance System

Chinese government attaches great importance to maintaining financial stability, protecting

depositor rights and interests, and initiated the study on the establishment of deposit insurance system. In 1993, the *Decision of the State Council on Financial System Reform* first put forth "the need to establish deposit insurance funds to protect public and social interests". In 2006, the Eleventh Five-year Plan for National Economic and Social Development of the PRC adopted at the fourth session of the tenth NPC clearly put forth "the need to standardize market-oriented exit mechanisms for financial institutions, establish corresponding deposit insurance system, investor protection system and policy-holder guarantee system". To give a better expression of government initiatives, the following key aspects are worthy to be highlighted in the process of introducing the deposit insurance system.

Functions of Deposit Insurance Institution

Deposit insurance institution can be "broadly" or "narrowly" authorized in terms of its functions. A deposit insurance institution in narrow sense is a "paybox" that only compensates depositors after financial institution fails. A deposit insurance institution in broad sense takes on a wider range of responsibilities apart from the basic "paybox" function, including accumulating and managing the deposit insurance fund, collecting assessments from member banks, getting access to the risk profile of insured institutions and participating the liquidation of failed banks. The Deposit insurance institution in a broad sense generally acts as a "cost-minimizer" or "risk-minimizer".

Under the "paybox" system, the deposit in-

insurance institution only works after bank fails, paying the bill for failure. The moral hazard is therefore evident since the regulatory authority may tolerate trouble banks to continue operations and therefore delay their closure. Therefore, many countries and regions in the world have gradually expanded the mandates of deposit insurance institution. For instance, when Canada and Columbia set up the deposit insurance institution in 1967 and 1985, they adopted a "paybox" system, but began to authorize the agency more powers and responsibilities since 1987 and 1998 respectively.

As for China, although the present banking sector is broadly stable, potential financial risk still is a concern, especially those of small-and-medium sized financial institutions with less capabilities to fend off risk. Therefore, most market participants agree that the deposit insurance institution shall take the responsibility of protecting depositor interests as the base, while at the same time enjoy certain powers necessary for performing its functions. When problems in the operation of a financial institution are discovered, which shall include fraudulence in the payment of assessments, necessary early-stage correction measures shall be adopted. This is of vital importance to reduce the losses of deposit insurance institution and minimize financial risks.

Membership

Deposit insurance membership can be compulsory or voluntary. Compulsory membership means all deposit-taking financial institutions under the scope as defined by the law must participate in the deposit insurance and pay the

assessments. Under the voluntary membership insurance model, above deposit-taking financial institutions choose whether or not to participate in deposit insurance on a voluntary basis.

The statistics of the World Bank indicates that in all the countries and regions adopting a deposit insurance system, more than 90% practice compulsory membership and only a few countries practice voluntary membership. The merit of compulsory deposit insurance lies in that it avoids the possibility of adverse selection and gives full play to inter-bank monitoring, which is the basic market discipline.

While in China, various deposit-taking financial institutions show extreme differences in management, asset scale and CAR, it is necessary to adopt compulsory membership to prevent adverse selection and achieve fair competition. Most experts and researchers agree that all deposit-taking financial institutions (including SOCBs, JSCBs, city commercial banks, cooperative banks, UCCs, RCCs and postal saving institution) should participate in the deposit insurance system. As for the potential "egalitarianism" (premium from low-risk banks are used to compensate high-risk banks) that might accompany compulsory deposit insurance, risk-based differentiated premiums on different risk profile of insured institutions should be implemented as well.

Funding for Deposit Insurance System

The major source of financing for deposit insurance system comes from the assessments

contributed by insured financial institutions. There are two methods of funding: ex-funding or post-funding. As the post-funding faces various uncertainties and may reduce public confidence in deposit insurance institution, most countries and regions adopt ex-funding and establish specific deposit insurance fund.

In the long run, the major sources of deposit insurance fund in China should also come from the assessments contributed by insured financial institutions and the liquidation proceeds from failed financial institutions. As the reform of banking sector in China has not yet finished, and the historical burdens on various deposit-taking financial institutions are heavy, most experts suggest that premium rate should not be set at a high level during the initial stage of deposit insurance system. In this transitional period, deposit insurance fund should be supported by government through special funding channel.

Compensation Limit

In terms of coverage, deposit insurance consists of full coverage insurance and limited-coverage insurance. Full coverage insurance means that deposits will be fully compensated if financial institution fails. Limited coverage insurance means that compensation will be paid to depositor within certain limits. When determining the compensation limit, "the rule of thumb" is to fully protect most small-and-medium depositors.

International experience shows that full coverage insurance increases the economic burdens

of the state, weakens the risk awareness of investors and the market discipline imposed on the insured. Full coverage is also likely to cause moral hazards. As a result, full coverage is generally regarded as a transitional arrangement to cope with financial crisis.

According to the survey of the PBC in 2005, the percentage of deposit accounts under RMB 50,000 yuan, RMB 100,000 yuan, RMB 200,000 yuan and RMB 500,000 yuan are 96.18%, 98.32%, 99.32% and 99.70% respectively. The percentage in terms of the balance of above accounts over that of total deposit accounts under survey are 20.54%, 29.47%, 37.61% and 46.06% respectively. The findings will provide important reference when we determine the compensation limit for the establishment of deposit insurance system in China.

Premium Rate

Premium rate can be flat or risk-differentiated. Under flat-rate model, all insured financial institutions shall pay assessments based on the same rate, while under the risk-based differentiated rate model, the assessment is calculated based on different rates that reflect different risk profiles of the insured financial institutions. The more the risk, the higher the insured institution pays for deposit insurance. The flat-rate model is simple and easy to be carried out, but more likely to result in moral hazards and prompt "adverse selection" by high-risk financial institutions. Risk-based differentiated premium model may prevent the subsidizing of high-risk financial institutions by low-risk financial institutions and is more likely to restrict the risk-taking behavior of fi-

nancial institutions and more acceptable to insured financial institutions.

Since early 1990s, the number of countries adopting a risk-based differentiated premium model is on the rise obviously. Many countries have moved from flat-rate model to risk-based differentiated rate model. In 1995, only the US adopts a risk-based differentiated premium model, but the countries by 2003 has totaled 24.

For the effective implementation of risk-based differentiated premium model, we need many auxiliary measures. It is also difficult to design an optimal premium rate scheme pegged to risk situation dynamically. Experts agree that according to China's conditions, in the early stage, a simplified differentiated premium model could be adopted based on the asset scale and capital adequacy ratio of the insured financial institutions. This would make deposit insurance system more incentive-compatible.

Box 14 International Experience in Deposit Insurance System

Explicit deposit insurance system has been existing for more than 70 years. The significance of such a system in maintaining financial security and stability in the world is more and more recognized by governments and financial regulatory authorities.

Establishment of Deposit Insurance System

The United States was the first country to establish an explicit deposit insurance system. The banking crisis of 1933 prompted the US to establish a federal deposit insurance system. By the end of the 1960s, nine countries have established explicit deposit insurance system. In the 1980s and 1990s, many countries were hit by serious banking crisis and financial crisis. In order to cope with the crisis and maintain financial stability,

many governments and financial regulatory authorities are establishing or considering establishing explicit deposit insurance systems. Explicit deposit insurance system therefore enters its stage of rapid development around the world. While there is still debate in theory on the role of deposit insurance, shift from implicit to explicit deposit insurance system has become an international trend. By June 2006, 95 countries and regions have established explicit deposit insurance system. In addition, 20 more countries are studying, planning or preparing to implement such a system⁶. In the countries that have already implemented explicit deposit insurance system, there are 8 in Africa, 25 in Asia, 42 in Europe and 20 in Americas.

6 "Listing of countries with a deposit insurance system", Deposit Insurance Systems in the world, <http://iadi.org>.

Goal and Content of Deposit Insurance System

While the goals of countries may vary when establishing deposit insurance system, the basic goals can be summed up as the following: (1) protect the interests of most small depositors; (2) prevent any crisis from spreading further by establishing standardized treatment rules of troubled banks; (3) enhance public confidence in the financial system and ensure the stability of banking system, thus further increase savings and promote economic growth.

In terms of governance, the deposit insurance system is established and managed by the governments in most countries. As of the end of 2003, deposit insurance institutions in 51 countries are government agencies, 11 are private and 22 are mixed agencies. According to statistics, by 2001, out of all those countries with a deposit insurance institution, 22 have the central bank in charge of management thereof, while the numbers for banking regulatory authorities in charge, ministry of finance in charge and independent institutions in charge are 10, 11, and 29 respectively⁷.

Most deposit insurance systems are funded jointly by government and commercial banks. According to IMF statistics, 1.25% is government-funded, 36.25% is funded by commercial banks and 61.25% is funded by

government and commercial banks together. Due to different conditions and goals, the coverage of insurance may vary in different countries. Generally, the insured deposit includes current and time deposit. In most countries, inter-bank and insider deposit are not covered. However, in the US, Canada and 12 countries with low-income level like Thailand, the Philippines, Kenya etc., inter-bank deposit is also under the coverage. And in 76% of the countries, foreign currency deposit is covered.

In terms of maximum benefit, the target of most countries is to cover more than 90% of depositors. According to survey, countries with low per capita GDP enjoy higher insurance benefit than countries with high per capita GDP. The world average insurance benefit is about 2.4 times of per capita GDP, with the highest in Middle East and lowest in Europe.⁸

Assessment can be calculated by flat rate or risk-based rate. According to World Bank survey, in low-income countries, premium is not based on risk rating and therefore is not adjustable. In other countries, a risk-based premium rate system is not common either with only about 23% countries adopting such a system. The premium base also varies in different countries and generally the premium is calculated on the basis of total deposit or insured deposit.

7 *Deposit Insurance Actual and Good Practices*, Gillian G. H. Garcia, 2001.

8 *Deposit Insurance Actual and Good Practices*, Gillian G. H. Garcia, 2001.

For a long time, the deposit insurance system played a significant role in mitigating financial risks, enhancing the public confidence in the banking industry and maintaining financial stability. However the possible moral hazards and adverse selection arising from this system have always plagued market economy countries and impeded their steps towards expeditious establishment of explicit deposit insurance system. After many financial crisis where deposit insurance system withstood the test, people began to realize that a well-designed deposit insurance system is conducive to the financial stability and a good deposit insurance system also requires the following economic environment: advanced legal framework, accounting system consistent with international standards, a healthy and robust banking regulatory framework, standard information disclosure system and wide public education on financial security.

Trends in the Development of Deposit Insurance System

Deposit insurance systems tend to be more uniform. With the development of financial sector and integrated financial services, the co-existence of multiple deposit insurance systems or investor protection systems is considered a potential cause for unfair competition and different premium collection and will increase the cost for preventing financial risks. Therefore, developing a single and uniform deposit insurance system or investor protection system has become the

future trend for some countries which at present have several deposit insurance systems or investor protection systems. In its reform legislation of 2006, the US has already merged BIF with SAIF. In Korea, deposit insurance companies cover not only deposits from banks, credit cooperatives, mutual savings and finance companies, but also losses of securities and insurance companies. In UK, the Financial Service Compensation Scheme compensates not only losses from deposit, but also losses from insurance policy, insurance brokerage, investment business and secured loans.

Deposit insurance institutions tend to be government-led. The development history has shown that deposit insurance institutions funded by the government and supported by assessments have more authority and strong state credibility. Their channels of funds are broader than private ones and can give the depositors a sense of security. Such institutions can provide liquidity timely, but private deposit insurance companies cannot, therefore deposit insurance institutions funded by the government and supported by assessments have an important role in protecting financial stability. According to statistics, 90% of deposit insurance agencies are administered and run by the government.

The function of deposit insurance institutions tends to be more comprehensive. As an important component of financial safety net, deposit insurance system has received

extensive attention from governments and financial regulatory authorities of many countries. More and more countries have come to realize that financial regulation alone cannot completely prevent banks from failing. Moreover, regulation failure or regulation forbearance of banking regulatory authorities often emerges, and there exists regulatory vacuum in financial innovation in particular. Besides, if deposit insurance institutions serve only as "paybox", it will lead to certain moral hazard and increase the difficulty in handling financial risks. As a result, governments and financial regulatory authorities gradually start increasing the risk disposal functions of deposit insurance agency and deposit insurance agency is empowered in compliance with its responsibilities. For instance, in Ireland, the Philippines, Japan and the US, deposit insurance agency have certain regulatory power. After evolving from being a "paybox" onto the principle of "lowest cost" or "risk minimization", deposit insurance institutions are developing a three-in-one comprehensive function.

Deposit insurance assessments are calculated from a flat rate to differentiated premium rate. At the early stage of the establishment of the deposit insurance system, most countries and regions adopt a single premium rate system, like the US, Canada and Malaysia, as well as Singapore and Hong Kong SAR that have set up deposit insurance institutions recently. While the flat-rate model is simple and easy to be carried out, but more likely to result in moral hazards, a differentiated premium rate system based on risk rating is more likely to reflect the accurate risk profile of insured banks and match risk with cost, therefore effectively containing moral hazards and restricting the risk-taking behavior of banks. Therefore, countries and regions are moving from flat-rate premium rate system to risk-adjusted differentiated premium rate system to make deposit insurance system more incentive-compatible.

(By Wang Cong, Liu Qin, Hu Ping
and Yan Haibo)



Chapter IX

Payment Systems

Payment systems are the core infrastructure in a country's financial system. Payment systems cover all institutional and infrastructure arrangement and process regarding the transfer of currency liability initiated by commercial banks and central banks. Payment systems consist of payment instruments, payment system, payment service organizations and payment systems regulation. Safe and efficient operation of payment systems concerns monetary policy, financial stability and the development of the whole economy. As monetary policy maker, financial stability maintainer as well as payment and settlement service provider, payment systems regulator and operator of CNAPS, the PBC attaches great importance to payment systems risk management, monitoring the development of payment systems, evaluating the impact of payment systems on the central bank in terms of implementing monetary policy and conducting relevant transactions, analyzing the impact of payment systems on financial market efficiency and financial stability, controlling the possibility of financial risk spreading through the payment systems, building safe and efficient payment systems and maintaining public confidence in money and its transfer mechanism thereof.

Recent Developments

In 2005, aiming at building safe and efficient payment systems and considering the needs of business, technology and regional economic development, the PBC expedited the building of payment system and disaster back-up system. It also encouraged the promotion and innovation of non-cash payment instruments, promoted the diversification in the payment services market, strengthened the management of bank settlement accounts, improved the rules and regulations on payment, endeavored to prevent payment systems risks and promoted the development of China's payment systems.

First, substantial progress was made in the building of CNAPS. In June 2005, LVPS replaced the electric inter-bank system⁹, completing its nationwide application. All policy banks, Chinese and foreign-funded commercial banks and most RCCs were connected to the LVPS, marking the basic formation of a payment and settlement network with CNAPS as the core, the intra-commercial bank clearing system as the basis and other payment systems as complement. The LVPS was directly linked with over 1,500 financial institutions and covering more than 60,000 branches and

⁹ Electric inter-bank system is a nationwide electric exchange system based on satellite network. For long, it played an important role to provide cross-bank payment clearing services. However, the function of the system is simple and efficiency for remittance and transfer transactions thereof is not high. Therefore it cannot suit the new situation of economic and financial development. Accordingly, there is an urgent need for building a more efficient and safer multi-functional CNAPS that can support the application of a variety of payment instruments.

processed 425,000 cross-bank remittance and transfer transactions daily with an amount of RMB 566.6 billion yuan, realizing a nationwide real-time settlement of cross-bank funds with international leading function and efficiency. The pilot operation of the retail payment system ("RPS") was successfully carried out in Tianjin and Fujian in November 2005, providing low-cost and bulk-volume payment services to the public.

Second, non-cash payment instruments expanded rapidly. In 2005, 960 million bank cards were issued, up by 191 million or 24.8% from 2004. There were 8.8 billion bank card transactions with the amount reaching RMB 47 trillion yuan. As of the end of 2005, almost 20 countries and regions handled RMB bank card business. Bank card consumption accounted for around 10% of total retail sales of consumer goods in 2005, compared with 2.1% in 2001. Bill financing business developed quickly, with RMB 70 trillion yuan of bank drafts and RMB 4.45 trillion yuan of commercial drafts issued in the whole year and RMB6.75 trillion yuan of accumulated bills discounted.

To promote the use of bank cards, improve non-cash payment instrument system and maintain the public confidence in bank cards payment system, the PBC increased support to bank card industry. In April 2005, the PBC, together with relevant departments, jointly issued the *Opinions on Promoting the Development of the Bank Card Industry*, which comprehensively and systematically proposed policy measures to promote the development of

bank card industry in China.

Third, bank settlement accounts management reached a new level. Bank settlement account is the starting and ending points of fund movement. The RMB bank accounts management system had extended to all banking institutions by June 2005. As of the end of 2005, nearly 20 million enterprise bank settlement accounts were verified and set up and 1.6 billion individual bank settlement accounts were registered through the accounts management system. That provided modernized means to standardize bank settlement accounts management and prevent money laundering, fraud and other criminal activities through bank accounts.

Fourth, management of payment and settlement organizations became more standardized. In order to satisfy the increasing demand for payment services, more and more non-financial institutions enter the payment service sector and their services gradually become important complement to traditional payment service sector. At the same time, the security and reliability of payment services provided by them have an impact on the public interest and the public confidence in the national money transfer mechanism and have a potential effect on financial stability. To protect the social and public interests and promote financial stability, the PBC is actively studying and drafting the regulations on payment and settlement organizations management to regulate and manage these organizations for the orderly development of the payment service sector.

Fifth, the nationwide application of central

bank centralized accounting system was successfully completed. As of April 2005, as an important foundation of LVPS application, centralized accounting system had been applied nationwide with internal control strengthened, accounting procedures improved, accounting quality and efficiency improved, and accounting risks reduced. These provided solid basis for final settlement of LVPS.

Risk Management of Payment Systems

Payment systems are the core infrastructure in supporting economic and financial operation and maintaining financial stability. Any payment risks are likely to produce a domino effect and cause a chain of reactions in the entire financial system, weakening the public confidence in currency. The PBC pays great attention to the risk management of payment systems. By improving the organizational structure in terms of the operation and maintenance of payment system, strengthening institutional establishment of payment and business management, improving crisis treatment and disaster back-up of payment systems, the PBC continuously promotes the development of a secure and efficient payment systems and maintains financial stability.

Organizational Structure for Improving Payment System Operation and Maintenance

In order to ensure the secure and stable operation of the payment systems, the PBC has been committed to establishing a scientific and efficient mechanism to operate and maintain the payment system. In 2005, the PBC ap-

proved the establishment of settlement centers in the PBC branches located in provincial capitals for the daily operation and maintenance of the city processing centers of payment system. That provided organizational guarantee for the unified operation of the payment system.

