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**CHINA'S FINANCIAL SECTOR REFORMS**

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by  
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## ABSTRACT/RÉSUMÉ

### China's financial sector reforms

Reforms to modernise and strengthen the financial sector have continued in recent years. The cleaning-up of the stock of non-performing loans is largely completed and considerable progress has been made in improving commercial banks' corporate governance structures and risk management systems. These reforms have given rise to stronger Chinese banks which have so far weathered the global slowdown well. Reform of capital markets has focused on phasing out trading prohibitions on non-traded shares and modernising securities market institutions. Efforts have also been made to improve credit access to underserved segments, notably small and medium-sized enterprises and rural China. Despite progress in opening up the financial sector to international investors and in allowing domestic investors to invest abroad, liberalisation has been slow and in most market segments the foreign share remains very small. Ownership of financial institutions remains dominated by the State, raising issues concerning the financial system's ability to serve the private sector as well as the extent to which banks lending decisions are based purely on commercial considerations. Although the bond market has continued to grow, corporate bond issuance remains relatively small and this segment will need to be further developed in order to address the over-reliance on the banking system.

This Working Paper relates to the 2010 *OECD Economic Survey of China* ([www.oecd.org/eco/surveys/china](http://www.oecd.org/eco/surveys/china))

JEL classification: G00; H81

Keywords: China; liberalisation; financial sector; capital market; non-performing loans; commercial banks; risk management; non-traded shares; SMEs; international capital movements.

### Les réformes financières en Chine

Les réformes visant à moderniser et à renforcer le secteur financier ont continué dans les années récentes. L'assainissement des bilans a beaucoup avancé et on a assisté à une nette amélioration des systèmes de gouvernance et de gestion des risques dans les banques commerciales. Ces changements ont abouti à une consolidation des banques chinoises, qui jusqu'ici ont bien résisté au ralentissement mondial. La réforme des marchés de capitaux a privilégié la suppression progressive des restrictions concernant les actions non négociables et la modernisation des institutions opérant sur les marchés de titres. On a aussi pris des mesures pour faciliter l'accès au crédit des secteurs mal desservis, notamment les PME et le milieu rural. Malgré l'ouverture progressive du secteur financier aux investisseurs internationaux et l'autorisation postérieure donnée aux investisseurs nationaux d'opérer à l'étranger, la libéralisation a été lente et la part étrangère reste très réduite dans la plupart des compartiments du marché. L'État demeure le principal propriétaire des institutions financières, ce qui amène à s'interroger sur leur capacité à servir le secteur privé et sur le degré auquel les décisions de prêt des banques sont guidées par des considérations commerciales. Bien que le marché obligataire continue à se développer, l'émission de titres de sociétés est encore relativement limitée et devra s'accroître pour réduire le recours excessif au système bancaire.

Ce Document de travail a trait à l'*Étude économique de l'OCDE de la Chine, 2010* ([www.oecd.org/eco/etudes/chine](http://www.oecd.org/eco/etudes/chine)).

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Mots clés: Chine; libéralisation; secteur financier; marchés des capitaux; prêts non productifs; banques commerciales; gestion des risques; actions non-négociables; PME; mouvements de capitaux internationaux.

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## CHINA'S FINANCIAL SECTOR REFORMS

Richard Herd, Charles Pigott and Sam Hill<sup>1</sup>

### Financial reforms have accelerated and broadened since 2005

1. Much progress has been made in recent years with the key financial reforms reviewed in the previous *Economic Survey of China* in 2005. The financial health of the banking system has improved considerably and headway has been made with respect to the problem of non-traded shares. Laws on new companies, securities and investment funds have been enacted which together provide a more coherent, comprehensive and modern framework for the development of capital markets. Financial institutions have broadened the scope of their activities, housing and consumer credit have expanded rapidly and new financial instruments and facilities have been introduced. The pilot programmes to rejuvenate the rural credit system have developed into a nationwide and multifaceted reform effort. Steps have been taken to relax controls on international capital flows, and Chinese financial institutions are a growing presence in OECD and other foreign countries.