Payment Institution Building and Business Management

The rapid development of innovative payment instruments and ways like on-line payment and mobile payment played a positive role in meeting diversified needs for payment services. Compared with traditional payment instruments, innovative payment instruments have their special nature in terms of business procedures, cost structure, risk prevention and responsibilities clarification. However, the related regulations and rules are still a state of blankness. To prevent payment risks, protect the legitimate rights and interests of participants of electronic payment and the safety of funds in electronic transactions, the PBC issued the *Guidelines on Electronic Payment (No. 1)* in October 2005, setting up an initial framework for supervision and regulation over electronic payment.

To fend off financial risks, the PBC made scientific design and arrangement to the payment system and set up and implemented a series of practical and feasible measures. First, the PBC adopted the widely accepted RTGS mechanism for LVPS, which effectively controlled credit risks while improving settlement efficiency. Second, by connecting LVPS and CBGS, the PBC realized the DVP settlement between bond transactions and central bank open market

businesses, and eliminated the settlement risks caused by time lag between payment and asset delivery. Third, the PBC launched the automatic pledge financing mechanism¹⁰ on May 8, 2006 to facilitate liquidity management for participants and lower liquidity risks. Fourth, in the design of RPS, the PBC adopted a risk control mechanism that sets a net debit cap¹¹ to direct participants so as to prevent credit risks.

Crisis Management and Disaster Back Up of Payment System

To improve the capability of the payment system to deal with emergencies and prevent risks, the PBC developed a disaster back-up system for LVPS, promulgated and implemented Contingency Plans for Payment and Clearing System Crisis and Contingency Plans for RMB Bank Settlement Accounts Management System, which basically established contingency plans for CNAPS, the Centralized Accounting System, and the Bank Accounts Management System and improved the capability to prevent payment system risks. In addition, the exercise of switching between the national processing center ("NPS") of LVPS and the emergency back-up center marked initial success of the payment system contingency management.

Further Develop and Improve the Payment Systems

The Eleventh Five-year Plan for National Economic and Social Development of the PRC puts forward the requirement of "improving payment and settlement systems and enhancing its efficiency". To obtain this goal and meet the requirements for payment systems of economic development and financial stability, the PBC will quicken the building of the CNAPS, further advance the building of the nationwide clearing system, improve laws and regulations, and establish a scientific and standardized analysis system of payment information.

First, quickening the building of the disaster back-up system of the CNAPS. Efforts are made to establish an early warning system for payment risks, improve information feedback and reporting system, improve emergency response mechanism of payment system to continually enhance the emergency response capability of the system and ensure the safe and stable operation of the payment system.

Second, further advancing the establishment of the national clearing system. While the electronic payment instruments are growing fast,

10 Automatic pledge financing refers to the action that in the event of insufficient intra-day settlement account balance in the payment system, a banking institution will borrow funds from the PBC through automatic pledge financing system with bonds as pledged assets, and the pledged bonds will be automatically released from pledge after repayment. Automatic pledge financing is a widely adopted mechanism to provide financing facility for payment and settlement systems supplied by many central banks, and also an important measure to improve payment and settlement efficiency as well as prevent liquidity risks.

11 Net debit cap is composed of credit granting limitation, collateral and earmarked funds in settlement accounts. Credit granting limitation is the credit limit granted by the PBC to direct participants with sound credit records. Collateral is the qualified asset with high liquidity provided by direct participants. Earmarked funds are cash guarantee provided by direct participants for the settlement of retail payment business, which is a certain proportion of funds frozen in the settlement accounts of direct participants.

checks remain one of the most prevailing payment instruments and will be playing an important role in national economic and social life for a long time. In the past, checks can only be used intra-city in most cases. With the rapid development of economy and finance and stronger momentum of economic regionalization, cross-administrative-areas use of checks becomes more and more urgent. The PBC will further advance the establishment of a nationwide cross-region clearing system to further broaden the usage scope of bills, improve capital use efficiency and promote regional and inter-regional economic development.

Third, continually improving laws and regulations concerning payment. Efforts will be made, as soon as possible, to complete the revising of the *Negotiable Instruments Law*, introduce the *Regulations on Bank Card* and the *Administrative Rules on Payment and Settlement Organizations* to standardize payment activities, increase regulatory transparency and prevent payment risks.

Fourth, establishing a scientific and standardized analysis system of payment information. The PBC will begin to establish a payment

management information system and a business monitoring system to collect data and information regarding the payment system. On the basis of the payment business reporting system, which was established in 2005, the PBC will set up a scientific and standardized payment information analysis system to strengthen research on payment information, provide references for decision-making in monetary policy and supervision and regulation of payment system, and maintain financial stability.

The development of payment systems is an ongoing and complicated process. The major factors driving the development and reform of payment systems have always been scientific advancement, integration of financial markets, legal framework and market competition, particularly the demand for payment and settlement efficiency and security from the financial market. The PBC will continue to follow the trends in the payment system-related fields and work for preventing payment risks, resolve such important problems as coordinated development between LVPS and securities settlement system¹² and legal validation of settlement finality¹³, so as to promote the stable development of China's payment systems and maintain financial stability.

12 According to the latest research by BIS, LVPS of a country should develop together with securities settlement system so as to ensure the safety and efficiency of financial system. An important reason is that the two systems are inter-dependent. Specifically, fund settlement of securities system relies on LVPS to achieve DVP effectively and prevent payment risks. On the other hand, in order to reduce liquidity risks, LVPS usually supports market participants with liquidity according to the pledged assets provided thereof, which would require supports from the securities system. At present, China has achieved the inter-connection between CBGS and LVPS, but the connection between stock exchange settlement system and LVPS is still under discussion and research.

13 To prevent risks, payment orders are irrevocable and final if they enter netting or settlement procedures. However, according to Rule of Zero O'clock, on the date of announcement for bankruptcy, all transactions entering the payment system of a bank will be regarded as void. This does not secure the finality of settlement and is likely to trigger systemic risk. Therefore, in most countries, waiver provisions are added to Rule of Zero O'clock (a provision in the bankruptcy laws of many countries stipulating that all transactions after the zero o'clock of the day when bankruptcy is announced by a bankrupt institution is void) to ensure the finality of settlement. China also follows the international practices to ensure the finality of settlement legally.

Box 15 Payment Systems Building Referred in Financial Stability Reports of Other Countries

Payment system supports the application of all payment instruments and channels the funds. Its security and efficiency directly concern the effective operation of the entire financial system. Accordingly, financial stability reports of other countries pay close attention to their payment systems, as shown by *Financial Stability Reports/Review* of Sweden, Korea and UK.

Considering the key role of the Sweden Riksbank in payment systems, the Swedish parliament authorized the Riksbank to be responsible for the secure and efficient operation of the payment system. The main body of the payment systems in Sweden is the Riksbank and commercial banks. From the viewpoint of the Riksbank, the possibility for negative effects to spread among financial infrastructures will be reduced if the financial infrastructure is effective. The Riksbank monitors the operation of financial infrastructures to control the structural weakness through which risks might spread within the payment system. The Riksbank described the status quo of its payment system in the *Financial Stability Report* released in May 2006. Important payment systems in Sweden include Rix, VPC, Stockholm Stock Exchange's Derivatives Clearing Center and BGC. The annual assessments of these systems by the Riksbank show that they meet international standards quite well. But some participants of the payment sys-

tem have some problems in terms of transparency and regular check.

The *Financial Stability Report* released by Korean central bank on April 2006 described the latest development of Korean payment system. Payment system in Korea plays an increasingly important role in a modern economy. In 2005, the average daily frequency of settlements by non-cash payment instruments increased by 9.9% annually, and daily trading value increased by 10.7% annually. This growth is largely attributed to more intensive application of BOK-Wire and electronic retail settlement systems. Bank of Korea also places great importance on monitoring and assessing the payment system. In 2005, Bank of Korea conducted an assessment of 7 systemically important payment systems (SIPs, including BOK-Wire) and 9 prominently important payment systems (PIPs, including the Giro System). The assessment of SIPs was focused on the results of measures taken to address shortcomings pointed out in the previous year's assessment. In the case of PIPs, the assessment in 2005 is the first full-scale assessment for the system. The results indicated that these systems were in compliance with international standards regarding safety and efficiency. In terms of legislation, Korea also fully considered certain technical features of the payment system. For example, in the *Act Concerning Debtor Rehabilitation and Bankruptcy*

(took into effect in April 2006), Bank of Korea added a provision to ensure the finality of settlement conducted through the payment system operated by the central bank.

Financial Stability Review of Bank of England pays close attention to the operation of payment system in UK. British financial institutions based its operation mainly on four payment systems: CHAPS (large-value payment system of UK), CLS, CREST (securities clearing system of UK) and LCH. Clearnet Ltd (derivatives and cash market settlement center). The value of transactions through the 4 systems is tremendous. In 2005, the daily value of transactions through CREST was 300 billion pound and that through CHAPS is close to 210 billion pound. These payment systems facilitate UK financial institutions and also reduce transaction risks. For instance, LCH. Clearnet Ltd's involvement in the transaction between the buyers and the sellers helps reduce counterpart risks; CHAPS's full amount real-time transaction contributes to preventing the parties of the transaction from credit risk; CLS and CREST prevent settlement risks resulting from mismatch of transaction time. The

payment, clearing and settlement of financial institutions in UK highly depend on these payment systems and breakdown of any of them will bring enormous effect on the whole system. This is a major potential source of operational risks in the UK financial system. Bank of England asserts that UK payment infrastructure and its participants operate stably, and sets up corresponding emergency plans to respond to possible operational problems. To effectively mitigate the operational risks within the system, Bank of England proposed in *Financial Stability Review* of July 2006 to strengthen the following aspects: First, increasing market participants' understanding about payment system emergency plans and the effect of such plan on the economic and financial situation; Second, clarifying the necessary measures that authorities need to take in the event of payment system problem, including measures that domestic agencies and the systems should take and policies and measures to be taken in coordination with foreign agencies and authorities; Third, ensuring the compatibility and mutual coordination among private sectors' emergency plans.

(By Tan Jinghui, Liang Jing, Hong Bo,
Zhang Tiantian and Wang Suzhen)



Appendix I

A Quantitative Study of the Soundness of the Banking Sector: the Case of 16 Commercial Banks

In order to monitor financial system soundness and development, analyze the linkages between the financial sector and the macro economy, assess the effectiveness of various aspects of monetary and financial policies, and promote harmonization and international convergence of key financial policies, several institutions are focusing on further developing the tools and methodologies of financial sector analysis and assessment. In 1999, the World Bank and the International Monetary Fund jointly launched FSAP. The objective of FSAP is to achieve an integrated analysis of stability and development issues using a wide range of analytical tools and techniques that include the following four aspects: The first is macroprudential analysis, including stress testing, analysis of financial soundness indicators and macro-financial linkages; The second is the analysis of financial sector structure, including analysis of efficiency, competitiveness, concentration, liquidity and access. The third is the assessment of observance and implementation of relevant international standards, codes and good practices in the financial sector. The fourth is the analysis of specific stability and development issues tailored to country circumstances.

A comprehensive analysis and assessment of

China's financial system stability lay a foundation for the government to make an accurate judgement on the financial situation, mitigate financial risks on a timely basis, and effectively maintain financial stability. The FSAP framework offers some valuable inspirations for the analysis of China's financial sector soundness. This Appendix is an attempt of quantitative analysis of China's banking sector soundness applying the FSAP framework. It has to be admitted that the quantitative analysis on China's financial stability is at the initial stage and faces some practical challenges, which are also encountered by many other countries, such as the lack of sufficient data and relevant empirical models.

The risk profile of banks with large asset size is the key aspect of a nation's financial stability analysis. The quantitative analysis on 16 commercial banks¹⁴, which collectively account for some 68% of the total assets of China's financial sector, is the first attempt in analyzing the financial soundness under the FSAP framework. This study has compared the major changes in profitability, asset structure and quality, liquidity and capital adequacy ratio of the 16 banks aiming to reflect the changes of strength of these banks in weathering shocks.

14 These 16 commercial banks include the four major state-owned banks (the Industrial and Commercial Bank of China, the Agricultural Bank of China, Bank of China and the China Construction Bank) and 12 joint-stock commercial banks (Bank of Communications, CITIC Bank, China Everbright Bank, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Bank, Evergrowing Bank, and China Zheshang Bank).

Profitability Analysis

The overall soundness of the banking sector has been enhanced significantly. In 2005, the overall profitability of the 16 commercial banks witnessed a significant increase over 2004. The income structure was further optimized and the profits arising from domestic business greatly increased. The pre-provisioning profits in 2005 reached RMB 257.3 billion yuan, showing an increase of RMB 47.02 billion yuan, or 22.36%, than that in previous year. The average ROE before provisioning was 26.10%. More specifically, the average ROE of ICBC, ABC, BOC, and CCB

(collectively referred to as the "Big Four") was 23.73% and that of the rest joint-stock commercial banks was 36.42%.

The major income of the domestic business of the 16 commercial banks in 2005 arised from the increase of investment income. This is more apparent in the Big Four. However, the banking sector still needs to expand their non-interest-bearing businesses so as to create more stable sources of income and mitigate the operational risk.

Return on Equity¹⁵

In 2005, the domestic business of the 16 commercial banks was more stable. The overall ROE increased by 0.24 percentage points compared with that in previous year, reaching 26.10% (Table 1.1).

Table 1.1 ROE Breakdown of the 16 Commercial Banks

(percent)

	Profit Margin		Risk Adjusted Return		Operational Risk		Leverage Ratio		ROE	
	2004	2005	2004	2005	2004	2005	2004	2005	2004	2005
16 Commercial Banks	13.25	13.63	13.44	14.56	58.09	55.04	2 500.06	2 389.35	25.86	26.10
Big Four	12.32	12.09	14.48	16.09	56.55	53.44	2 405.93	2 283.25	24.26	23.73
Joint-stock Commercial Banks	17.75	21.36	9.99	9.87	63.93	60.61	2 933.67	2 850.55	33.11	36.42

Source: The PBC.

The growth of ROE was mainly attributed to the improvement in the banks' risk management,

which increased the risk rate of return by 1.12 percentage points compared with that in previ-

15 All data come from the un-audited data submitted to the People's Bank of China by the commercial banks, and may differ from the audited data. Therefore, the financial indicators thus calculated may differ slightly from the ones disclosed in the annual reports of these commercial banks.

ous year. Table 1.1 also indicates that the operational risk and financial risk of the 16 commercial banks dropped while the operation became more stable.

Table 1.1 indicates that the profit margin or risk adjusted return of most of the 16 commercial banks witnessed an increase in 2005 while the operational risk dropped. However, Table 1.1 also indicates that the financial risk of most banks increased. In other words, in contrast to the equity, the liabilities (most of which are deposits) and hence the assets grew more rapidly.

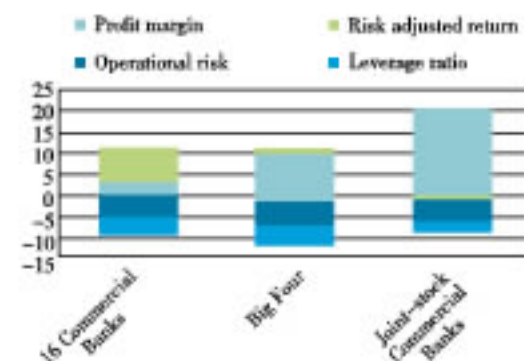
Figure 1.1 Changes in the ROE Breakdown of the 16 Commercial Banks



Source: The PBC.

Figure 1.2 describes the fluctuations in the ROE breakdown of the 16 commercial banks from 2004 to 2005 by the Big Four and the remaining joint-stock commercial banks. The vertical axis indicates the changes from 2004 to 2005.

Figure 1.2 Fluctuations in the ROE Breakdown of the 16 Commercial Banks (percent)



Source: The PBC.

The analysis on the ROE breakdown indicates that the risk rate of return of the Big Four has drastically increased but the profit margin dropped slightly; the profit margin of the remaining joint-stock commercial banks drastically increased but the risk adjusted return dropped slightly; and both the operational risk and financial risk of the 16 major commercial banks decreased.

The reforms of ICBC, BOC and CCB have driven down the overall financial risk of the Big Four, but the profit margin of these banks still lags behind the average of the 16 commercial banks. That means the Big Four need to further enhance their efficiency in the future. The profit margin, operational risk and leverage ratio of the remaining joint-stock commercial banks were high, while the risk adjusted return was relatively low. Therefore, these banks need to improve their risk management, replenish their capital by various means, and hence improve their opera-

tion by increasing the risk adjusted return and

lowering the financial risk.

Box 16 The Breakdown Analysis on ROE

The profitability of banks is relevant to their soundness. The profits of banks can be used to write off the loss and replenish capital, which will improve the banks' capacity in preventing risks. Hence, the profitability of banks is one of the most important financial soundness indicators.

The Return on Equity (ROE) is a key indicator of profitability. However, for banks, changes in ROE are affected not only by changes in profitability but also by efficiency, operational risk and leverage ratio. Therefore, while investigating the reasons of the changes in ROE of commercial banks, one should, first and foremost, analyze the profit margin, risk adjusted return, operational risk and leverage ratio. Based on such analysis, the impacts on ROE brought about by the changes of the above factors can be assessed.

Profit is the percentage of pre-provisioning profits in operation income. The rise of this ratio indicates that the operation income is growing faster than the costs and expenditures (excluding the provisions allocated for the year), resources consumption per unit income is dropping, and the bank's efficiency is increasing. Hence, the rise in profit plays a positive role in the sound operation of the bank. Vice versa.

Risk adjusted return is the ratio of operation income to the total risk-weighted assets.

The rise of the ratio indicates that the income generated by risk-weighted assets is increasing, and the bank's risk management is improving. Hence, the rise in risk adjusted return plays a positive role in the sound operation of the bank, and vice versa.

The operational risk is the ratio of risk-weighted assets to the total assets. The rise of the ratio indicates that the bank's operational risk is increasing, and the assets concerned are classified into the category with higher risk. The rise of the ratio plays a negative role in the sound operation of the bank, the vice versa.

Leverage ratio is the ratio of total liabilities to owner's equity. The rise of the ratio indicates that the percentage of liabilities in the total assets is increasing, which plays a negative role in the sound operation of the bank, and vice versa.

The following formula describes the relationship among these factors.

$$\begin{aligned} \text{ROE} &= \frac{\text{Pre-provisioning Profits}}{\text{Operation Income}} \times \\ &\quad \frac{\text{Operation Income}}{\text{Average Risk-weighted Assets}} \times \\ &\quad \frac{\text{Average Risk-weighted Assets}}{\text{Average Total Assets}} \times \\ &\quad \frac{\text{Average Total Assets}}{\text{Average Owner's Equity}} = \text{Profit Margin} \times \\ &\quad \text{Risk Adjusted Return} \times \text{Operational Risk} \times \\ &\quad \text{Leverage Ratio} \end{aligned}$$

Income Structure Analysis

The net operation income of the 16 commercial banks saw a dramatic increase compared with that in previous year. Thanks to the positive performance of the T-bond market and the increase in the securities and investments of the commercial banks, the return on investment of the banks greatly increased, contributing to the growth of net interest income. Further, as a result of active development of non-interest businesses, the net fee income also accounted for an increasing share in the banks' net operation income.