2. Despite the impressive progress, there are questions about its durability and sustainability. In recent years improvements in financial institutions' profitability and balance sheet quality have owed much to the booming economy. Moreover, while Chinese banks have so far weathered the global slowdown well, the acceleration in new lending since early 2009 raises the risk of a renewed surge in non-performing loans (NPLs) in the years ahead. Sharp increases in land prices, partly fuelled by low real interest rates and abundant liquidity, represent further risks to financial institutions. Over the longer term, financial system development is likely to be conditioned by decisions about broader economic reforms, such as pension reform. Under current policies, state ownership is likely to continue to dominate the financial system for the foreseeable future. At what pace such arrangements should evolve as the private sector expands is a major issue.

### Banking reforms are coming to fruition

3. Over the past several years considerable progress has been made to restore and modernise China's banking system. The authorities have made good use of international experience in accompanying government financial assistance with reforms to establish banks' capabilities and incentives to lend prudently in the future.

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1. Richard Herd heads the China/India Desk in the Economics Department of the OECD and Sam Hill is an economist on the Desk. Charles Pigott is a consultant. A shorter version of this paper appeared as a chapter in the *OECD Economic Survey of China* published in February 2010 on the responsibility of the Secretary-General of the OECD. Useful feedback on earlier drafts was received in Beijing from Chinese experts in the context of two seminars organised by the State Information Centre in July and October 2009, and at the OECD from Andrew Dean, Robert Ford, Yu-Wei Hu and Vincent Koen. Thomas Chalaux provided technical assistance and Nadine Dufour and Lillie Kee editorial assistance.

***Financial institutions' health has improved greatly***

4. The massive NPLs the commercial banks carried in the late 1990s have largely been cleaned up. Their NPL ratio had fallen from 17.9% at end-2003 to 1.8% by mid-2009 (Table 1). In 2008, the NPL ratio of the state-owned commercial banks (SOCBs)<sup>2</sup> fell sharply, to 2.8%, mainly reflecting the decline in NPLs for the Agricultural Bank of China, which was the last SOCB to be restructured into a shareholding company. The joint-stock commercial banks (JSBs), which began reforms earlier than the other banks, along with the city commercial banks (CCBs), have also achieved impressive reductions in NPL ratios.

**Table 1. Non-performing loans of commercial banks**

	2003	2004	2005	2006	2007	2008	2009H1
<b>Outstanding balance of non-performing loans (CNY Billion)</b>							
Commercial banks	2 230	1 847	1 314	1 254	1 268	560	519
Major commercial banks	2 104	1 718	1 220	1 170	1 201	487	444
State-owned banks	1 590	1 575	1 072	1 053	1 115	421	376
Joint stock banks	154	143	147	117	86	66	67
City commercial banks	116	119	84	65	51	48	49
Rural commercial banks	n.a.	n.a.	6	15	13	19	19
Foreign banks	n.a.	n.a.	4	4	3	6	7
<b>Non-performing loans share of total loans (%)</b>							
Commercial banks	17.4	13.1	8.6	7.1	6.2	2.4	1.8
Major commercial banks	17.9	13.2	8.9	7.5	6.7	2.4	1.7
State-owned banks	16.9	15.6	10.5	9.2	8.1	2.8	2.0
Joint stock banks	6.5	5.0	4.2	2.8	2.2	1.3	1.0
City commercial banks	15.0	14.1	7.7	4.8	3.0	2.3	1.9
Rural commercial banks	n.a.	n.a.	6.0	5.9	4.0	3.9	3.2
Foreign banks	n.a.	n.a.	1.1	0.8	0.5	0.8	1.0

Source: China Banking Regulatory Commission.

5. The fall in NPLs has been accompanied by an equally impressive improvement in bank capital adequacy. At end-2003, only eight banks (none of them SOCBs), accounting for less than 1% of banking system assets, had achieved the minimum capital adequacy ratio (CAR) of 8% mandated by the Bank for International Settlements (BIS) and since adopted by the Chinese authorities (Box 1). By end-2008, 204 banks, including all the major commercial banks, the CCBs and a significant number of rural commercial banks (RCBs), and accounting for 99.9% of total commercial banking assets, had achieved the BIS minimum (Table 2).

2. Since 2005, the official definition of the SOCBs has been changed to include China Construction Bank, which originally was included among the JSBs.

6. In response to the global financial crisis and sharp increases in bank lending the China Banking Regulatory Commission (CBRC) has recently been urging banks to increase their capital adequacy ratios further.<sup>3</sup> By mid-2009, all four of the large listed SOCBs had attained overall (tier 1 plus tier 2) CARs of at least 11%, and the weighted average core CAR of all 14 listed banks was 8.8%.

**Table 2. Progress in meeting minimum capital adequacy**

	2003	2004	2005	2006	2007	2008
Number of banks meeting minimum capital adequacy requirement <sup>1</sup>	8	30	53	100	161	204
Share of total banking system assets (per cent)	0.6	47.5	75.1	77.4	79.0	99.9

1. Figures refer to State-owned commercial banks, joint-stock commercial banks, and city commercial banks, for the end of each year.

Source: China Banking Regulatory Commission.

#### **Box 1. China's rules for calculation of capital adequacy and loan classification**

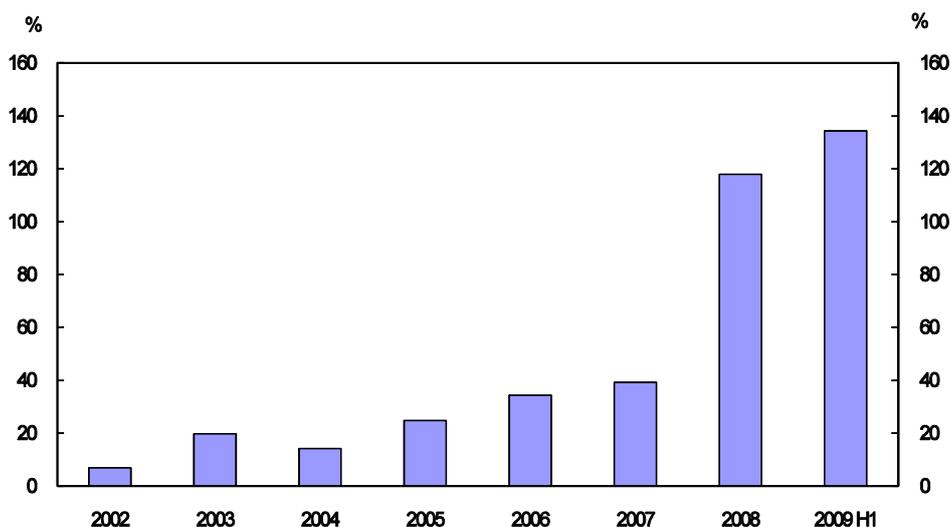
The current rules for calculation of capital adequacy of Chinese banks (CBRC, 2004), which took effect March 1, 2004, are largely consistent with the international standards set out in the Basel I accord (Kudrna, 2007). However the 20% risk weight applied to claims on domestic banks – which is the same as that adopted by most OECD countries – seems low given their past problems and still limited experience as commercial entities. The 50% risk weight for enterprises owned by the central government (loans to State-owned enterprises (SOEs) owned by local governments receive a 100% weight), while not inconsistent with Basel I, tends to reinforce Chinese banks' traditional propensity to lend to large SOEs. Claims on policy banks and bank asset management companies receive zero risk weight even though they do not carry explicit government guarantees, which is contrary to Basel I provisions.