In 2005, the net operation income¹⁶ generated from domestic businesses of the 16 commercial banks reached RMB 604.8 billion yuan, with an increase of RMB 101.8 billion yuan from 2004. More specifically, the figure for the Big Four was RMB 469.5 billion yuan, with an increase of RMB 75.3 billion yuan compared with that in 2004; and that for the remaining joint-stock commercial banks was RMB 135.3 billion yuan, with an increase of RMB 26.5 billion yuan from 2004. Net interest income¹⁷ still made up the majority of the net operation income. The proportion of net interest income to total net operation income rose by 0.58 percentage points compared with that in 2004, reaching 90.99%. The pro-

portion of net fee income to net operation income modest increase, with 0.67 percentage points compared with that in 2004.

In 2005, the net interest income generated from domestic businesses of the 16 commercial banks rose by RMB 95.6 billion yuan compared with that in previous year, among which investment income rose by RMB 54.1 billion yuan, accounting for 56.64% of the total increase. More specifically, the increase in net interest income of the Big Four was RMB 71.8 billion yuan, among which investment income rose by RMB 46.6 billion yuan, accounting for 64.84% of the total increase. The increase in net interest income of the joint-stock commercial banks was RMB 23.7 billion yuan, among which investment income rose by RMB 7.6 billion yuan, accounting for 31.83% of the total increase. The reason of the rapid increase in investment income was that the securities and investments held by commercial banks grew fast.

The decreasing share of margin income in the net operation income of these two types of banks reflects an increase in non-interest income (Figure 1.3). In 2005, the net fee income generated from domestic businesses of the 16 commercial banks rose by RMB 10.4 billion yuan compared with that in previous year. More specifically, the in-

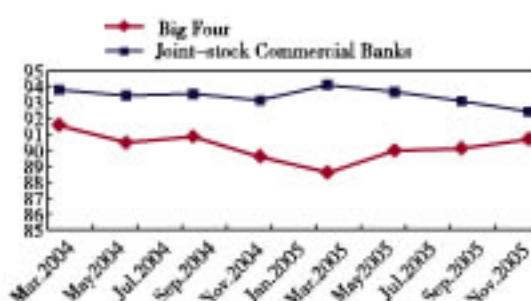
16 Net operation income refers to net interest income, net fee income, profit and loss on exchange and other operation income; net interest income includes return on investment.

17 The banks practice different accounting treatments for the interest income from bonds investment, gain from bonds trading and gain from equity investment. Some classify interest income from bonds investment as interest income while others classify it as investment gain. Under the current system, we cannot clearly define these components. In the meantime, both equity investment and bonds investment will utilize a portion of the interest-bearing liabilities and give rise to interest expenditure. Therefore, when we calculate the net interest income of the 16 commercial banks, investment gain is deemed as a part of interest income and calculated as such. Even though this adjustment may exaggerate the percentage of net interest income in the net operation income, it may better reflect the use of interest-bearing liabilities by commercial banks.

crease registered by the Big Four reached RMB 8.8 billion yuan, or a percentage of 32.52%; and that registered by the remaining joint-stock commercial banks reached RMB 1.6 billion yuan, or a percentage of 37.58%. In 2005, the share of margin income in net operation income of the Big Four was 3.31 percentage points higher than that of the remaining joint-stock commercial banks. The non-interest businesses used small portion of the bank's funds and therefore the risk weights of such assets were relatively low. Such businesses represent a higher risk adjusted return. The relative size of the net fee income of the Big Four was bigger than that of the remaining joint-stock commercial banks, which partly explains why the risk adjusted return of the former was higher than that of the latter.

Figure 1.3 Comparison of the Contribution of Margin Income to the Operation Income of the 16 Commercial Banks

(percent)



Source: The PBC.

Box 17 Analysis on the Changes in Major Items of Interest-bearing Assets and Liabilities of the 16 Commercial Banks

In order to extensively interpret change of a bank's net interest income, one needs to investigate the change of the size and structure of interest-bearing assets and liabilities, as well as the change of yield rates. Due to the

lack of data on the yield rates, we can only partly explain the question by studying the change of the size and structure of interest-bearing assets and liabilities.

Table 1.2 Changes in Major Items of Interest-bearing Assets and Liabilities of the 16 Commercial Banks

	Big Four			Joint-stock Commercial Banks		
	2004 (100 million of RMB yuan)	2005 (100 million of RMB yuan)	year-to-year increase (percent)	2004 (100 million of RMB yuan)	2005 (100 million of RMB yuan)	year-to-year growth (percent)
Deposits	137,686.63	157,675.92	14.52	35,765.73	43,573.67	21.83
Bonds Issue and Funds Raised Overseas	1,307.12	1,987.20	52.03	220.01	593.15	169.60

Table 1.2 (continued)

	Big Four			Joint-stock Commercial Banks		
	2004 (100 million of RMB yuan)	2005 (100 million of RMB yuan)	year-to-year increase (percent)	2004 (100 million of RMB yuan)	2005 (100 million of RMB yuan)	year-to-year growth (percent)
Payable and Temporary Receipts	2,867.84	3,832.03	33.62	815.69	1,070.15	31.20
Loans from the Central Bank	1,980.92	1,713.84	-13.48	89.42	13.33	-85.09
Current Account with Others	5,198.74	5,816.39	11.88	1,840.85	1,996.85	8.47
Total Major Interest-bearing Liabilities	149,041.24	171,025.38	14.75	38,731.71	47,247.15	21.99
Loans	98,241.42	101,744.50	3.57	26,906.40	31,887.74	18.51
Securities and Investments	35,993.63	49,695.85	38.07	6,485.56	8,826.60	36.10
Receivable and Advance	2,781.26	4,530.79	62.90	727.68	800.42	10.00
Deposits in the Central Bank	13,743.22	16,271.84	18.40	4,198.56	4,937.53	17.60
Current Account with Others	4,643.59	3,854.19	-17.00	1,252.51	1,733.05	38.37
Total Major Interest-bearing Assets	155,403.11	176,097.17	13.32	39,570.71	48,185.35	21.77

Source: The PBC.

Table 1.2 describes the changes in major items of interest-bearing liabilities and assets in 2004 and 2005 by the Big Four and the 12 joint-stock commercial banks. All figures are the monthly average, calculated by averaging the balance on January 1 and the end-of-month balances from January to December.

In 2005, securities and investments held by

the 16 commercial banks grew rapidly. The growth rate of deposits and loans of the remaining joint-stock commercial banks was higher than that of the Big Four. Among the Big Four, this growth rate differed significantly from one bank to another (If we do not consider the strip-off of NPL by ICBC in 2005, the growth rate of loans of the Big Four was 9.81%). For years, joint-stock

commercial banks have been active at expansion. This attitude, together with a more rational remuneration system, enabled these banks to witness a rapid growth in deposits and loans in 2005. In contrast, the growth in loans of the Big Four was slow because more loans would have to be approved by the superior branches and no effective remuneration system was in place for credit staff.

In 2005, the securities and investments held by the 16 commercial banks grew significantly, indicating that they were more active in the trading at the inter-bank market to enhance the efficiency in fund utiliza-

tion. In the meantime, the interest rate of inter-bank borrowing and bonds repurchase still remained at a low level¹⁸, indicating the limited capacity of the inter-bank market and the excessive liquidity of commercial banks. At the current stage, the commercial banks still lack other investment channels, and the inter-bank market plays a limited role in absorbing additional funds. If the growth rate of loans of SOCBs remains to be lower than that of deposits for a sustained period of time, a large sum of idle funds will appear, which will increase the banks' fund cost and reduce their income. If the situation continues, the profitability of the Big Four will decrease.

Cost Structure Analysis

In 2005, the operation cost¹⁹ in the domestic business of the 16 commercial banks was RMB 297.5 billion yuan, rising by RMB 22.4 billion yuan compared with that in previous year. The number for the Big Four was RMB 227.9 billion yuan, with an increase of RMB 12.3 billion yuan or a percentage of 5.72%. The number for the remaining joint-stock commercial banks was RMB 69.6 billion yuan, with an increase of RMB 10 billion yuan or a percentage of 12.88%.

Figure 1.4 indicates that the non-interest expenditure of the two types of banks was decreasing, implying an improvement in their management. Both the cost/income ratio²⁰ and

the cost/assets ratio of the Big Four were lower than those of the remaining joint-stock commercial banks, reflecting that the management of operation cost by the Big Four was more effective. As the scope of business and target customers of all commercial banks are similar, the aforesaid gap between these two types of banks mainly reflects the economy of scale in terms of bank management.

While experiencing rapid growth in net operation income, the Big Four successfully controlled their operation costs. However, while experiencing rapid growth in net operation income, the remaining joint-stock commercial banks also witnessed drastic increase in costs (Figure 1.5). The excessive increase in

18 In 2005, the interest rate of bonds repurchase once approached that of the commercial banks' excess reserves deposits.

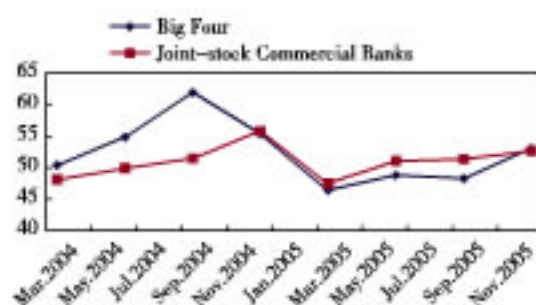
19 Operation cost includes operating expense, business tax and additions as well as other operating expenditures.

20 Cost/Income Ratio = (Operation Cost/Net Operation Income) × 100%.

the operation cost has lowered the profitability and competitiveness of the remaining joint-stock commercial banks and weakened their soundness.

Figure 1.4 Contribution of Non-interest Expenditure to the Operation Cost of the Big Four and 16 Commercial Banks

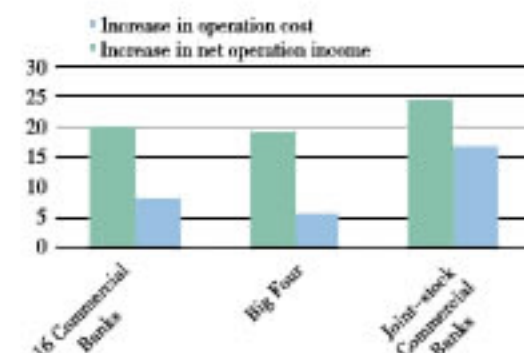
(percent)



Source: The PBC.

Figure 1.5 Growth Rate of Net Operation Income and Operation Cost of the 16 Commercial Banks

(percent)



Source: The PBC.

Assets Analysis

Total Asset Size and Structure

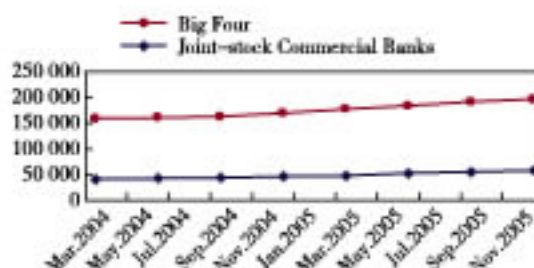
As of December 31, 2005, the total assets (in domestic and foreign currency) of the 16 commercial banks held within the country reached RMB 25.47 trillion yuan (Figure 1.6), rising by 17.75% on the year-to-year basis, and accounting for 67.98% of the total assets (in domestic and foreign currency) of the banking sector in China. By the end of 2005, the Herfindahl-Hirschman Index (HHI)²¹ of the Big Four in terms of the share of total assets in

21 Herfindahl-Hirschman Index (H) = $\sum (\text{Market Share } i \times 100)^2$. According to experience, a market with a result of less than 1,000 is a competitive marketplace; and a result of 1,800 or greater is a highly concentrated marketplace. In the formula, i indicates the percentage of the assets of the i th bank in the total assets of the banking sector.

China's banking sector was 710, decreasing by 62 compared with that in corresponding period of previous year; the HHI of the 16 commercial banks was 740, decreasing by 59. This means China's banking sector is less concentrated and becoming more competitive. The main reason lies in the rapid development of other banking institutions with increasing market shares (Figure 1.7).

Figure 1.6 Total Assets of 16 Commercial Banks

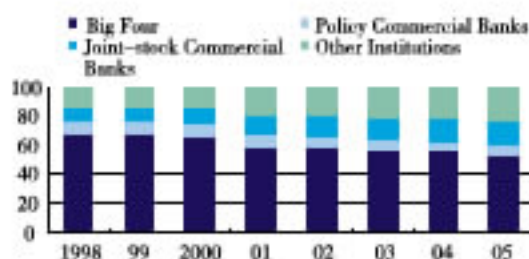
(100 million of RMB yuan)



Source: The PBC.

Figure 1.7 Changes of Asset Shares of 16 Commercial Banks (1998-2005)

(percent)

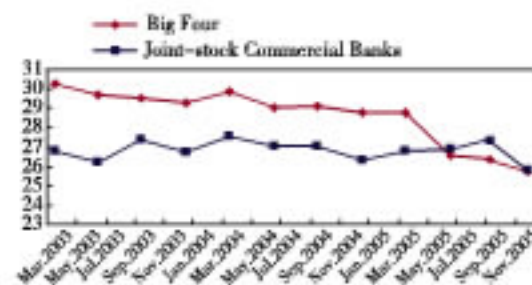


Source: The PBC.

In 2005, the asset structure of the 16 commercial banks did not experience any drastic change. Loan and investment still constituted a lion's share (about 80%) of the total assets of these banks. Influenced by the PBC policy of lowering the interest rate for excess reserves of deposits, the shares of cash and deposits in the central bank registered a slight drop in the total assets. The loans granted by the 16 commercial banks to the manufacturing industry dropped (Figure 1.8), while the share of personal loan in total loans increased steadily. More specifically, the personal loan granted by the Big Four rose from 14.47% of the total loans in 1Q 2004 to 16.47% in 1Q 2006; and that by the remaining joint-stock commercial banks rose from 9.54% in 1Q 2004 to 12.22% in 1Q 2006 (Figure 1.9). As medium-and long-term loans constitute a high percentage of the total loans for both types of banks (Figure 1.10), the risks may be exposed at a later stage.

Figure 1.8 Percentage of Loans Granted to the Manufacturing Industry by the Big Four and Joint-stock Commercial Banks

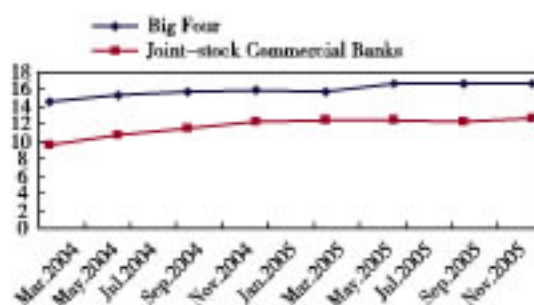
(percent)



Source: The PBC.

Figure 1.9 Percentage of Personal Loans Granted by the Big Four and Joint-stock Commercial Banks

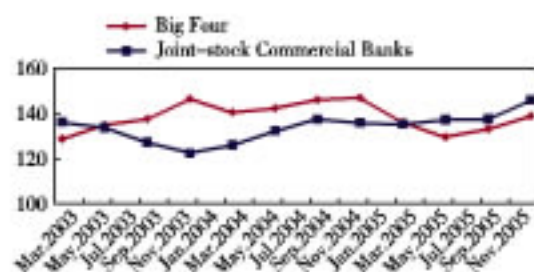
(percent)



Source: The PBC.

Figure 1.10 Percentage of Mid- to Long-term Loans Granted by the Big Four and Joint-stock Commercial Banks

(percent)



Source: The PBC.

Size and Quality of Loans

The NPL ratio of the 16 commercial banks was decreasing, and the growth rate of NPL has been slowing down. In 2005, NPL ratio of the 16 commercial banks dropped from 12.72% in Q1 to 8.90% by the end of year. By the end of 2005, the balance of loans of the 16 commercial banks was RMB 13.71 trillion yuan, increasing by RMB 0.71 trillion yuan, or 5.42% on a year-to-year basis. The growth rate in loans granted by the remaining joint-stock commercial banks was relatively high. Experiences show that a rapid growth in loan is usually accompanied by the deterioration of loan quality. As a result, these banks should pay special attention to the monitoring of the outstanding loans.

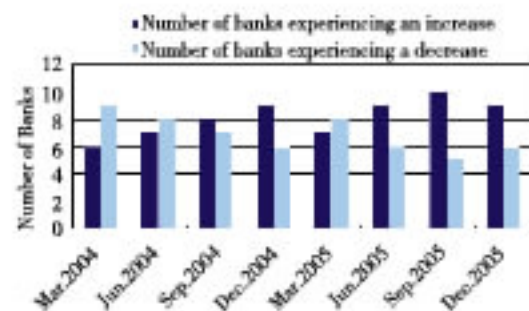
According to the 5-category loan classification system, as of December 31, 2005, the NPL of the 16 commercial banks was RMB 1,219.7 billion yuan, decreasing by RMB 498.5 billion yuan compared with that at the beginning of the year. The main reason of the decrease in both the balance and percentage of NPL of the 16 commercial banks at the end of 2005 was that in the second quarter, ICBC stripped off and wrote off large sum of NPL. Its percentage of NPL was maintained within the range of 10%-10.5%. However, the end of this year saw a slight increase. The percentage of NPLs of joint-stock commercial banks showed a slight decreasing trend, and the level was maintained at lower than 5% throughout the year.

Figure 1.11 demonstrates the number of banks

that saw either an increase or decrease (compared with the level at the beginning of the year) in the NPL in 2004 and 2005. In 2005, the number of banks with an increase in the NPL as compared with that of previous year remained unchanged from the level at the end of the previous year. The strip-off of NPL by BOC, CCB, and BOCOM was taken into consideration in compiling the 2004 data; while the strip-off of NPL by ICBC was taken into consideration in compiling the 2005 data.

The loan structure was not ideal in that the growth in medium-and long-term loans was too rapid and the loans continued to concentrate in big cities, large enterprises, large projects and monopolized industries.

Figure1.11 Increase or Decrease of the Balance of NPL of the 16 Commercial Banks as Compared with Year-beginning Level



Source: The PBC.

Provision Coverage

By the end of 2005, the provision coverage²² of the 16 commercial banks differed greatly from one another. However, the overall situation is better than that of previous year and the level of provision of all banks was drastically increased. The provision coverage of ICBC, BOC and CCB witnessed a significant rise. The average level of joint-stock commercial banks was 53.39%, or a growth of 8.13 percentage points compared with that in previous year.

Liquidity and Capital Adequacy Ratio (CAR)

The liquidity of the 16 commercial banks was high and the CAR increased. Some of the main methods of the banks to replenish capital and reduce historical indebtedness include the introduction of strategic investors, joint stock reform, overseas listing, provision allocation, and reducing the shortfall of provision.

Liquidity

The liquidity of the 16 commercial banks was high. Except for the ABC, whose liquidity in 2Q and 4Q 2005 was slightly lower than the standard level of 25%, the liquidity of the rest of the 15 commercial banks was higher than the standard level.

22 Provision Coverage = Loan Loss Provision / Balance of NPL × 100%.

The liquidity assets of the 16 commercial banks mainly included the reserves deposits and bonds that may be sold at any time at the secondary market in China. These two types of assets represented 69.85% of the total liquidity assets of the 16 commercial banks. The liquidity liabilities of the 16 commercial banks mainly included current deposits, representing 87.37% of the total liquidity liabilities.

CAR

At the end of 2005, both the core capital adequacy ratio (CCAR) and the CAR of most of the 16 commercial banks rose from the levels at the beginning of the year. The number of banks that met the CBRC requirements on

CCAR and CAR rose from 10 at the end of 2004 to 12 at the end of 2005.

The major reason for the increase in both CCAR and CAR was the rise in net core capital. On the one hand, ICBC and CITIC Bank filled their shortfall of loan loss provision through many means, which greatly decreased the overall shortfall of the 16 commercial banks as compared with the level at the end of 2004; on the other hand, the successful listing of the BOCOM and CCB at the Hong Kong Stock Exchange greatly enhanced their CAR. By the end of 2005, five banks still had huge shortfalls in provision, and the pressure to fill the gap is still heavy.

(By Zhao Zengde, Yan Xiandong, Liu Ke, Sun Tao and Hong Bo)



Appendix II

Overview of Regional Financial Stability

The year 2005 witnessed a sustained and rapid economic growth in different regions in China²³. Growth was achieved in investment, consumption, import and export; economic and industrial restructuring was deepened; and the gap between regions in terms of economic development was reduced. At the same time, the financial sector developed smoothly. Growth in the banking, securities and insurance sectors was striking; financial markets transactions were active; and many innovative financial products were launched. Thanks to the progress in financial reforms and the financial ecology, major financial institutions across the regions have become stronger; their corporate governance structures and internal control mechanisms have been consolidated; and the risk prevention and aversion capacity has improved. In short, regional financial stability has been maintained. Further, financial infrastructure, such as the payment system, credit system, anti-money laundering system, has been improved; the legal framework for the financial sector has been strengthened; and prudential financial supervision has been enhanced. They also contributed to the sound operation of the financial sector.

While the economy and financial sector have been growing steadily, the regions still face some common risks and problems due to the

deep-rooted structural economic and financial problems, as well as the inadequacy of the financial institution and financial market. Specifically, these problems include: excess capacity in some industries and the declining profits in industrial enterprises; the sustained high property price and the over-dependence on bank credit in the development and investment of real estate projects; increase in doggy financial operations due to the low investment yield in the money market and the over-competition in market for commercial bills; the renewed pressure in NPL in the banking sector, concentration of credit risk, and the weak risk-prevention capacity of small-and medium-sized local financial institutions; as securities companies are becoming more diversified, the competition has been intensified in business and product innovation, and the operational risk of these companies needs to be further reduced; the integrity, image and credibility of the insurance sector have to be improved; the pressure on the business operations of insurance companies has been increased due to the rapid growth of insurance withdrawal from life insurance policies and declining profitability of property insurance business etc.

The diverging level of economic and financial development, financial resources and the financial ecology in different regions has trans-

23 The Eastern Region consists of 10 provinces (municipalities), including Beijing, Tianjin, Hebei, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, and Hainan; the Central Region consists of 6 provinces, including Shanxi, Anhui, Henan, Hubei, Hunan, and Jiangxi; the Western Region consists of 12 provinces (autonomous regions/municipalities), including Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Ningxia, Inner Mongolia, Qinghai, and Xinjiang; and the Northeastern Region consists of 3 provinces, including Liaoning, Heilongjiang, and Jilin.

lated into differing risk factors, which could affect the financial stability in different regions. Different level of economic and financial development should have different focus; the Eastern Region should focus more on the opening up of the financial sector, the growth of foreign financial institutions, and cross-border and cross-region capital flow; while the Central Region is undergoing rapid industrialization and urbanization, the financial support for county-level local economy has gradually shifted to small-and medium-sized financial institutions, and therefore the credit risk has been increased; the Western Region and Northeastern Region have witnessed rapid growth in investment, but problems arise in the long-term fund allocation, increasing bank

loans of local government and new NPL in the banks.

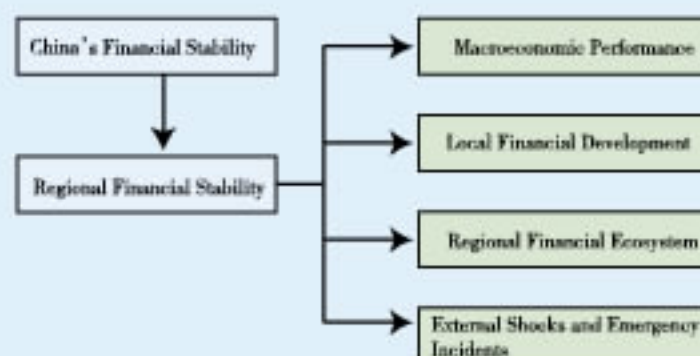
The year 2006 marks the first year of the Eleventh Five-year Plan. The regions will face both challenges and opportunities. Local governments should make best use of the favorable economic environments at home and abroad. While carrying out policies to promote industrial upgrading, the governments shall further improve the quality of economic growth, optimize the economic structure, mend the weakness in the economic and financial systems, curb the unhealthy and instable factors in the economic and financial sectors, and establish a long-term and effective mechanism to maintain financial stability.

Box 18 Regional Financial Stability in China: Concept and Framework for Analysis

In theory, pronounced differences in financial risks should not exist among the regions in a unified economy. In other words, the “regional financial stability” does not stand as a concept on its own. Due to this reason, there are limited amount of literatures and discussions on regional financial stability in other countries. Nonetheless, regional difference has been a salient feature in the Chinese economy. Due to different economic level development and uneven financial resources distribution, the financial risks differ greatly from

one region to another. If we measure according to the credit quality of financial assets, we may discover that difference in the ratio of non-performing assets may be more than 10 times between the worst region and the best. Accordingly, we need to introduce the concept of regional financial stability in the framework of maintaining China's financial stability; we should focus on regional financial risks; and construct an evaluation framework for the analysis of regional financial stability.

Figure 2.1 Framework for the Analysis of China's Regional Financial Stability



Regional financial stability is certainly not a sector specific concept. Rather, it entails the sustained, dynamic, and balanced development of the local financial market and the financial sector. The essence of regional financial stability is the healthy operation of the local economy; the stable development of the financial sector; the improvement in the financial market, the financial infrastructure, and the financial ecology; as well as the continued enhancement in the capacity

to prevent and avert financial risks. All branches of the PBC endeavor to maintain the financial stability of their respective regions; conduct comprehensive evaluation on the stability of local financial systems; study the weaknesses in local economic and financial systems; take prompt measures to deal with problematic financial institutions that may lead to more widespread systemic risks; and maintain the overall stability of the financial system.

Regional Economic Performance and Financial Stability in China

Overview of Regional Economic Performance

In 2005, the policies of macroeconomic management have resulted in concrete improve-

ments; the economy of different regions were growing steadily and rapidly; economic operations were becoming more stable; breakthroughs were achieved in the reform in some key areas and sectors; and regional economic integration accelerated.

In 2005, the GDP of the Eastern, Central, Western and Northeastern Regions were RMB

10.90 trillion yuan, RMB 3.71 trillion yuan, RMB 3.34 trillion yuan, and RMB 1.71 trillion yuan respectively, and the weighed average growth rates were 13.1%, 12.5%, 12.8%, and 12% (Table 2.1). Some new features of China's regional economic deve-

lopment include: the growth rates of some provinces and municipalities in Central and Western Regions surpassed those of the coastal areas in the Eastern Region, and the overall growth rate of northern areas surpassed that of the central and southern areas in the Eastern Region.

Table 2.1 China's Regional GDP Data and Growth in 2005

Item	Northeastern	Eastern	Central	Western	Total
Regional GDP (100 million of RMB yuan)	17 129.92	109 009.3	37 046.94	33 359.71	196 545.8
Percentage (percent)	8.72	55.46	18.85	16.97	100.00
Growth Rate (percent)	13.10	12.50	12.8	12	—
Per Capita Regional GDP (RMB yuan)	15 924.44	23 825.86	10 090.96	8 934.281	15 053.89

Source: Statistical bureaus of the provinces, municipalities and autonomous regions in China; growth rate calculated by simple weighted average.

In 2005, total fixed-assets investment in the Eastern, Central, Western and Northeastern Regions reached RMB 4.73 trillion yuan, RMB 1.63 trillion yuan, RMB 1.77 trillion yuan, and RMB 0.78 trillion yuan respectively, rose 22.7%, 28.8%, 28.1% and 37.6% compared with that in 2004 (Table 2.2). Since the growth of investment in the Eastern Region was heavily affected by real estate sector, total investment

slowed down in this region following the central government's macroeconomic tightening policies. The absolute size of investment in the Western and Northeastern Regions were small, but the growth rates were high, reflecting the policy orientation of the development of the Western Region and the rejuvenation the old industrial bases in the northeast.

Table 2.2 Total Fixed-assets Investment, Real Estate Investment and Percentage of Regions across China in 2005

Item	Northeastern	Eastern	Central	Western	Total
Total Fixed-assets Investment (100 million of RMB yuan)	7,800.58	47,333.20	16,266.74	17,737.35	89,137.87
Percentage (percent)	8.75	53.10	18.25	19.90	100.00
Growth Rate of Investment in Fixed Assets (percent)	37.64	22.65	28.80	28.09	26.02
Investment in Real Estate Projects (100 million of RMB yuan)	1,336.83	9,555.21	2,218.86	2,648.37	15,759.27
Percentage (percent)	8.48	60.63	14.08	16.81	100.00
Growth Rate of Investment in Real Estate Projects (percent)	23.98	12.60	32.62	32.49	19.06

Source: Statistical bureaus of the provinces, municipalities and autonomous regions in China.

Table 2.3 Size of Import/Export, Size of Utilization of Foreign Capital and Growth Rate of Regions across China in 2005

Item	Northeastern	Eastern	Central	Western	Total
Total Import and Export Volume (100 million of USD)	571.11	12,786.15	415.59	454.21	14,227.06
Total Import Volume (100 million of USD)	251.35	5,965.98	169.09	203.53	6,609.95
Total Export Volume (100 million of USD)	319.76	6,800.17	246.50	250.68	7,617.11
Growth Rate of Total Import and Export (percent)	18.93	23.43	18.91	22.47	23.08
FDI (100 million of USD)	56.98	647.71	90.00	43.79	838.48

Source: Statistical bureaus of the provinces, municipalities and autonomous regions in China.

In 2005, the total volume of the Eastern Region imports and exports of was still the largest in China, but the difference in growth rates between regions was relatively small. The total volume of imports and exports in the Eastern, Central, Western and Northeastern Regions were USD 1,278.615 billion, USD 41.559 billion, USD 45.421 billion, and USD 57.111 billion respectively, up 23.4%, 18.9%, 22.5%, and 18.9% respectively over 2004. China's Central, Western and Northeastern Regions became the new "hot spots" attracting foreign capital inflow. In 2005, the utilized foreign investment in the Eastern, Central, Western and Northeastern Regions reached USD 64.771 billion, USD 9 billion, USD 4.379 billion, and USD 5.698 billion respectively (Table 2.3). As the key regions of economic growth designated by the central government, the Western and Northeastern Regions were more and more attractive

to foreign capital. In particular, the growth rates of the utilized foreign investment in Inner Mongolia, Guizhou and Liaoning were 89.0%, 64.8% and 172.7% respectively.

Overall, the primary, secondary and tertiary industries developed healthily in all the regions. The growth rate of the secondary industry was higher than that in the primary and tertiary industries. It is fair to say that the economic growth was mainly driven by industrial growth (Table 2.4). Due to China's favorable policies on agricultural development, the output of grain continued to increase, the comprehensive production capacity improved, and farmers' income increased relatively rapidly. The industrial production also increased rapidly. In 2005, the growth rates of the value-added of industry in Eastern, Central, Western and Northeastern Regions reached 19.8%, 21.4%, 19.6% and 16.6% respectively.

Table 2.4 Size and Structure of the Primary, Secondary and Tertiary Industries of Regions across China in 2005

Item	Northeastern	Eastern	Central	Western	Total
Primary Industry (100 million of RMB yuan)	2,133.10	8,433.85	6,155.34	5,880.82	22,603.11
Percentage (percent)	12.45	7.74	16.62	17.63	11.50
Secondary Industry (100 million of RMB yuan)	8,482.73	56,262.30	17,375.33	14,256.08	96,376.44
Percentage (percent)	49.52	51.61	46.90	42.74	49.04
Tertiary Industry (100 million of RMB yuan)	6,514.09	44,313.13	13,515.97	13,221.49	77,564.68
Percentage (percent)	38.03	40.65	36.48	39.63	39.46

Source: Statistical bureaus of the provinces, municipalities and autonomous regions in China.

Because of rising prices in upstream products such as raw materials, fuel and power, the industrial profits of resources rich provinces, including Shandong, Inner Mongolia, Shanxi and Shaanxi, experienced very strong growth. The service industry was growing steadily, playing a more and more important role in economic growth. The share of the service sector was quite high in some areas in the Eastern Region. For instance, tertiary industry accounted for over 50% of the economy in both Beijing and Shanghai, while the growth rate of the tertiary industry in Shandong, Jiangsu and Zhejiang exceeded 14%.

Concerns in the Regional Economic Performance

The economic structure is imbalanced and the quality of economic growth is low. Excess ca-

capacity and declining profits existed in some industries. In 2005, total retail sales of consumer goods in the Eastern, Central, Western, and Northeastern Regions increased by 14.2%, 14.1%, 13.9% and 13.4% respectively. The actual growth rate was higher than past years, with consumption playing a more important role in economic growth. However, the economic growth of all regions still relied too much on investment and export. Problems such as imbalanced economic structure and low quality of growth are still very serious. Against the background of excess capacity in some industries, many enterprises were operating below capacity and profits were declining in industries like steel, automobile, aluminum, cement, coal, electricity and textile. As the expansion projects constructed earlier are gradually put into operation, the supply of

these products will further exceed market demand. As a result of the central government's macroeconomic management policies, the investment in some over-heated industries was under control, and the financial institutions were more prudent in granting loans to these industries.

On the one hand, many companies in the steel, non-ferrous metal and cement sector in some provinces and municipalities are very small-sized with outdated technology. They cannot produce high-end products, of which demand remained strong, while their low-end products are over-supplied in the market. Given the supply-demand imbalance and the macroeconomic management policies, these enterprises will find it more and more difficult to be profitable, and some small enterprises of them will probably go bankrupt. On the other hand, some industries had a track record of high profitability, and therefore, they were granted huge sums of loans by financial institutions in the past. Given the government policy trying to reduce capacity in over-heated industries, there is a high possibility that loans to the bankrupt enterprises may not be able to be recovered. These are some worrying developments.

Real estate investment and credit to the sector rose significantly, while property prices in some regions have been rising too quickly. Despite the drastic slowdown of real estate investment growth in the Yangtze River Delta Area during 2005, the investment growth picked up in some provinces/municipalities in the Central and Western Regions. In 2005, all

provinces/municipalities, which recorded over 30% real estate investment growth, were located in Central and Western Regions. Currently, China's real estate development still relies heavily on bank loans. The demand for real-estate-related loans has been rising in some areas, and the outstanding loans are growing. Consequently, the risks of the real estate market fluctuation are concentrated in the banking sector.

While the real estate prices in most cities witnessed a slight decline, the property prices in some cities in Hebei and Guangdong province still recorded substantial increase. In 2005, the average prices of property and residential property in Hebei rose 16.5% and 18.6% year-on-year respectively; and the average property price in Guangdong rose 7.7% year-on-year. In particular, the average prices of newly built residential property units in Guangzhou and Shenzhen rose 10.7% and 17.4% year-on-year respectively. In contrast, the reducing transaction has resulted in tightening capital condition for real estate developers as well as the slowing growth of residential mortgages in Shanghai and some other cities. "Collective refusal by buyers to honor the purchase agreements and default of loan repayment" took place in some property projects. At the same time, expectation of further RMB appreciation induces foreign capital inflow into the market, which is becoming a new risk factor to the property market.

There are uncertainties in some export-oriented regional economies. In the aftermath of the foreign exchange reform, the exchange rate of

RMB is becoming more flexible and the possibility of international trade friction has increased, which leads to more uncertainties. Firstly, trade frictions are more frequent while more trading partners and products are involved. Risk management capability of the labor-intensive and low-value-added export enterprises in the textile, garment and shoe industries is weak in coping with such frictions and uncertainties. Secondly, the sustained fluctuation in the exchange rate of RMB directly affects the foreign exchange income and pricing of export products, thus adversely affect the profitability of these enterprises. Thirdly, due to intensifying competition and rising labor cost, the profitability of some foreign companies in the low-entry-barrier and non-resource industries has declined, within which a certain portion of them is becoming loss-making. This will reduce the interest of foreign investment in these sectors, and reducing size of utilized foreign capital there.

Analysis of the Regional Financial Stability

Eastern Region

The Eastern Region is the most economically developed area in China. It is the region where the three most active economic spheres; located—Beijing-Tianjin-HeBei Economic Sphere, Yangtze River Delta Economic Sphere, and Pearl River Delta Economic Sphere. In 2005, the economy of this Region witnessed sustained and rapid growth, and all economic indicators were healthy. The growth rate of in-

vestment in real estate and fixed-assets has slowed down; the pace of the industrial upgrade sped up; and the macroeconomic management policies witnessed remarkable success. As a result of its booming economy, the Eastern Region has the largest size of financial assets as well as the largest number of financial institutions and financial professionals in China. In 2005, the financial sector in the Eastern Region maintained rapid growth. It has attracted more Chinese and foreign financial institutions; the size of the financial market was growing; more financial tools are available; financial innovation was active; and the financial reform made greater progress. With the development of the export-oriented economy in the Eastern Region, the financial sector has been more open; foreign financial institutions have grown more rapidly; and the size and frequency of cross-border capital flow have increased. All these may affect the regional financial stability.

Foreign financial institutions have grown rapidly. The Eastern Region is China's first region that opened up to the outside world. It also had the largest number of foreign financial institutions and related business transactions. Most of the foreign financial institutions coming to China have chosen this Region to establish representative offices or major business venues. The majority of foreign financial institutions can be found in Beijing, Shanghai, and Guangdong (especially in Shenzhen). For example, by end 2005, around 320 foreign-funded financial institutions were established in Shanghai. In the last few years, the businesses of these institutions have been

growing rapidly with expanding market share. By end 2005, the outstanding deposits and loans (including both RMB and foreign currency) of foreign financial institutions in Shanghai rose 32.8% and 32.9% over 2004. The respective growth rates were 17.4 and 23.6 percentage points higher than those registered by domestic financial institutions. While introducing new operation expertise and financial product ideas for their domestic competitors, foreign financial institutions also intensified the competition between Chinese and foreign financial institutions. The pressure faced by Chinese financial institutions has been growing and market uncertainties have increased. In the meantime, it is increasingly more challenging to supervise the overall risk of foreign banks due to the multi-business platforms of the foreign banks' parent corporations, the sharing of customer resources, and the centralized business management of their Chinese branches.