Loan classification is a complex process: while there are some internationally accepted principles, specific standards and practices vary considerably. The five-part classification is the same as that used by other countries. Classifications are supposed to be based on forward-looking indicators of borrowers' ability to repay rather than only on past performance in meeting loan payments, as was the case under the earlier system. The largest Chinese banks' procedures for loan classification and provisioning appear to be fairly close to those of banks in Hong Kong, China (Kudrna, 2007).

The real key to effective loan classification, however, is the skill and experience of bank staff in analysing borrowers' current and prospective cash flow and the quality of their balance sheets. China's banks are relatively new to such analyses and their task is further complicated by the fact that the financial information provided by their customers, while improving, is still imperfect. While classification criteria are broadly similar to those used in OECD countries, they may understate the risks of default in China. Accordingly, loan classifications in China are likely to be less accurate for some time than would be expected in more developed financial systems. Implementation will need to be refined as experience accumulates. To this end, the CBRC and some of the major banks have been monitoring loan outcomes versus their original classification.

7. Banks have further improved their ability to deal with NPLs by increasing their provisions against loan losses. The provisioning ratio for the SOCBs and JSBs combined rose from nearly 20% at end-2003 to over 130% by mid-2009 (Figure 1). Since 2005 this increase has reflected both falling NPLs and rising loan loss provisions.

3. In July 2009 the CBRC also issued new guidelines on fixed asset loans designed to limit the amount of new lending that was flowing into stock markets (China Law and Practice, 2009b).

**Figure 1. Loan-loss provisions of major commercial banks**

Notes: Figures are expressed as a percentage of non-performing loans and are the average for the State-owned commercial banks and joint-stock banks.

Source: China Banking Regulatory Commission.

8. Improving balance sheet quality has been accompanied by a marked recovery in bank profitability (Table 3). Measured by net return on assets, profitability has risen from levels that were quite low by international standards.

**Table 3. Pre-tax profits of commercial banks**

CNY billions

	2003	2004	2005	2006	2007 <sup>2</sup>	2008 <sup>2</sup>
All commercial banks <sup>1</sup>	28.5	98.5	247.0	325.0	413.4	554.9
State-owned	-3.2	45.9	156.1	197.5	246.6	354.2
Joint-stock	14.7	17.6	28.9	43.4	56.4	84.1
City	5.4	8.7	12.1	18.1	24.8	40.8
Rural	0.1	0.8	2.9	4.1	4.3	7.3
Foreign	1.7	2.4	3.7	5.8	6.1	11.9

1. All commercial banks include State-owned commercial banks, joint-stock banks, city commercial banks, rural commercial banks, policy banks, the Postal Savings Bank, foreign commercial banks and rural and urban credit co-operatives.

2. After-tax profits.

Source: China Banking Regulatory Commission.

9. Much of the improvement in banks' financial health in recent years has been due to the booming economy. Profits have risen given the substantial spread between loan and (still controlled) deposit rates and the rapid growth in lending. The transfer of NPLs to the four bank asset management companies brought down the level of NPLs considerably.<sup>4</sup> Since 2004, the decline in NPL ratios is almost entirely due to loan growth. Indeed, in 2007, the level of NPLs rose modestly, due to a small rebound for the SOCBs.

4. The reformed SOCBs did manage to write off or otherwise resolve a modest amount of their NPLs prior to 2004, as did a number of the JSBs and CCBs, but the portion was small compared to the overall reduction.

10. Banks' better performance also reflects important improvements in their capabilities. Efforts that began in the late 1990s to close unnecessary branches and cut labour have continued and banks have invested heavily in data processing and other facilities to improve the efficiency of their operations. Operating costs in relation to income have fallen to levels that are low not only in relation to OECD countries (due in large part to their lower labour costs) but also to other large emerging market economies such as India and Korea (McKinsey Global Institute, 2006). Income from fees and other charges have been rising gradually in relation to total income to around 10% for the major banks, but this remains below average levels of other BRIC and G7 countries (Feyzioglu, 2009).