Cross-border capital flow has increased. China's Eastern Region has had the most active cross-border capital flow in the country, and this trend accelerated in 2005. On the one hand, the Region witnessed increased capital inflow. For example, in 2005, the surplus of capital and financial accounts in Shanghai grew by 33.41% over 2004, sales of foreign exchange under the capital account rose by 40.52%, and foreign exchange purchases decreased by 7.91%. Also, in Beijing, sales of foreign exchange in 2005 reached USD 66.192 billion, surged 77.97% over 2004, and equal to the aggregated amount in 2003 and 2004. In particular, foreign exchange sales

under the capital account reached USD 27.02 billion, rose 199.42%. On the other hand, domestic and international financial markets have been increasingly integrated with the growth of the export-oriented economy in the Eastern Region. With the strategy of "going global", Chinese started to invest overseas. Some Chinese banks with the status of designated foreign exchange transaction have become major players in the international financial market, leading to more uncertainties.

The Region witnessed a substantial increase of finance in other locations. Over the past few years, the trend of economic and financial integration has become more and more evident in the Eastern Region—particularly within the Yangtze River Delta Economic Sphere, Pearl River Delta Economic Sphere, and Beijing-Tianjin-HeBei Economic Sphere. Inter-region capital flow has become more frequent. In particular, inter-region credit flow has played an important role in the regional economic and financial development.

Central Region

In the strategic framework of "Rise of the Central Region", the growth potential of this region is started to become realized. The economic return has increased and the quality of economic operations has improved drastically. At the same time, banks, securities and insurance sectors in the Central Region have been developing in a coordinated manner. The financial market has been operating smoothly and steadily. The reforms of the financial institutions have been intensified and the business management pattern has been changed.

The financial infrastructure and ecology have been improving, laying a solid foundation for the stable growth of the financial sector. By end 2005, there were 16,498 secondary branches of Chinese banks in the Central Region, an increase of 2,245 as compared with the end of 2004. The total assets of Chinese financial institutions (both RMB and foreign currency denominated) reached RMB 5,008.19 billion yuan, up 16.7% year-on-year; and the total reported profits (for both RMB and foreign currency businesses) reached RMB 17.67 billion yuan, surged 57.5% year-on-year. As a result of prolonged weak A share market, the number and assets of securities and futures institutions are shrinking, and their role in financing economic activities is declining. The trend of declining profit of securities and futures companies, however, has been curbed. In 2005, for the insurance sector, the premium income in the Central Region reached RMB 87.995 billion yuan, up 11.1% year-on-year; and the indemnity expenditure reached RMB 17.34 billion yuan, up 9.1% year-on-year. Twenty-eight provincial-level subsidiaries were established in 2005. Overall, the sector was developing smoothly. However, some problems still exist in this Region.

The majority of financing for county level economic development was by small-and medium-sized financial institutions, which implies a growing credit risk. Economic development at the county level is the cornerstone of the "Rise of the Central Region" strategy. Unfortunately, though, after the adjustment of business strategy from late 1990s onwards, most of the state-owned and joint stock commercial

banks have given up this relatively unattractive market. According to statistics, by end 2005, the loans for county level economic development in Hunan province accounted for 27.5% of total outstanding loans of the province, or a drop of nearly 10 percentage points compared to 2000. In Henan province, the number of county-based outlets of state-owned commercial banks and policy banks has been decreasing—down 15.7% from 2002 onwards. The market share of local small-and medium-sized financial institutions has been expanding, which also implies higher risks.

After a breakthrough in direct financing, the consequent "crowding out" effect has posed a new challenge for risk management and business expansion capacity of financial institutions in the banking sector. In 2005, RMB 11.7 billion yuan was raised in the Central Region through short-term corporate debt, and the percentage of debt financing rose by 2.1 percentage points compared to 2004, indicating a breakthrough in direct financing. The coordinated development of direct and indirect financing is conducive to improving market efficiency and reducing the dependence of enterprises on bank loans. However, at the current stage, only domestic large and high-quality enterprises are likely to get the approval to issue bonds. After successfully raising funds at the bonds and stock market, some high-quality enterprises would immediately repay a large amount of their loans, thus crowding out the "high-quality loans" of "premium clients" of financial institutions.

The non-tradable share reform has been imple-

mented in the Central Region, but it is faced with many hurdles. By end 2005, there were 230 domestically listed companies in the Central Region, within which 76 completed the non-tradable share reform or started the reform procedure. This represents only 18.3% of all listed companies in the country, which have either completed or in the process of undergoing. The favorable policies of such as reintroduction of re-financing and new share issue will be introduced to areas with more rapid implementation of the non-tradable share reform and companies that have completed the reform process. If the pace of reform in the Central Region still lags behind, the development of its capital market will be adversely affected by the non-tradable share reform.

Western Region

Over the past few years, the economy of the Western Region has been growing rapidly thanks to the favorable policies and investment of the central government. As a result, the financial sector in the Region has witnessed a positive trend of growth. The increase of assets in banking system is substantial—asset growth of banks in Shaanxi, Guangxi, Inner Mongolia and Tibet exceeded 20%; and the outstanding deposits and loans by end 2005 were RMB 4.6 trillion yuan and RMB 3.2 trillion yuan respectively, up 17.4% and 13.1% respectively compared to 2004. After the experiences during the stock market downturn in last few years, the securities companies have adopted more prudent operations. The non-tradable share reform is progress smoothly. The insurance industry has been growing

rapidly, and the premium income rose 13.1% year-on-year, second only to the growth rate in the Eastern Region. Transactions of the financial market have become more active, with more and more local financial institutions participated in money market trading, and the net cash inflow from such transactions has increased. In 2005, the net cash inflow from money market transactions in the Western Region reached RMB 2.4 trillion yuan, or RMB 1.5 trillion yuan more than that of 2004. Overall, however, the economic and financial infrastructure of the Western Region is still very weak; the financial market is growing at a slow pace; the financial institutions are weak at risk management; and the penetration of insurance and financial services is still low. In 2005, the Western Region was especially troubled by such problems as the maturity mismatch, the increase of bank loans of local governments, and the concurrent risk exposure by securities companies.

The problem of maturity mismatch has been more evident, and the percentage of medium-to long-term loans is too high. By end 2005, long-term loans accounted for 51% of the total loans in the Western Region, 6, 9, and 10 percentage points higher than that in the Eastern, Central and Northeastern Regions respectively. In particular, long-term loans accounted for 59.2%, 68.1%, and 52% of total bank loans in Guangxi, Qinghai and Inner Mongolia respectively. At present, short-term savings deposits still is the major part of the liabilities of commercial banks in the Western Region, and the contribution of time deposits to banks' liabilities has been declining. The

growing percentage of medium-to long-term loans and the declining percentage of longer-term time deposits imply more problems in the maturity mismatches between assets and liabilities. In particular, under the existing mechanism, the banks cannot replenish medium-to long-term liabilities. Nor can they increase the liquidity of assets through securitization. All these mean higher potential liquidity and interest rate risk.

The substandard operation of some local securities companies gave rise to concurrent risks exposure. In 2005, many cases of risk exposure of securities companies broke out in the Western Region. Five companies were placed under administrative control by CSRC, one of which submitted a restructuring plan; and 8 companies registered a loss. The potential risk of securities companies is huge.

Bank loans of local governments increased rapidly, which could make the banking system more fragile. Over the past few years, the economy and investment in the Western Region have been growing rapidly. At the same time, government indebtedness has also been increasing. According to a survey conducted in some provinces, debts owed by provincial governments have accounted for over 10% of outstanding loans of the local banks. The debts of some provincial governments could even be comparable to their fiscal revenue. As the government's role is changing, more and more local governments are obtaining credit indirectly from banks to finance the needs of local economic development, resulting in the rapid growth of loans to local government-

controlled companies. The substantial increase in the debts of local governments may make the banking sector more fragile.

Northeastern Region

In 2005, the economy of the three northeastern provinces continued its rapid growth. The rejuvenation of the old industrial bases in the northeast achieved some preliminary success, paving the way for the financial stability. At the same time, the financial market developed quickly, the overall quality of financial institutions improved, the financial infrastructure was consolidated, some high-risk financial institutions were placed under close regulation, and the financial sector remained stable. However, compared with other regions in the country, the Northeastern Region is still troubled by such problems as the excessive growth of fixed asset investment, inferior quality of fixed-assets, imbalance between direct and indirect financing, and the emergence of high quantities of new NPL. These problems may adversely affect the regional financial stability, and therefore demand our close attention.

The rejuvenation of the old industrial bases in the northeast has led to a substantial increase in fixed asset investment in the Region, which may easily result in excess capacity in some industries and a new round of NPL. In 2005, the weighted average growth rate of fixed asset investment in the Northeastern Region was as high as 40%, or 0.7 percentage points higher than the level of 2004. The contribution of fixed assets to GDP growth in Liaoning, Jilin and Heilongjiang reached 137.3%, 162.9%, and 56.1% respectively. In particular, the

fixed asset investment growth in Liaoning and Jilin was 14.4 and 28.1 percentage points higher than the national average. The economic growth driven by investment may result in overheated industries and economic fluctuations, which in turn, would affect the overall profitability of the economy and the capacity of sustainable development. Also, due to the price fluctuations in energy and raw materials, since May 2005, the total profits of industrial enterprises started to decline on a year-on-year basis. It is expected that in next few months, the pressure from a higher demand of loans and growing NPL will increase.

Direct financing has been developing slowly, and direct and indirect financing is out of proportion. By the end of 2005, there were 114 domestic listed companies in the Northeastern Region—6 companies less than that in 2004. This is only 8.16% of the national total. Twenty companies had completed the non-tradable share reform or started the procedure, only amounted to 4.8% of national total. The

development of the stock and bond markets still lags behind. In 2005, a total of RMB 3.2 billion yuan was raised in this Region through short-term financing bonds, representing 1.7% of the national total. No funds were raised from the A-share market. The enterprises in the Northeastern Region have relied extensively on bank financing, and result in the concentration of financial system risk in the banking sector.

New NPL is still substantial, and some commercial banks are experiencing serious loss. The decline in both the absolute amount of NPL and NPL ratio in the three northeastern provinces was mainly attributed to the transfer of large amount of NPL by ICBC to its asset management company. Excluding this factor, the absolute NPL and NPL ratio in major banks in Liaoning, Jilin and Heilongjiang would increase significantly. The banking sector faces huge pressure from rising NPL.

(By Chen Jing)



Appendix III

Statistics

Table 3.1 Selected Economic Indicators

(Year-end Balance)

(100 million of RMB yuan unless otherwise noted)

Items	2001	2002	2003	2004	2005
Gross domestic product	95,933.0	102,398.0	116,694.0	136,515.0	182,321.0
Industrial value added	42,607.0	45,935.0	53,612.0	62,815.0	76,190.0
Fixed asset investment	36,898.0	43,202.0	55,118.0	70,073.0	88,604.0
Retail sales of consumer goods	37,595.2	40,911.0	45,842.0	53,950.0	67,177.0
Urban	23,543.4	25,898.0	29,777.0	35,573.0	45,095.0
County & below	14,051.8	15,013.0	16,065.0	18,377.0	22,082.0
Export & Import (100 million of USD)	5,097.7	6,208.0	8,512.0	11,548.0	14,221.0
Export	2,661.6	3,256.0	4,384.0	5,934.0	7,620.0
Import	2,436.1	2,952.0	4,128.0	5,614.0	6,601.0
Balance	225.5	304.0	256.0	320.0	1,019.0
Foreign direct investment (100 million of USD)	468.5	527.0	535.0	606.0	603.0
Foreign exchange reserve (100 million of USD)	2,121.7	2,864.0	4,033.0	6,099.0	8,189.0
Consumer price index (previous year = 100)	100.7	99.2	101.2	103.9	101.8
Government revenue	16,371.0	18,914.0	21,691.0	26,355.9	31,628.0
Government expenditure	18,844.0	22,012.0	24,607.0	28,360.8	33,708.1
Fiscal balance	-2,473.0	-3,098.0	-2,916.0	-2,004.9	-2,080.1
Per capita urban household disposable income (yuan)	6,859.6	7,703.0	8,500.0	9,422.0	10,493.0
Per capita rural household net income (yuan)	2,366.0	2,475.6	2,622.0	2,936.0	3,255.0
Number of employed persons in urban area (million)	239.4	247.8	256.4	264.8	273.31
Number of unemployed persons by registration in urban area (10 thousand)	894.0	770.0	800.0	—	—
Total population (million)	1,276.3	1,284.5	1,292.3	1,299.9	1,307.56

Source: The PBC.

Table 3.2 Selected Financial Indicators (1)

(Year-end Balance)

(100 million of RMB yuan)

Items	2001	2002	2003	2004	2005
Money & Quasi-money (M_2)	158,301.9	185,007.0	221,222.8	254,107.0	298,755.7
Money (M_1)	59,871.6	70,881.8	84,118.6	95,969.7	107,278.8
Currency in circulation (M_0)	15,688.8	17,278.0	19,746.0	21,468.3	24,031.7
Total deposits with financial institutions	143,617.2	170,917.4	208,055.6	241,424.3	287,169.5
Urban & rural household deposits	73,762.4	86,910.7	103,617.7	119,555.4	141,051.0
Enterprise deposits	51,546.6	60,028.6	72,487.1	84,669.5	96,143.7
Total lending by financial institutions	112,314.7	131,293.9	158,996.2	178,197.8	194,690.4

Source: The PBC.

Table 3.3 Selected Financial Indicators (2)

(Growth Rates)

(percent)

Items	2001	2002	2003	2004	2005
Money & Quasi-money (M_2)	14.4	16.8	20.0	14.7	17.6
Money (M_1)	12.7	16.8	18.7	13.6	11.8
Currency in circulation (M_0)	7.1	10.1	14.3	8.7	11.9
Total deposits with financial institutions	16.3	18.9	21.7	16.0	19.0
Urban & rural household deposits	14.7	17.8	19.2	15.4	18.0
Enterprise deposits	16.2	16.3	20.8	16.8	13.6
Total lending by financial institutions	11.6	15.8	21.1	14.5	13.0

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

Source: The PBC.

Table 3.4 International Liquidity

(Millions of USD)

Items	2002	2003	2004	2005
Total reserves (minus gold)	291,128	408,129	613,725	821,514
Special drawing rights (SDRs)	998	1,080	912	1,251
Reserve positions in IMF	3,723	3,798	2,432	1,391
Foreign exchange	286,407	403,251	609,932	818,872
Gold (millions of ounce)	19.29	19.29	19.29	19.29
Gold (national valuation)	4,074	4,074	4,074	4,074
Other liabilities of deposit monetary banks	39,810	45,489	55,655	41,962

Note: The PBC made adjustment to data on gold and RMB purchase of gold and silver in December 2001 and December 2002.

Source: The PBC.

Table 3.5 Gold and Foreign Exchange Reserves

Year	Gold reserves (10 thousand of ounce)	Foreign exchange reserves (100 million of USD)	Change in foreign exchange reserves (percent)
1993	1,267	212.0	9.0
1994	1,267	516.2	143.5
1995	1,267	736.0	42.6
1996	1,267	1,050.3	42.7
1997	1,267	1,398.9	33.2
1998	1,267	1,449.6	3.6
1999	1,267	1,546.8	6.7
2000	1,267	1,655.7	7.0
2001	1,608	2,121.7	28.1
2002	1,929	2,864.1	35.0
2003	1,929	4,032.5	40.8
2004	1,929	6,099.3	51.3
2005	1,929	8,188.7	34.3

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

Source: The PBC.

Table 3.6 Consolidated Balance Sheet of the Financial Sector in China

(Including foreign currencies)

(December 31, 2005)

(100 million of RMB yuan)

Items	Total balance
Current assets	243,476.39
Long-term assets	242,409.37
Fixed assets	6,283.28
Intangible & other assets	10,571.26
Total assets	502,740.30
Current liabilities	236,615.08
Long-term liabilities	239,621.05
Total liabilities	476,236.13
Owner's equity	26,504.18
Of which: Paid-up capital	17,294.91
Total liabilities and owner's equity	502,740.30

Source: The PBC.

Table 3.7 Depository Corporations Survey in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets (net)	58,477.4	65,421.2	69,287.0	75,722.5
Domestic credit	229,149.8	232,885.7	241,467.6	249,560.3
Claim on governments (net)	12,222.6	10,493.7	11,539.6	15,190.0
Claim on non-financial sectors	197,827.0	198,627.5	203,350.8	205,952.5
Claim on other financial sectors	19,100.2	23,764.5	26,577.2	28,417.7
Money & Quasi-money	261,444.3	272,522.6	284,052.1	295,507.6
Money	94,738.1	98,597.3	100,960.5	107,275.6
Currency in circulation	21,239.0	20,848.8	22,272.9	24,031.7
Demand deposits	73,499.1	77,748.5	78,687.6	83,243.9
Quasi-money	166,706.2	173,925.4	183,091.6	188,232.1
Time deposits	35,706.7	39,767.9	44,728.0	45,224.7
Household deposits	129,259.4	132,339.1	136,316.3	141,051.0
Other deposits	1,740.1	1,818.3	2,047.3	1,956.4
Deposit not included in M ₂	12,854.3	13,110.2	12,160.7	12,361.9
Bonds	16,275.3	17,114.4	18,867.3	20,378.8
Paid-in capital	10,491.2	11,755.9	10,130.1	10,796.3
Other items (net)	-13,423.4	-16,186.0	-14,455.6	-13,761.8

Source: The PBC.

Table 3.8 Balance Sheet of Policy Banks in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	297.1	295.2	335.5	546.4
Reserve assets	430.4	327.6	510.1	798.1
Required reserves	428.1	325.3	506.9	796.3
Cash in vault	2.2	2.3	3.2	1.9
Claims on government	18.2	18.1	6.4	29.9
Central bank bonds	221.4	236.0	107.5	209.5
Claims on other depository corporations	98.3	225.1	150.2	483.2
Claims on other financial corporations	1,000.0	1,000.0	1,000.0	1,000.0
Claims on non-financial corporations	23,271.7	24,447.7	25,349.7	26,367.6
Claims on other resident sections	9.4	10.9	10.4	15.1
Other assets	282.8	288.7	292.5	329.8
Total assets	25,629.2	26,849.3	27,762.2	29,779.7
Liabilities to non-financial institutions and residents	1,568.0	2,014.6	1,889.4	2,127.0
Deposit included in M ₂	1,135.2	1,495.9	1,392.1	1,605.4
Enterprise demand deposit	1,040.0	1,386.6	1,282.1	1,468.7
Enterprise time deposit	95.3	109.3	110.0	136.7
Household savings deposit				
Deposit not included in M ₂	388.0	515.0	493.3	514.8
Negotiable deposit	126.7	386.1	367.1	388.6
Other deposits	261.3	128.9	126.3	126.2
Other Liabilities	44.8	3.7	3.9	6.8
Liabilities to central bank	5,879.0	5,692.0	5,230.0	5,230.0
Liabilities to other depository corporations	194.8	324.0	103.8	481.0
Liabilities to other financial corporations		3.4		
Deposits included in M ₂				
Foreign liabilities	700.0	697.4	790.6	870.5
Bond issuance	14,667.3	15,510.0	16,845.3	18,071.6
Paid-in capital	665.0	711.5	715.0	710.9
Other liabilities	1,955.1	1,896.3	2,188.3	2,288.7
Total liabilities	25,629.2	26,849.3	27,762.2	29,779.7

Source: The PBC.