11. Ongoing reforms to improve banks' governance and internal systems are improving the prospects that they will continue to perform profitability and prudently. All the major banks along with the CCBs and many RCBs have been converted into corporate entities subject to boards of directors and supervisors. These reformed governance structures incorporate most internationally-accepted best practices and should foster banks' transition from their traditional role as government agencies toward a commercial orientation. However, their effectiveness is presently constrained by limited experience with the new structures along with vestiges of past practices and ties to the government. Chinese bank boards are required to include several independent directors, but finding qualified people to fill this role is often difficult (Taylor, 2006; Thompson, 2005). The boards typically include audit, related-party transactions, and other committees that are widely regarded internationally as critical to effective governance, but the committees not infrequently lack effective authority or capability (Taylor, 2006). Former government officials and party members continue to dominate senior management and board positions. These limitations will probably ease as experience is gained with the new governance structures and as bank managements become more professionalised.

12. Internal reforms, also based on international best practices, to banks' loan assessment and risk management systems that have been underway since the mid-1990s are maturing. The issue in 2006 by the CBRC of *Guidelines for the Corporate Governance of SOCBs*, incorporating the elements of the 2002 guidelines for governance of the JSBs, was an important further step. They contain specific benchmarks for improvement in financial ratios and internal controls along with timetables for their achievement. These include: implementation of the reformed five-part loan classification system, which all of the major banks were required to adopt by 2005; reduction (and containment) of the NPL ratio to no greater than 5%; a CAR of at least 8%; attainment of a minimum return on assets of 0.6% within two years following the completion of financial restructuring and a rate "in line with international standards" by the end of the following year. While formally applying to SOCBs, these targets are also being adopted by the other segments of the commercial banking sector. By end-2007, all of the SOCBs, JSBs, CCBs and many of the RCBs had met all or most of the targets. Also at the behest of the authorities, significant progress is being made in improving public disclosure of bank performance. All the SOCBs and JSBs, along with the majority of CCBs now publish annual reports.

13. More recently, the authorities announced a requirement that seven of the largest commercial banks, including the SOCBs, meet Basel II standards by end-2010. Beginning in late 2008 the CBRC released for public comment draft guidelines on the new standards and is aiming to finalise implementation details by end-2009. In addition to setting new standards for capital adequacy, the adoption of Basel II will require banks to meet new international benchmarks on the assessment and management of credit, market and operational risks. According to the CBRC (2009) the seven banks to which Basel II will apply are already well advanced in meeting the new standards.

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The bank asset management companies have largely completed the resolution of the NPLs acquired from the SOCBs (see Annex 3).

14. The authorities have made good use of conditionality to encourage banks to effectively implement the reforms. For example, the SOCBs that were most successful in writing off or otherwise resolving NPLs and in reforming their risk management and governance structures became the first to receive capital injections and were first-in-line for listing on the exchanges. Progress on reforms has been a criterion for allowing selected banks to expand their business lines or (in the case of some CCBs) their geographic scope.

15. The authorities have been strengthening their supervisory oversight, which is crucial to ensure that reforms are effectively implemented and to contain problems before they become too big. In 2005, the CBRC began to monitor the migration of loans among classification categories, to make comparisons of original credit assessments versus the subsequent outcomes, and to develop peer group comparisons of the banks' progress on reforms (García-Herrero *et al.*, 2006). The authorities have also instituted a ratings system for individual banks based on the CAMEL system (capital adequacy, asset quality, management effectiveness, earnings, and liquidity) widely used internationally. In recent years there has been a trend increase in the coverage of on-site examinations, although it fell sharply in 2008 to 24% (CBRC, 2009). Greater coverage is probably needed, particularly given the changes China's banks are undergoing.