Table 3.9 Balance Sheet of State-owned Commercial Banks in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	10,415.5	11,294.6	11,194.2	13,850.0
Reserve assets	16,951.3	16,392.5	17,830.9	16,400.9
Required reserves	15,886.1	15,428.4	16,707.5	15,436.2
Cash in vault	1,065.1	964.0	1,123.5	964.7
Claims on government	10,024.7	10,299.2	11,075.3	11,418.3
Central bank bonds	8,574.4	15,922.0	18,557.3	20,698.7
Claims on other depository corporations	10,390.3	12,010.7	13,584.0	14,260.5
Claims on other financial corporations	8,164.4	8,184.2	8,712.8	8,357.8
Claims on non-financial institutions	91,620.4	86,953.0	87,437.8	87,423.4
Claims on other resident sections	15,512.7	15,763.2	15,895.3	16,085.9
Other assets	9,030.2	10,490.8	11,105.3	11,837.3
Total assets	180,684.1	187,310.1	195,392.9	200,332.6
Liabilities to non-financial institutions and residents	151,029.2	155,375.8	160,400.7	163,061.8
Deposit included in M_2	142,002.8	146,552.4	152,128.3	154,547.6
Enterprise demand deposit	43,865.2	45,477.7	46,270.5	47,508.9
Enterprise time deposit	16,301.8	18,034.3	20,468.7	19,997.8
Household savings deposit	81,835.9	83,040.4	85,389.1	87,040.9
Deposit not included in M_2	8,926.1	8,701.3	8,139.5	8,287.5
Negotiable deposit	1,640.5	1,684.5	1,490.6	1,631.6
Other deposits	7,285.5	7,016.7	6,648.8	6,655.9
Other Liabilities	100.3	122.2	132.9	226.7
Liabilities to central bank	2,267.0	1,900.2	1,854.5	1,802.0
Liabilities to other depository corporations	3,884.2	4,741.0	5,306.4	5,542.1
Liabilities to other financial corporations	5,584.8	6,067.7	7,420.3	7,571.9
Deposits included in M_2	890.0	984.4	1,112.6	986.2
Foreign liabilities	1,584.2	1,409.5	1,205.8	971.0
Bond issuance	1,000.4	1,000.4	1,351.2	1,353.8
Paid-in capital	5,633.0	6,507.8	4,725.8	5,240.5
Other liabilities	9,701.4	10,287.8	13,128.4	14,789.6
Total liabilities	180,684.1	187,310.1	195,392.9	200,332.6

Source: The PBC.

Table 3.10 Balance Sheet of Joint-stock Commercial Banks in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	1,697.6	1,971.8	1,740.0	1,938.0
Reserve assets	4,982.7	5,585.6	5,525.1	5,826.1
Required reserves	4,810.4	5,415.9	5,310.4	15,626.5
Cash in vault	172.3	169.7	214.7	199.6
Claims on government	3,064.6	3,065.0	3,315.5	3,494.6
Central bank bills	1,407.2	1,494.8	1,510.6	2,618.7
Claims on other depository corporations	4,568.9	5,734.2	6,426.3	7,009.4
Claims on other financial corporations	338.1	407.3	406.6	598.7
Claims on non-financial institutions	26,687.8	28,752.4	30,495.8	31,291.3
Claims on other resident sections	3,463.6	3,683.0	3,816.2	4,014.3
Other assets	2,308.7	2,476.2	2,438.2	2,208.3
Total assets	48,519.2	53,170.2	55,674.2	58,999.4
Liabilities to non-financial institutions and residents	37,656.1	41,180.6	43,061.9	45,771.0
Deposit included in M ₂	35,147.8	38,329.6	40,528.3	43,273.8
Enterprise demand deposit	14,728.5	15,873.9	15,717.2	16,977.2
Enterprise time deposit	12,427.7	13,883.9	15,618.1	16,266.3
Household savings deposit	7,991.6	8,571.8	9,193.0	10,030.3
Deposit not included in M ₂	2,460.5	2,796.4	2,473.0	2,425.6
Negotiable deposit	500.2	651.2	469.1	531.5
Other deposits	1,960.3	2,145.2	2,003.9	1,894.1
Other Liabilities	47.8	54.6	60.6	71.6
Liabilities to central bank	14.2	13.9	12.4	29.8
Liabilities to other depository corporations	2,210.7	2,913.3	3,048.3	2,842.6
Liabilities to other financial corporations	4,092.8	4,055.9	4,189.9	4,402.4
Deposits included in M ₂	785.8	739.1	849.7	892.2
Foreign liabilities	148.5	152.5	156.6	174.8
Bond issuance	564.2	561.7	628.9	859.1
Paid-in capital	892.4	1,029.9	1,043.0	1,137.0
Other liabilities	2,940.2	3,262.5	3,533.2	3,782.7
Total liabilities	48,519.2	53,170.2	55,674.2	58,999.4

Source: The PBC.

Table 3.11 Balance Sheet of City Commercial Banks in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	97.5	105.8	109.4	98.6
Reserve assets	1,380.1	1,588.7	1,593.4	2,186.6
Required reserves	1,288.5	1,494.5	1,494.7	2,079.6
Cash in vault	91.5	94.2	98.7	107.1
Claims on government	2,022.8	2,005.1	2,184.3	2,460.2
Central bank bills	183.2	240.0	184.2	257.7
Claims on other depository corporations	1,949.5	2,410.7	2,540.5	2,621.8
Claims on other financial corporations	211.2	220.6	212.8	298.5
Claims on non-financial institutions	8,657.0	9,213.4	9,785.1	10,113.0
Claims on other resident sections	938.2	973.9	982.4	1,012.4
Other assets	1,087.0	1,143.3	1,173.9	1,221.4
Total assets	16,526.3	17,901.4	18,766.0	20,270.2
Liabilities to non-financial institutions and residents	13,540.2	14,539.3	15,382.3	16,931.9
Deposit included in M_2	13,391.3	14,378.5	15,205.8	16,744.9
Enterprise demand deposit	6,070.3	6,529.2	6,709.4	7,652.2
Enterprise time deposit	3,279.5	3,613.5	3,959.6	4,176.1
Household savings deposit	4,041.6	4,235.8	4,536.8	4,916.6
Deposit not included in M_2	136.2	145.3	160.0	166.9
Negotiable deposit	41.3	49.1	54.9	53.5
Other deposits	94.9	96.2	105.1	113.5
Other Liabilities	12.7	15.5	16.5	20.1
Liabilities to central bank	97.8	78.7	62.2	64.8
Liabilities to other depository corporations	1,354.6	1,631.0	1,592.4	1,342.0
Liabilities to other financial corporations	361.8	395.3	364.0	373.4
Deposits included in M_2	64.3	94.7	84.7	75.9
Foreign liabilities	3.4	2.0	0.5	0.4
Bond issuance	30.6	30.4	30.0	73.0
Paid-in capital	469.6	481.3	487.7	591.6
Other liabilities	668.2	743.5	846.8	893.2
Total liabilities	16,526.3	17,901.4	18,766.0	20,270.2

Source: The PBC.

Table 3.12 Balance Sheet of Foreign-funded Banks in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	1,563.6	1,569.5	1,356.5	1,547.4
Reserve assets	189.5	199.3	320.3	364.9
Required reserves	188.7	198.5	319.3	363.6
Cash in vault	0.7	0.8	1.0	1.3
Claims on government	120.8	126.4	82.4	101.8
Central bank bills				
Claims on other depository corporations	778.1	862.3	880.8	952.2
Claims on other financial corporations	24.6	21.8	22.8	26.4
Claims on non-financial institutions	2,683.4	2,904.6	3,031.6	3,183.7
Claims on other resident sections	10.4	13.0	13.6	15.1
Other assets	115.2	137.0	157.0	161.5
Total assets	5,485.5	5,833.7	5,865.1	6,353.0
Liabilities to non-financial institutions and residents	1,450.9	1,536.0	1,608.9	1,793.0
Deposit included in M ₂	655.2	744.1	868.4	980.2
Enterprise demand deposit	328.0	350.2	390.5	463.0
Enterprise time deposit	327.0	393.6	476.9	516.8
Household savings deposit	0.2	0.3	1.0	0.4
Deposit not included in M ₂	795.7	791.9	740.4	812.7
Negotiable deposit	518.6	514.5	453.6	479.1
Other deposits	277.1	277.4	286.9	333.6
Other Liabilities				
Liabilities to central bank				
Liabilities to other depository corporations	467.6	475.2	500.4	603.4
Liabilities to other financial corporations	67.6	75.3	81.3	89.5
Deposits included in M ₂				
Foreign liabilities	2,765.9	2,929.6	2,806.3	2,973.1
Bond issuance	12.8	11.8	12.0	21.1
Paid-in capital	483.5	510.2	543.6	571.4
Other liabilities	237.2	295.5	312.7	301.4
Total liabilities	5,485.5	5,833.7	5,865.1	6,353.0

Source: The PBC.

Table 3.13 Balance Sheet of Urban Credit Cooperatives in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets				
Reserve assets	165.5	186.1	178.5	330.4
Required reserves	150.7	170.6	161.2	311.3
Cash in vault	14.8	15.5	17.3	19.1
Claims on government	44.6	47.1	51.6	64.4
Central bank bills	3.4	3.6	3.2	2.5
Claims on other depository corporations	319.6	344.7	353.3	352.5
Claims on other financial corporations	8.8	8.0	8.0	7.3
Claims on non-financial institutions	1,019.0	1,088.1	1,049.1	1,115.7
Claims on other resident sections	28.0	28.7	30.0	32.7
Other assets	138.0	140.5	144.2	144.8
Total assets	1,726.8	1,846.8	1,817.8	2,050.3
Liabilities to non-financial institutions and residents	1,540.2	1,640.2	1,603.8	1,814.1
Deposit included in M ₂	1,539.2	1,639.1	1,603.1	1,813.1
Enterprise demand deposit	476.5	521.7	508.1	613.4
Enterprise time deposit	235.8	257.4	245.0	273.5
Household savings deposit	826.8	860.0	849.9	926.5
Deposit not included in M ₂				
Negotiable deposit				
Other deposits				
Other Liabilities	1.0	1.1	0.7	0.9
Liabilities to central bank	21.8	20.6	18.9	16.9
Liabilities to other depository corporations	96.9	102.3	110.7	108.3
Liabilities to other financial corporations	4.4	2.5	3.5	4.9
Deposits included in M ₂				1.4
Foreign liabilities				
Bond issuance				
Paid-in capital	45.2	47.5	45.2	52.7
Other liabilities	18.4	33.8	35.7	53.4
Total liabilities	1,726.8	1,846.8	1,817.8	2,050.3

Source: The PBC.

Table 3.14 Balance Sheet of Rural Credit Cooperatives in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	16.9	17.0	16.9	14.7
Reserve assets	3,211.6	2,998.5	3,092.4	4,779.7
Required reserves	2,685.6	2,487.4	2,512.0	4,314.1
Cash in vault	526.0	511.1	580.4	465.6
Claims on government	1,075.8	1,040.0	883.6	1,019.9
Central bank bills	54.0	122.0	36.2	31.5
Claims on other depository corporations	4,069.5	4,292.5	3,956.2	3,373.2
Claims on other financial corporations	121.5	116.0	116.3	115.9
Claims on non-financial institutions	19,770.0	19,822.9	19,375.2	18,551.9
Claims on other resident sections	517.6	550.0	494.8	456.8
Other assets	2,516.9	2,948.4	3,306.8	3,410.6
Total assets	31,353.9	31,907.2	31,278.4	31,754.3
Liabilities to non-financial institutions and residents	27,743.2	27,874.8	27,362.1	27,698.1
Deposit included in M_2	27,672.5	27,804.0	27,295.1	27,645.0
Enterprise demand deposit	4,571.3	4,633.5	4,361.0	4,436.1
Enterprise time deposit	1,459.9	1,473.7	1,457.3	1,462.4
Household savings deposit	21,641.2	21,696.8	21,476.8	21,746.6
Deposit not included in M_2	46.9	45.0	41.9	29.3
Negotiable deposit	2.0	2.1	1.8	2.0
Other deposits	44.9	42.9	40.1	27.3
Other Liabilities	23.9	25.8	25.1	23.8
Liabilities to central bank	969.7	937.4	845.8	639.6
Liabilities to other depository corporations	822.2	897.9	764.7	845.7
Liabilities to other financial corporations	19.1	65.9	28.4	65.8
Deposits included in M_2				
Foreign liabilities				
Bond issuance				
Paid-in capital	1,662.2	1,806.2	1,830.6	1,717.8
Other liabilities	137.5	325.1	446.8	787.3
Total liabilities	31,353.9	31,907.2	31,278.4	31,754.3

Source: The PBC.

Table 3.15 Balance Sheet of Postal Savings & Remittance Bureau in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets				
Reserve assets	8,822.4	8,770.8	8,391.0	8,635.3
Required reserves	8,654.6	8,650.4	8,230.1	8,259.2
Cash in vault	167.8	120.4	160.9	376.1
Claims on government	170.0	141.1	211.5	541.3
Central bank bills	606.2	998.0	851.8	1,054.8
Claims on other depository corporations	2,007.4	2,471.8	2,694.2	3,449.2
Claims on other financial corporations	1.0	4.8	27.2	49.7
Claims on non-financial institutions	6.7	6.7	15.4	90.1
Claims on other resident sections				
Other assets	306.7	-4.8	499.0	-33.5
Total assets	11,920.4	12,388.5	12,690.0	13,786.8
Liabilities to non-financial institutions and residents	11,852.6	12,284.6	12,595.1	13,599.0
Deposit included in M ₂	11,852.6	12,284.6	12,594.9	13,599.0
Enterprise demand deposit				
Enterprise time deposit				
Household savings deposit	11,852.6	12,284.6	12,594.9	13,599.0
Deposit not included in M ₂			0.2	
Negotiable deposit				
Other deposits			0.2	
Other Liabilities				
Liabilities to central bank	28.5	11.2	0.1	0.2
Liabilities to other depository corporations	15.0	45.0	40.0	138.9
Liabilities to other financial corporations	12.6	14.1	14.1	6.0
Deposits included in M ₂				
Foreign liabilities				
Bond issuance				
Paid-in capital				
Other liabilities	11.8	33.6	40.8	42.8
Total liabilities	11,920.4	12,388.5	12,690.0	13,786.8

Source: The PBC.

Table 3.16 Balance Sheet of Finance Companies in 2005

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign assets	16.6	15.5	13.1	13.8
Reserve assets	231.9	298.4	290.8	326.4
Required reserves	231.8	298.3	290.8	326.4
Cash in vault	0.1	0.1	0.1	0.1
Claims on government	297.5	309.8	285.2	266.0
Central bank bills	144.5	125.7	127.0	51.6
Claims on other depository corporations	1,093.9	1,619.8	1,682.8	1,815.7
Claims on other financial corporations	57.9	109.2	101.2	176.5
Claims on non-financial institutions	2,120.0	2,246.5	2,518.4	2,624.3
Claims on other resident sections	11.1	12.9	13.1	14.2
Other assets	38.7	70.5	44.8	89.8
Total assets	4,012.1	4,808.3	5,076.4	5,378.4
Liabilities to non-financial institutions and residents	3,108.4	3,745.8	3,897.4	4,351.3
Deposit included in M ₂	3,010.7	3,634.4	3,789.2	4,244.5
Enterprise demand deposit	1,780.8	2,105.7	2,009.1	2,553.3
Enterprise time deposit	1,229.9	1,528.7	1,780.1	1,691.3
Household savings deposit				
Deposit not included in M ₂	92.0	105.7	102.5	101.3
Negotiable deposit	86.5	99.0	99.7	94.8
Other deposits	5.5	6.7	2.8	6.5
Other Liabilities	5.7	5.7	5.8	5.5
Liabilities to central bank	5.3	7.4	3.3	11.9
Liabilities to other depository corporations	286.0	375.2	412.2	311.0
Liabilities to other financial corporations	24.5	49.8	105.1	18.9
Deposits included in M ₂			0.4	0.8
Foreign liabilities	0.9	0.7	0.7	0.5
Bond issuance				
Paid-in capital	363.3	354.9	393.1	402.3
Other liabilities	223.6	274.6	264.6	282.4
Total liabilities	4,012.1	4,808.3	5,076.4	5,378.4

Source: The PBC.

Table 3.17 Statistics of Securities Market

Year	1992	1993	1994	1995	1996	1997
Number of domestic listed companies (share A, B)	53	183	291	323	530	745
Number of domestic listed foreign companies (Share B)	18	41	58	70	85	101
Number of overseas listed companies (Share H)	—	6	15	18	25	42
Number of shares issued (100 million of shares)	68.87	587.73	684.54	848.42	1,219.54	1,942.67
Of which: Negotiable shares (100 million of shares)	21.18	107.88	226.04	301.46	429.85	671.44
Total marketization of shares (millions of RMB yuan)	1,048.13	3,531.01	3,690.61	3,474.28	9,842.39	17,529.24
Of which: Marketization of negotiable shares (100 millions of RMB yuan)	—	861.62	968.89	938.22	2,867.03	5,204.42
Number of shares transacted (millions of shares)	3,795.39	23,422.17	201,333.91	70,547.06	253,314.06	256,079.12
Total trading volume (100 million of RMB yuan)	681.25	3,667.02	8,127.63	4,036.47	21,332.16	30,721.84
Shanghai Composite Index (Closing)	780.39	833.80	647.87	555.29	917.01	1,194.10
Shenzhen Composite Index (Closing)	241.21	238.27	140.63	113.24	327.45	381.29
Number of investor accounts (10 thousand)	216.65	835.17	1,107.76	1,294.19	2,422.08	3,480.26
Average P/E						
Shanghai	—	42.48	23.45	15.70	31.32	39.86
Shenzhen	—	42.69	10.28	9.46	35.42	41.24
Average conversion rate (percent)						
Shanghai	—	—	1,134.65	528.72	913.43	701.81
Shenzhen	—	—	583.83	254.52	1,350.35	817.43
Treasury bonds issuance (100 million of RMB yuan)	460.78	381.31	1,137.55	1,510.86	1,847.77	2,411.79
Enterprise bonds issuance (100 million of RMB yuan)	683.71	235.84	161.75	300.80	268.92	255.23
Trading volume of bonds (10 thousand units)	—	—	—	100,660.50	174,297.17	161,732.38
Trading turnover of bonds (100 million of RMB yuan)	—	—	—	59,367.61	18,089.35	16,476.89
Treasury bonds spot transaction turnover (100 million of RMB yuan)	7.1276	61.02	468.37	775.20	5,029.24	3,582.75
Treasury bonds repo transaction turnover (100 million of RMB yuan)	0	0.42	75.78	1,248.52	13,008.64	12,876.06
Number of security investment funds	—	—	—	—	—	—
Security investment fund scale (100 million of RMB yuan)	—	—	—	—	—	—
Trading turnover of securities investment fund (100 million of RMB yuan)	—	—	—	—	—	—
Trading volume of futures (10 thousand units)	—	890.69	12,110.72	63,612.07	34,256.77	15,876.32
Trading turnover of futures (100 million of RMB yuan)	—	5,521.99	31,601.41	100,565.00	84,119.16	61,170.66

Source: CSRC.