***Banks are diversifying their activities but state control remains dominant***

16. The improvement in banks' performance is facilitating diversification in their products, activities and overall scope. Credits to individuals, through consumer, housing and auto loans continue to be the fastest growing segment of bank lending (Figure 2). Outstanding consumer credit reached 12.4% of China's GDP in 2008, a ratio which the experience of other emerging economies suggests is likely to continue to rise.<sup>5</sup>

17. Reported delinquency and default rates on consumer and housing loans have so far been low. However, experiences in other countries illustrate that problem housing loans can soar when real estate price booms, such as the one China has been experiencing in major cities over the past several years, give way to contraction. Moreover, Chinese banks already had problems with automobile loans: delinquent auto loans rose to nearly CNY 100 billion (\$ 14.7 billion) by 2006, the bulk of which were held by the SOCBs, leading the CBRC to mandate tighter standards on auto loans in 2006 and again in early 2008, amid signs of renewed excesses. As the participation of households in the financial system increases through greater access to loans, as well as exposure to a broader range of investment opportunities, efforts to promote sound lending principles would be complemented by initiatives to improve financial literacy. Experience in OECD countries suggests that improving households' understanding of the risks associated with borrowing can be an effective strategy in reducing the incidence of over borrowing (OECD, 2005a).

18. The authorities are gradually allowing banks as well as non-bank financial institutions to expand outside their traditional activities. Beginning in 2005, selected banks were authorised to establish fund management companies and in early 2008 the authorities announced a pilot programme to allow banks to invest in insurance companies.<sup>6</sup> In a move designed to enhance household access to small loans the CBRC announced a pilot programme in 2009 to allow the establishment of non-bank consumer finance companies in four cities. Normally loans provided under this system would be capped at CNY 100 000 (\$ 14 700) and were designed to facilitate the purchase of consumer durables. These moves toward an eventual "universal banking" model now typical in other countries are necessary to allow banks and other financial institutions

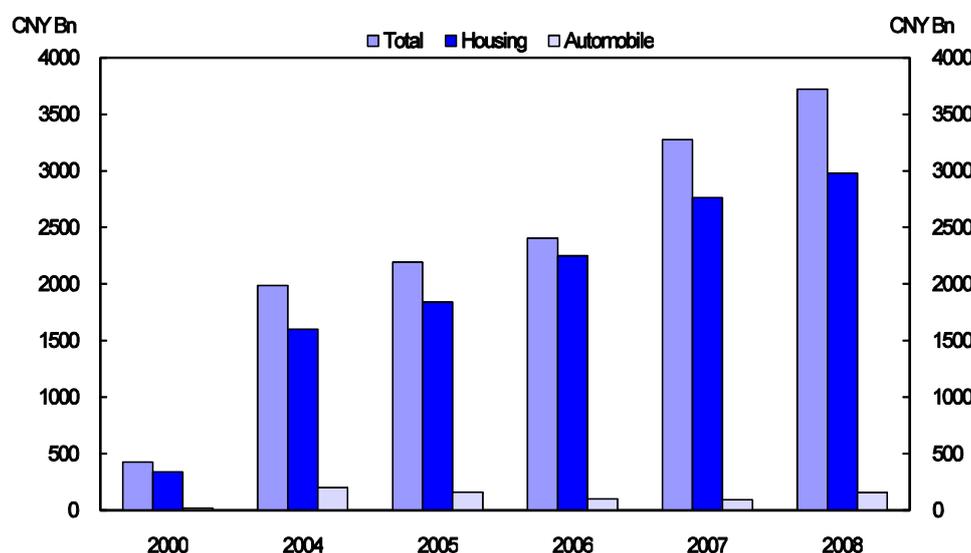
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5. For example, consumer loans are 18% of total loans in India and nearly 50% in Malaysia (McKinsey Global Institute, 2006).

6. "Banks Dip into Insurance Market", *China Daily*, 12 January 2008. Insurance companies were authorised to invest in listed banks in 2004 and in unlisted banks in 2006. By end-2008 banks had established eight fund management companies offering 46 different products (CBRC, 2008).

to diversify their products and income sources, and for the development of the capital markets. The authorities have conditioned permission for individual banks to engage in these new activities on their progress in improving their balance sheets and reforming their governance and internal systems.

Figure 2. Consumer loans outstanding



Source: People's Bank of China.

19. While banks are in much healthier condition, there has been limited change in the concentration of the banking sector and even less in the dominance of state ownership. The market share (of total assets) of the SOCBs continues to decline gradually, by about 1-1.5% per year, but remains above half of the total (Figure 3).<sup>7</sup> Shares of the JSBs and CCBs have risen modestly but are still relatively small.

20. The creation of the Postal Savings Bank in 2006, along with the conversion of the Agricultural Bank of China and China Development Bank into commercial banks in 2008, is intended, in part, to help improve financing for the rural economy. Their entry, however, also tends to reinforce the dominance of large state-owned banks with traditionally strong ties to the central government.

21. Domestic as well as foreign private capital investment in Chinese banks has increased markedly. However, central and local governments retain the controlling interests in nearly all cases. Despite much earlier speculation about the creation of new private banks, there have been only a few, quite small, new entrants since China's accession to the World Trade Organisation (WTO) in 2001.<sup>8</sup> Private investors and companies have gained significant ownership shares in some CCBs, in some cases sufficient to allow them to influence management decisions. However, early on this was followed by some abuses, witness the rise and fall of D'Long Investments, which used loans from banks it partially owned to fund its own

7. The share of the four largest banks making up the SOCBs under the earlier definitions did drop below 50 % in 2007 for the first time since their formation.

8. On the eve of China's WTO entry, there was much discussion that up to 12 new regional private banks would be authorised, but the decision was repeatedly postponed. In 2004, Zhejiang Commercial Bank, a joint-venture created in the 1990s between Bank of China and Nanyang Commercial Bank of Hong Kong, was restructured into Zheshang bank with dominant private ownership (13 of 15 of its original shareholders were non-bank companies in Zhejiang province). While this was widely viewed as the advent of more private banks, the expectations were not fulfilled.

speculative activities (Hirson, 2005). This has led the CBRC and other authorities to closely monitor investments by non-financial companies in the banking sector.

22. Institution of a formal deposit insurance system, which has been under consideration for some time, is key. A well designed deposit insurance scheme would bolster financial system stability and signal to the market that the government will not bail out (most) banks in the future and so reduce the moral hazard inherent in the present system (Box 2). It would also help level the competitive playing field between the SOCBs and the smaller banks. Their close ties to the central government and essential role in the payments system gives the SOCBs an implicit deposit guarantee that is not enjoyed by smaller banks (at least not with nearly the same degree of certainty).

### **Box 2. Designing efficient deposit insurance schemes**

The central aim of deposit insurance is to protect depositors against bank insolvency and thereby bolster confidence in banks and prevent bank runs. Designing such schemes in a way that protects depositors while limiting the moral hazard that explicit guarantees on investments might induce is critical to ensuring their overall effectiveness. There are no generally agreed standards for designing deposit insurance systems and tailoring to individual country circumstances is important. In practice, the parameters of such schemes vary considerably across countries (Table 4). Nevertheless, a number of principles can help guide implementation (Schich, 2008).

It is important to set an appropriate limit on the level of coverage. Higher levels of coverage will tend to increase moral hazard while unduly low coverage will undermine the usefulness of deposit insurance. In many countries the response to this trade-off has been to establish limits which ensure that the vast majority of small depositors, who are likely to lack the resources to assess bank soundness, are protected while leaving large institutional investors exposed to market discipline. Setting clear and appropriate limits on coverage will also help limit implicit guarantees of state support. The experience during the recent financial crisis has highlighted how concerns about systemic failures, state ownership or political pressure can force governments into providing support beyond the explicit boundaries set by a deposit insurance scheme which is likely to increase moral hazard in the longer run (OECD, 2009).