1998	1999	2000	2001	2002	2003	2004	2005
851	949	1,088	1,160	1,224	1,287	1,377	1,381
106	108	114	112	111	111	110	109
43	46	52	60	75	93	111	122
2,526.79	3,088.95	3,791.71	5,218.01	5,875.45	6,428.46	7,149.43	7,629.51
861.94	1,079.65	1,354.26	1,813.17	2,086.90	2,269.92	2,577.18	2,914.77
19,505.64	26,471.17	48,090.94	43,522.20	38,329.13	42,457.72	37,055.57	32,430.28
5,745.59	8,213.97	16,087.52	315,228.76	12,484.55	13,178.52	11,688.64	10,630.51
215,411.00	293,238.88	475,840.00	315,228.76	301,619.49	416,308.40	582,773.29	662,373.2
23,544.25	31,319.60	60,826.65	38,305.18	27,990.46	32,115.27	42,333.95	31,664.78
1,146.70	1,366.58	2,073.40	1,645.97	1,357.65	1,497.04	1,266.50	1,161.06
343.85	402.18	635.73	475.94	388.76	378.62	315.81	278.75
4,259.88	4,810.63	6,123.24	6,898.68	6,841.84	6,981.24	7,215.74	7,336.07
34.38	38.13	58.22	37.71	34.43	36.54	24.23	16.33
32.31	37.56	56.03	39.79	36.97	36.19	24.63	16.36
453.63	471.46	492.87	269.33	214.00	250.75	288.71	274.37
406.56	424.52	509.10	227.89	198.79	214.18	288.29	316.43
3,808.77	4,015.00	4,657.00	4,884.00	5,934.30	6,280.10	6,923.90	7,042.00
147.89	158.20	83.00	147.00	325.00	358.00	327.00	2,046.50
203,161.40	170,716.33	197,979.00	204,707.68	329,252.26	620,194.41	504,218.50	283,714.36
21,661.78	18,284.12	19,119.16	20,417.76	33,249.53	62,136.36	50,323.50	28,367.85
6,059.95	5,300.87	4,157.49	4,815.59	8,708.68	5,756.11	2,966.46	2,780.63
15,540.84	12,890.53	14,733.68	15,487.63	24,419.64	52,999.85	44,086.61	23,621.17
6	22	34	51	71	95	161	218.00
120.00	510.00	562.00	804.23	1,318.85	1,614.67	3,308.79	4,714.18
555.33	1,623.12	2,465.79	2,561.88	1,166.58	682.65	728.58	773.15
10,455.57	7,363.91	5,461.07	12,046.35	13,943.37	27,992.43	30,569.76	32,287.41
36,967.24	22,343.01	16,082.29	30,144.98	39,490.28	108,396.59	146,935.32	134,463.38

Table 3.18 Stock Market Capitalization to GDP Ratio*(100 million of RMB yuan unless otherwise noted)*

Year	GDP	Market Capitalization	Ratio (percent)	GDP	Negotiable Market Capitalization	Ratio (percent)
1992	26,638.10	1,048.13	3.93	26,638.10	—	—
1993	34,634.40	3,531.01	10.20	34,634.40	—	—
1994	46,759.40	3,690.62	7.89	46,759.40	964.82	2.06
1995	58,478.10	3,474.00	5.94	58,478.10	937.94	1.60
1996	67,884.60	9,842.37	14.50	67,884.60	2,867.03	4.22
1997	74,772.40	17,529.23	23.44	74,772.40	5,204.43	6.96
1998	79,552.80	19,505.64	24.52	79,552.80	5,745.59	7.22
1999	82,054.00	26,471.17	32.26	82,054.00	8,213.97	10.01
2000	89,404.00	48,090.94	53.79	89,404.00	16,087.52	17.99
2001	95,933.00	43,522.19	45.37	95,933.00	14,463.16	15.08
2002	102,398.00	38,329.12	37.43	102,398.00	12,484.55	12.19
2003	116,694.00	42,457.72	36.38	116,694.00	13,178.52	11.29
2004	159,587.00	37,055.57	23.22	159,587.00	11,688.64	7.32
2005	183,192.00	32,430.28	17.70	183,192.00	10,630.51	5.80

Note: GDP for the year 2004 and 2005 has been adjusted according to data from the first economic survey of securities sector as conducted by National Bureau of Statistics of China.

Source: CSRC, National Bureau of Statistics of China.

Table 3.19 Domestic Stock Funding to Bank Loan Increment Ratio*(100 million of RMB yuan unless otherwise noted)*

Year	Domestic Stock Funding	Loan Increment	Ratio (percent)
1993	314.54	6,335.40	4.96
1994	138.05	7,216.62	1.91
1995	118.86	9,339.82	1.27
1996	341.52	10,683.33	3.20
1997	933.82	10,712.47	8.72
1998	803.57	11,490.94	6.99
1999	897.39	10,846.36	8.27
2000	1,541.02	13,346.61	11.55
2001	1,182.13	12,439.41	9.50
2002	779.75	18,979.20	4.11
2003	823.10	27,702.30	2.97
2004	862.67	19,201.60	4.49
2005	338.13	16,492.60	2.05

Note: Domestic stock funding includes share A and B funding.

Source: The PBC, CSRC, and National Bureau of Statistics of China.

Table 3.20 Statistics of Stock Market

Year	1992	1993	1994	1995	1996	1997
Number of domestic listed companies (Share A, B)	53	183	291	323	530	745
Of which: ST companies	—	—	—	—	—	—
Medium/ small-sized companies	—	—	—	—	—	—
Number of domestic listed foreign companies (Share B)	18	41	50	70	85	101
Of which: ST companies	—	—	—	—	—	—
Number of shares issued (millions of shares)	7,322.20	32,867.50	63,947.08	76,563.11	111,036.04	177,125.19
Of which: Medium/ small-sized	—	—	—	—	—	—
Market capitalization (millions of RMB yuan)	104,814.9	354,152.07	569,061.68	547,427.64	904,258.66	1,732,923.70
Of which: Medium/ small-sized	—	—	—	—	—	—
Negotiable market capitalization (millions of RMB yuan)	—	86,162.97	96,890.11	93,821.91	296,704.01	520,442.39
Of which: Medium/ small-sized	—	—	—	—	—	—
Total	3,689.78	22,656.47	101,333.91	70,580.78	253,314.43	256,001.89
Volume (millions of shares)	Daily average	14.41	87.92	402.12	283.19	1,025.57
Medium/ small-sized	—	—	—	—	—	—
Total	68,303.73	362,720.32	812,762.89	403,645.27	2,133,217.43	3,072,183.20
Turnover (millions of shares)	Daily average	266.53	1,407.49	3,225.25	1,618.56	8,636.51
Medium/ small-sized	—	—	—	—	—	—
Average conversion rate (percent)	Shanghai	—	—	1,154.65	520.72	913.43
Shenzhen	—	—	583.83	254.52	1,350.55	817.43
Medium/ small-sized	—	—	—	—	—	—
Average P/E	Shanghai	—	42.48	23.45	15.70	51.52
Shenzhen	—	42.69	10.37	9.35	35.42	39.86
Medium/ small-sized	—	—	—	—	—	—
Shanghai Composite Index	Opening	—	802.14	837.70	637.72	550.26
Highest	1,429.01	1,538.95	1,062.94	926.41	1,258.69	1,510.18
Date	05/26/1992	02/16/1993	09/13/1994	05/22/1995	12/11/1996	05/12/1997
Lowest	292.76	750.46	325.89	524.43	512.83	870.18
Date	01/02/1992	12/20/1993	07/29/1994	02/07/1995	01/19/1996	02/20/1997
Average	668.52	1,013.39	674.10	657.80	764.65	1,175.59
Closing	—	833.80	647.87	555.29	917.02	1,194.10
Shenzhen Composite Index	Opening	110.53	241.21	258.28	159.62	112.85
Highest	312.21	359.44	242.06	169.66	473.02	517.91
Date	05/26/1992	02/22/1993	01/07/1994	05/22/1995	12/11/1996	05/12/1997
Lowest	107.08	203.91	96.56	112.63	105.54	305.81
Date	01/16/1992	07/21/1993	07/29/1994	12/28/1995	01/22/1996	01/06/1997
Average	215.76	277.51	165.86	131	224.67	388.16
Closing	241.21	238.28	140.63	113.25	327.34	381.29

Source: Shanghai and Shenzhen Stock Exchanges.

1998	1999	2000	2001	2002	2003	2004	2005
851	949	1,088	1,160	1,224	1,287	1,377	1,381
29	56	61	47	89	99	135	115
—	—	—	—	—	—	38	50
106	108	114	112	111	111	110	109
4	11	11	7	13	14	20	15
234,535.36	290,885.19	361,339.05	483,835.69	546,299.21	599,794.35	671,473.31	716,354.05
—	—	—	—	—	—	3,223.36	5,614.41
1,952,181.21	2,647,117.52	4,809,094.43	4,352,220.39	3,832,912.86	4,245,771.60	3,705,556.82	3,243,028.14
—	—	—	—	—	—	41,343.14	48,115.15
574,537.94	821,396.38	1,608,751.96	1,446,317.01	1,248,455.65	1,317,851.70	1,168,863.95	1,063,051.43
—	—	—	—	—	—	11,996.09	18,529.34
215,246.10	293,238.88	475,838.21	315,228.76	301,619.49	416,308.40	582,773.29	662,373.20
888.39	1,226.94	1,990.96	1,313.45	1,272.66	1,727.40	2,398.25	2,737.08
—	—	—	—	—	—	5,915.87	13,029.95
2,352,731.48	3,131,960.25	6,082,664.99	3,830,518.00	2,799,045.51	3,211,527.00	4,233,394.72	3,166,477.62
9,710.80	13,104.44	25,450.48	15,960.00	11,810.32	13,325.80	17,421.38	13,084.62
—	—	—	—	—	—	82,263.06	120,392.27
453.63	471.46	492.87	269.33	214.00	250.75	288.71	274.37
406.56	424.52	509.10	227.89	198.79	214.18	288.29	316.43
—	—	—	—	—	—	617.75	999.70
34.38	38.13	58.22	37.71	34.43	36.54	24.23	16.33
30.59	36.30	56.04	39.79	36.97	36.19	24.63	16.36
—	—	—	—	—	—	31.33	24.49
1,200.95	1,144.89	1,368.69	2,077.08	1,643.49	1,347.43	1,492.72	1,260.782
1,422.98	1,756.18	2,125.72	2,243.00	1,748.89	1,649.60	1,783.01	1,328.53
06/04/1998	06/30/1999	11/23/2000	06/13/2001	06/25/2002	04/16/2003	04/07/2004	02/25/2005
1,043.02	1,047.83	1,361.21	1,515.00	1,339.20	1,307.40	1,259.43	998.23
08/18/1998	05/17/1999	01/04/2000	10/22/2001	01/29/2002	04/07/2003	09/13/2004	06/06/2005
1,261.04	1,377.33	1,882.00	1,956.00	1,567.23	1,467.75	1,482.85	1,153.55
1,146.70	1,366.58	2,073.48	1,645.97	1,357.65	1,497.04	1,266.50	1,161.057
382.85	343.29	402.71	636.62	475.14	386.61	377.93	313.81
441.04	525.14	654.37	664.85	512.38	449.42	470.55	333.28
06/18/1998	06/29/1999	11/23/2000	06/13/2001	06/24/2002	04/15/2003	04/07/2004	03/09/2005
317.1	310.65	414.69	439.36	371.79	350.74	315.17	237.18
08/18/1998	05/18/1999	01/04/2000	10/22/2001	01/22/2002	11/18/2003	09/13/2004	07/18/2005
384.7	407.62	579.61	580.9	455.65	404.08	379.43	282.64
343.85	402.18	635.73	475.94	388.76	378.63	315.81	278.75

Table 3.21 Summary of China's Bond Issuance
(100 million of RMB years)

Year	Government Debts			Financial Bonds			Subordinated Debts			Corporate Bonds		
	Issuance	Redemption	Outstanding balance	Issuance	Redemption	Outstanding balance	Issuance	Redemption	Outstanding balance	Issuance	Redemption	Outstanding balance
1990	197.23	76.22	890.34	64.40	50.07	84.88	—	—	—	126.37	77.29	195.44
1991	281.25	111.60	1,059.99	66.91	33.67	118.12	—	—	—	249.96	114.31	331.09
1992	460.73	238.05	282.72	55.00	30.00	143.12	—	—	—	683.71	192.76	822.04
1993	381.31	123.29	1,540.74	—	34.29	108.83	—	—	—	235.84	255.48	802.40
1994	1,137.55	91.89	2,286.40	—	13.54	95.29	—	—	—	161.75	282.04	682.11
1995	510.86	496.96	3,300.30	—	—	1,708.49	—	—	—	300.80	336.30	646.61
1996	1,847.77	786.64	4,361.43	1,055.60	254.50	2,509.59	—	—	—	268.92	317.80	597.73
1997	2,411.79	1,264.29	5,508.93	1,431.50	12.30	3,628.80	—	—	—	255.23	19.81	521.02
1998	3,808.77	2,060.86	765.70	1,950.23	320.40	5,121.13	—	—	—	147.89	105.25	676.93
1999	4,015.00	1,238.70	10,542.00	1,800.89	473.20	6,447.48	—	—	—	158.20	56.50	778.63
2000	4,657.00	2,179.00	3,020.00	645.00	709.20	383.28	—	—	—	83.00	—	861.63
2001	4,884.00	2,286.00	15,618.00	2,590.00	1,438.80	8,534.48	—	—	—	147.00	—	—
2002	5,934.30	2,216.20	19,336.10	3,075.00	1,555.70	10,054.10	—	—	—	325.00	—	—
2003	6,280.10	2,755.80	22,603.60	4,561.40	2,505.30	11,650.00	—	—	—	358.00	—	—
2004	6,923.90	3,749.90	25,777.60	4,148.00	1,778.70	14,019.30	918.80	—	918.80	327.00	—	—
2005	7,042.00	4,045.50	28,774.00	5,851.70	2,053.00	17,818.00	966.30	—	1,885.10	2,046.50	37.00	—

Notes: As China Minsheng Banking Corp., Ltd issued subordinated debts worth RMB 5.81 billion yuan in October 2004, which was registered in 2005, the data for 2004 subordinated debts has been adjusted.

Source: The PBC.

Table 3.22 Statistics of China's Insurance Development

(10 thousand of RMB yuan unless otherwise noted)

Items	1999	2000	Increase/ decrease Y-o-Y (percent)	2001	Increase/ decrease Y-o-Y (percent)	2002	Increase/ decrease Y-o-Y (percent)	2003	Increase/ decrease Y-o-Y (percent)	2004	Increase/ decrease Y-o-Y (percent)	2005	Increase/ decrease Y-o-Y (percent)
Premium income	13,932,179	15,958,577	14.5	21,093,543	32.2	30,531,391	44.7	38,803,961	27.1	43,181,349.81	11.3	49,273,350	14.1
1. Property insurance	5,211,215	5,483,980	5.3	6,853,912	24.5	7,782,974	13.6	8,694,049	11.7	10,189,358.9	25.4	12,998,600	27.8
2. Personal insurance	672,549	808,154	20.2	740,358	8.4	707,138	-4.5	995,817	40.6	1,170,697.48	17.6	1,408,938	20.4
3. Health insurance	365,384	654,896	79.2	615,512	-6.0	1,224,491	98.9	2,419,241	97.6	2,598,770.68	7.4	3,123,019	20.2
4. Life insurance	7,683,031	8,511,717	10.8	12,875,762	51.3	20,736,847	61.1	26,694,854	28.7	29,513,022.75	6.8	32,442,793	13.8
Claim payment	5,102,436	5,273,572	3.4	5,982,472	13.4	7,067,309	18.1	8,410,137	19.0	10,044,403.34	19.4	11,296,695	12.5
1. Property insurance	2,802,422	3,058,896	9.2	3,329,369	8.8	4,049,198	21.6	4,763,183	17.6	5,675,226.15	19.1	6,717,468	18.4
2. Personal accident insurance	267,270	323,606	21.1	290,011	-8.4	267,322	-7.8	306,473	14.6	394,216.48	20.6	435,112	10.4
3. Health insurance	110,025	129,166	17.4	335,189	159.5	499,370	49.0	699,019	40.0	891,031.9	27.5	1,079,160	21.1
4. Life insurance	1,922,719	1,761,904	-8.4	2,027,963	15.1	2,251,419	11.0	2,641,463	17.3	3,083,928.81	16.8	3,064,955	-0.6
Operating expenses	1,827,345	2,166,066	18.5	2,583,581	19.3	3,143,722	21.7	3,612,184	14.9	4,358,195.9	20.7	5,259,627	20.7
Bank deposits	9,259,787	12,353,827	33.4	19,305,949	56.3	30,262,700	56.8	45,496,683	50.3	49,687,838.81	9.2	52,414,307	5.5
Investment	8,914,152	13,032,248	46.2	17,125,878	31.4	25,040,608	46.2	38,288,655	52.9	57,119,395	49.2	88,944,100	55.7
Including: Treasury	6,784,880	9,559,535	40.9	7,958,294	-16.8	11,078,479	39.2	14,068,963	27.0	26,517,062.94	88.5	35,882,884	35.3
Security investment funds	147,909	1,335,396	922.8	2,089,939	56.5	3,077,758	47.3	4,632,840	50.5	6,731,655.4	45.3	10,992,068	63.3
Total assets	26,040,938	33,738,948	29.6	45,913,431	36.1	64,940,741	41.4	91,228,392	40.5	118,585,464.6	29.9	152,259,681	28.5

Note: ①Data on premium income, claim payment and operating expenses from January to December.

②Data on bank deposits, investment and total assets at the end of December.

Source: This table is prepared based on data from CBRC Website.

Table 3.23 Statistics of China's P&C Insurance Development in 2005

(10 thousand of RMB yuan unless otherwise noted)

	Premium Income	Increase Y-o-Y (percent)	Claim Payment	Increase Y-o-Y (percent)
Total	12,827,369.87	14.03	6,910,943.43	18.71
Enterprise property insurance	1,487,820.99	7.90	926,733.01	31.84
Automobile insurance	8,578,846.81	13.82	4,844,929.34	16.70
Liability insurance	453,233.16	35.71	175,842.39	-0.62
Accident insurance	464,322.92	45.40	156,518.02	65.64
Short-term health insurance	51,416.67	85.56	25,571.48	90.68
Others	1,791,729.32	9.07	781,349.19	21.42

Note: Due to different statistics caliber and timing, data provided here may differ from those in Table 3.22.

Source: CIRC.

Table 3.24 Statistics of China's Life Insurance Development in 2005

(10 thousand of RMB yuan unless otherwise noted)

	Premium Income	Claim Payment	Annuity Payment	Payment at Expiration	Payment for Death/Injury/Medical Care
Total	36,485,369.06	1,164,265.01	1,270,328.46	1,402,913.94	618,144.30
Personal insurance	28,987,217.92	449,576.62	788,962.59	776,393.38	505,403.38
Group insurance	7,498,151.14	714,688.38	481,345.87	626,520.55	112,740.91
Professional agent	97,347.24				
Distribution Channels					
Individual agent	19,542,225.95				
Part-time agent	287,261.81				

Note: Due to different statistics caliber and timing, data provided here may differ from those in Table 3.22.

Source: CIRC.

Table 3.25 The Insurance Business by Provinces, Autonomous Regions and Municipalities in 2005

(Million of RMB yuan unless otherwise noted)

Regions	Total		Property Insurance			Personal Insurance		
	Premium Income	Increase Y-o-Y (percent)	Premium Income	Increase Y-o-Y (percent)	Market Share (percent)	Premium Income	Increase Y-o-Y (percent)	Market Share (percent)
Beijing	49,691.23	75.03	6,696.11	1.61	13.48	42,995.12	97.22	86.52
Jiangsu	43,333.67	3.84	9,351.53	11.98	21.58	33,982.14	1.80	78.42
Guangdong	39,152.78	13.89	11,813.17	13.02	30.17	27,339.61	14.28	69.83
Shanghai	33,404.17	8.76	8,847.63	18.26	26.49	24,556.54	5.70	73.51

Table 3.25 The Insurance Business by Provinces, Autonomous Regions and Municipalities in 2005
(Continue)

Regions	Total		Property Insurance			Personal Insurance		
	Premium Income	Increase Y-o-Y (percent)	Premium Income	Increase Y-o-Y (percent)	Market Share (percent)	Premium Income	Increase Y-o-Y (percent)	Market Share (percent)
Shandong	29,123.49	7.50	7,203.15	18.80	24.73	21,920.34	4.24	75.27
Zhejiang	26,208.79	7.36	8,860.86	19.22	33.81	17,347.93	2.17	66.19
Heibei	21,731.32	5.80	5,363.42	7.63	25.35	16,367.99	5.21	74.65
Heinan	21,302.07	5.44	3,665.50	11.37	17.20	17,636.57	4.29	82.80
Sichuan	18,935.09	18.53	4,888.87	7.71	25.82	14,046.22	22.83	74.18
Liaoning	16,729.98	8.89	3,943.31	14.49	23.57	12,786.67	7.27	76.43
Heilongjiang	13,964.32	9.41	2,152.97	21.49	15.42	11,811.35	7.46	84.58
Hubei	13,472.45	10.51	3,636.34	26.00	26.99	9,836.11	5.71	73.01
Anhui	13,325.53	9.01	3,168.82	17.11	23.78	10,156.71	6.71	76.22
Hunan	12,724.82	9.96	2,970.16	19.56	23.34	9,754.66	7.33	76.66
Fujian	12,577.67	9.66	3,137.91	10.89	24.95	9,439.78	9.26	75.05
Shangxi	12,176.73	16.92	3,157.53	9.10	25.93	9,019.20	19.94	74.07
Shenzhen	10,648.20	16.03	5,013.52	13.25	47.08	5,634.68	18.62	52.92
Shangxi	9,739.20	17.95	2,391.04	9.65	24.55	7,348.16	20.94	75.45
Tianjin	9,064.29	16.97	2,181.99	17.73	24.07	6,882.30	10.38	75.93
Jiangxi	8,979.04	12.12	1,817.15	17.53	20.24	7,161.89	10.83	79.76
Yunnan	8,094.84	9.14	2,908.47	9.63	35.93	5,186.37	8.86	64.07
Jilin	7,573.51	1.89	1,457.75	14.77	19.25	6,115.76	-0.77	80.75
Chongqing	7,309.92	9.89	2,090.60	19.83	28.60	5,219.32	6.37	71.40
Guangxi	7,311.42	9.86	2,263.93	12.65	30.96	5,047.49	8.65	69.04
Xinjiang	7,250.44	6.42	2,093.32	6.37	28.87	5,157.12	6.44	71.13
Inner Mongolia	6,086.67	10.22	1,738.15	20.58	28.56	4,348.53	6.56	71.44
Dalian	5,730.00	10.00	1,630.00	14.00	28.45	4,100.00	8.42	71.55
Ningbo	5,117.70	9.70	2,232.30	19.38	43.62	2,885.40	2.29	56.38
Qingdao	4,957.00	4.18	1,598.00	16.76	32.24	3,359.00	-2.85	67.76
Gansu	4,789.08	7.72	1,351.25	12.14	28.22	3,437.83	7.70	71.78
Guizhou	4,082.89	21.41	1,441.94	13.00	35.32	2,640.95	26.55	64.68
Xiameng	2,331.17	12.22	829.82	11.45	35.60	1,501.35	12.65	64.40
Ningxia	1,573.93	13.90	458.37	10.28	29.00	1,115.56	15.45	71.00
Hainan	1,497.43	3.21	542.76	9.95	36.25	954.67	-0.25	63.75
Qinghai	785.354	6.64	355.35	11.00	45.00	430.00	3.00	55.00
Tibet	156.97	9.38	156.97	9.38	100.00			

Note: Due to different statistics caliber, data provided here may differ slightly from those of CIRC.

Source: Yearbook of China's Insurance 2006.

Table 3.26 Statistics of the Businesses of 25 Property Insurance Companies in 2005

(Millions of RMB yuan)

Companies	Premium Income							
	Total	Enterprise property insurance	Automobile insurance	Cargo transportation insurance	Liability insurance	Agriculture insurance	Accident insurance	Others
PICC P&C	65,981.69	8,628.36	44,504.19	2,803.67	2,586.22	170.90	2,309.52	4,978.84
CPIC P&C	14,866.00	2,264.50	8,966.70	756.20	330.80	0.20	657.40	1,890.20
Ping An P&C	12,675.81	1,717.18	7,907.57	541.41	577.21	0.00	326.39	1,606.06
China United Property Insurance	10,483.79	427.63	8,455.49	124.55	168.90	248.31	371.83	687.08
Tian An Insurance	6,335.43	331.91	5,159.40	86.69	60.50	0.00	251.51	445.42
China Continent P&C	3,814.60	268.02	3,038.04	103.47	80.70	0.10	202.40	121.87
China Insurance	3,319.00	715.00	1,413.00	206.00	416.00	—	114.00	455.00
Yong An Insurance	3,162.00	131.52	2,698.85	27.48	29.37	0.00	122.53	157.25
Sinosafe Insurance	2,121.29	101.62	1,709.40	19.57	20.68	0.00	152.81	117.21
Taiping Insurance	1,391.31	174.82	940.38	78.64	44.93	0.00	47.53	105.01
Huanai P&C	1,176.79	178.09	649.25	123.87	55.67	0.00	30.02	139.99
Dazhong P&C	1,060.71	141.97	733.86	43.06	24.95		43.36	73.51
Anbang P&C	1,001.01	13.66	736.03	1.33	222.75	0.00	12.37	14.87
AIU	567.90	129.44	4.68	159.03	186.26	1.11	28.03	59.35
Tokio Marine	236.64	65.88	8.32	113.32	22.15	0.00	0.86	26.11
Nichido Shanghai								
Ming An Insurance	228.89	124.56	89.85	5.47	8.50		1.17	7.13
Sunshine Agriculture Insurance	228.40	2.82	2.33	0.04	0.39	219.84	2.13	0.85
Sumitomo Mitsui Shanghai	156.30	51.69	0.00	82.04	16.14	0.00	1.21	5.23
All Trust Insurance	133.43	87.21	6.04	1.98	1.43	0.00	2.24	34.54
Anxin Agriculture Insurance	132.42	7.31	2.04	0.05	0.60	114.49	3.72	4.21
Samsung Fire & Marine Insurance	114.90	39.04	0.00	67.90	4.32	0.00	0.82	2.82
Winterthur Insurance Shanghai	78.84	22.61		12.40	22.96			20.87
Royal & Sun Alliance Shanghai	71.73	18.88	0.04	16.98	24.98	0.00	0.32	10.53
Allianz	70.54	22.17	0.00	4.40	17.54	0.00	0.65	25.78
BOC Insurance	61.72	34.44		2.45	2.02		0.25	22.56

Note: Ming An Insurance includes Ming An Insurance Shenzhen and Ming An Insurance Haikou; AIU includes AIU Shanghai, AIU Guangzhou and AIU Shenzhen.

Source: Yearbook of China's Insurance 2006.

Claim Payment							
Total	Enterprise property insurance	Automobile insurance	Cargo transportation insurance	Liability insurance	Agriculture insurance	Accident insurance	Others
39,518.05	5,402.16	28,244.69	1,206.65	1,191.56	159.28	966.58	2,347.14
7,452.39	1,150.78	5,049.70	241.71	154.00	0.00	191.97	664.23
6,133.52	942.49	4,004.76	163.75	230.94	0.00	67.98	723.60
4,589.33	333.69	3,665.59	33.53	49.30	168.80	113.88	224.54
3,014.48	180.30	2,689.79	17.59	23.96	0.00	70.83	32.01
1,337.80	105.31	1,143.79	19.19	13.75	0.00	40.55	15.21
1,780.00	259.00	721.00	69.00	508.00	—	25.00	197.00
1,454.90	50.17	1,329.40	3.95	9.89	0.00	19.67	41.82
1,191.02	46.51	1,022.33	6.01	5.83	0.00	37.41	72.93
550.69	55.10	407.76	46.38	9.90	0.00	6.93	24.62
537.72	74.96	354.26	49.01	16.89	0.00	4.84	37.76
801.97	141.44	508.63	13.62	12.90		21.32	104.04
29.62	0.58	28.57	0.00	0.34	0.00	0.13	0.00
117.63	26.45	0.89	62.59	22.36	0.00	1.69	3.65
94.06	25.82	0.18	46.95	4.30	0.00	0.07	16.74
110.94	80.98	25.98	0.75	1.77		0.01	1.45
153.65	0.06	0.19		0.01	153.23	0.16	
32.13	9.01	0.00	20.72	0.77	0.00	0.06	1.57
19.34	18.05	0.14	0.00	0.00	0.00	0.01	1.14
91.29	3.66	0.11	0.03	0.06	86.13	0.30	1.00
46.54	17.16	0.00	28.97	0.17	0.00	0.00	0.24
8.25	1.30		4.33	1.56			1.06
12.28	4.64	0.00	4.04	3.39	0.00	0.00	0.21
9.60	0.00	0.00	0.26	0.31	0.00	0.01	9.02
10.17	8.26		0.50	0.35		0.02	1.04

Table 3.27 Statistics of the Businesses of 25 Personal Insurance Companies in 2005

(Millions of RMB yuan)

Companies	Premium					
	Total	Personal Insurance				
		Life Insurance				Accident Insurance
		Sub-total	Common life insurance products	Participating products	Others	
China Life	160,949.00	124,404.00	38,498.00	85,913.00	73.00	3,975.00
Ping An Life	58,848.90	39,248.30	9,075.96	15,336.59	14,835.75	617.45
CPIC Life	36,201.40	26,723.11	11,946.92	14,759.89	16.30	612.43
New China Life	21,077.57	17,824.04	707.09	14,711.08	570.81	53.99
Generally China Life	19,971.95	576.35	16.08	395.17	165.09	9.60
Tai Kang Life	17,805.06	14,341.20	423.92	11,209.95	2,707.33	98.33
Tai Ping Life	7,830.60	6,202.04	164.77	3,798.64	2,238.63	47.16
AIA	6,453.28	5,293.53	1,617.10	1,301.25	2,375.19	335.24
Sino Life Insurance	3,245.90	2,436.00	149.90	2,259.20	26.90	9.00
CITIC-Prudential	1,059.45	1,054.93	71.31	248.10	542.17	35.93
Aviva-Cofco Life	889.71	648.35	33.46	177.47	437.42	2.09
Pacific-Anhui Life	711.86	707.65	287.40	183.98	96.40	17.49
Manulife-Sinochem	701.95	623.13	73.91	526.55	22.67	12.47
Minsheng Life	674.37	422.55	0.91	421.64	0.00	35.17
Union Life	579.81	340.03	285.73	54.30	0.00	1.16
AXA Minmentals	294.47	293.48	66.76	194.64	9.30	3.59
Allianz Dazhong	289.93	248.96	6.26	55.80	186.80	18.09
AEGON-CNOOC Life	270.32	240.31	12.06	44.32	183.93	25.13
Sun Life Everbright	256.65	195.11	20.79	4.50	169.82	3.59
Haier New York Life	235.92	235.91	3.43	204.80	0.00	5.39
ING Capital Life	227.07	217.98	51.15	131.50	35.33	3.28
China Life-CMG	219.77	212.63	5.97	85.70	120.96	2.35
Heng An Standard	219.31	217.82	217.57		0.28	0.80
Cathay Life Insurance	176.85	117.77	2.14	115.63	0.00	0.28
John Hancock Tianan	156.98	125.16	61.85	48.69	14.62	2.09

Note: AIA includes AIA Shanghai, AIA Guangzhou, AIA Shenzhen, AIA Beijing, AIA Suzhou, AIA Dongguan and AIA Jiangmen.

Source: Yearbook of China's Insurance 2006

Income						
	Group Insurance					
Health Insurance	Life Insurance				Accident Insurance	Health Insurance
	Sub-total	Common life insurance products	Participating products	Others		
3,496.00	22,476.00	1,408.00	21,068.00	0.00	1,190.00	5,328.00
11,651.49	5,307.42	1,098.07	3,930.03	279.32	856.78	1,167.45
171.93	6,978.68	5,347.45	994.02	637.21	970.44	744.81
1,781.07	3,253.52	78.90	2,702.61	0.00	146.06	325.95
23.46	19,347.08	25.53	19,321.55	0.00	2.94	12.53
755.39	1,851.63	435.67	1,415.96	0.00	225.86	532.65
227.01	766.55	19.38	745.01	2.16	92.42	495.43
824.51						
28.80	737.60	0.50	164.40	572.70	9.50	25.00
157.42	4.52	0.37	0.00	0.00	1.71	2.44
27.17	208.48	74.11	129.37	0.00	5.15	3.48
122.38	4.21	0.09	0.00	1.62	1.27	1.23
65.44	0.07	0.07			0.43	0.43
156.24	44.98	44.73	0.25	0.00	6.97	8.46
5.59	208.92	2.25	206.67	0.00	2.74	21.37
19.19	0.99	0.09			0.59	0.30
6.04	16.33	0.07		16.26	0.35	0.26
4.88						
57.27	0.02	0.02			0.19	0.47
22.29	0.01	0.00	0.00	0.00	0.00	0.00
4.63	0.08	0.08			0.92	0.19
4.55	0.00	0.00	0.00	0.00	0.17	0.07
0.00	0.00				0.11	0.35
2.86	54.09	0.18	0.00	53.91	0.75	1.10
3.86	19.48	0.05	0.00	19.43	3.57	2.82

Table 3.27 Statistics of the Businesses of 25 Personal Insurance Companies in 2005

(continue)

Companies	Claim				
	Total	Personal Insurance			
		Claim payment	Payment for death/ injury/medical care	Payment at expiration	Annuity
China Life	18,271.00	2,903.00	2,217.00	316.00	3,860.00
Ping An Life	8,750.57	998.01	950.78	3,818.15	342.69
CPIC Life	4,864.22	219.22	372.75	194.05	278.34
New China Life	577.43	93.73	126.54	4.64	57.06
Generali China Life	1,374.83	6.76	2.11	5.71	1.75
Tai Kang Life	1,327.16	135.28	135.78	116.41	195.00
Tai Ping Life	217.35	43.96	23.54	0.00	0.88
AIA	654.79	197.86	55.90	31.62	369.41
Sino Life Insurance	13.30	2.10	2.80	0.00	0.00
CITIC-Prudential	53.82	31.52	21.46	0.72	0.00
Aviva-Cofco Life	7.91	2.11	0.70	0.00	0.01
Pacific-Antai Life	94.01	9.64	18.67	0.00	65.43
Manulife-Sinochem	40.00	20.10	5.62	1.50	12.77
Minsheng Life	18.90	9.28	1.29	0.00	0.00
Union Life	0.71	0.03	0.04	0.00	0.00
AXA Minmentals	14.07	5.29	1.78		6.99
Allianz Dazhong	9.33	2.56	2.03	2.99	1.72
AEGON-CNOOC Life	2.32	1.38	0.10		0.84
Sun Life Everbright	3.78	1.67	2.01		0.10
Haier New York Life	1.14	0.85	0.29	0.00	0.00
ING Capital Life	5.32	1.47	0.92		2.81
China Life-CMG	2.47	0.13	0.98	1.36	0.00
Heng An Standard	0.41		0.41	0.00	0.00
Cathay Life Insurance	0.13	0.01	0.05	0.00	0.00
John Hancock Tianan	4.23	1.04	0.67	0.00	2.44

Payment				Withdrawal
Group Insurance				
Claim payment	Payment for death/ injury/medical care	Payment at expiration	Annuity	
4,053.00	1,017.00	3,710.00	196.00	26,892.00
1,060.21	31.46	9.78	1,539.48	6,956.10
820.68	22.67	2,850.19	106.32	6,475.05
172.88	34.15	25.47	62.96	2,790.50
1.84	0.00	0.00	1,356.65	10.92
580.62	8.98	3.97	151.12	1,408.85
124.61	1.87	5.34	17.16	497.25
				278.98
2.60	0.20	5.20	0.40	322.40
0.12	0.00	0.00	0.00	125.14
0.68	0.05	0.00	4.36	2.83
0.27	0.00	0.00	0.00	45.51
0.01				39.13
7.99	0.12	0.00	0.22	395.26
0.64	0.00	0.00	0.00	3.30
0.01				52.35
0.00	0.03			35.20
				2.50
				19.81
0.00	0.00	0.00	0.00	8.88
0.10	0.03			5.31
0.00	0.00	0.00	0.00	13.77
0.00	0.00	0.00	0.00	7.47
0.07	0.00	0.00	0.00	0.36
0.08	0.00	0.00	0.00	12.39

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