A deposit insurance scheme can either be funded, by way of periodic contributions, or unfunded. Again, trade-offs exist between these two options. A fully-funded scheme is likely to give rise to opportunity costs as the proceeds from premiums will need to be allocated to low-yielding, liquid investments. Equally, an unfunded system may exacerbate liquidity problems, particularly in the event of multiple bank failures. Whatever the funding arrangement, it is vital that funds are available when needed. A related question concerns membership. Most deposit insurance schemes are operated by the government or are a mix of government and private sector and often participation is compulsory, thereby ensuring that all depositors have protection and adverse selection amongst deposit-taking institutions is avoided.

Finally, deposit insurance schemes represent just one element of the overall regulatory framework and their effectiveness will depend on the extent to which they can complement other institutional arrangements. In this respect promoting good governance in the banking sector and ensuring a sound regulatory and supervisory framework promotes financial stability and reinforces the effectiveness of deposit insurance by minimising moral hazard. Also, to the extent that different institutions are entrusted with different responsibilities in the event of a financial crisis a clear demarcation of responsibilities and details of procedures *ex-ante*, including how and when a deposit insurance scheme will pay out can help to reduce uncertainty.

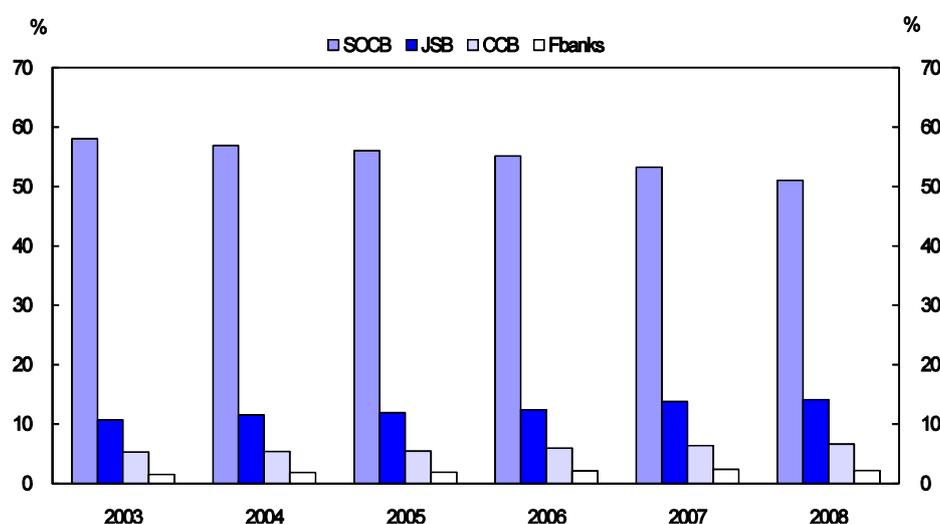
Table 4. Deposit insurance in selected countries: main features

	Coverage to GDP per capita ratio			Coverage to deposits per capita ratio	Co-insurance percentage	Per cent of deposits covered	Payment per depositor = 1 per deposit = 0	Funded = 1	Funding private = 0 public and private = 1	Administration Official = 1 Joint = 2 Private = 3	Annual premiums	
	December 2008	January 2008	2003	2003	2003	2003	2003	2003	2003	2003	Risk-based	Flat rate
Australia	∞											
Austria	∞	0.6	0.7	0.8	10		0	0	1	3		pro rata, <i>ex post</i>
Belgium	3.2	0.6	0.8	0.8	10		0	1	1	2		0.06%
Canada	2.2	2.2	1.6	2.5	0	34	0	1	1	1		0.33% maximum
Czech Republic	0.1	0.1		5.1	10	86	1	1	1	1		0.10%
Denmark	∞	0.9	1.2	2.3	0	45	1	1	1	2		0.20%
Finland	1.4	0.7	0.9	1.9	0	40	1	1	1	3	1	0.05% to 0.3%
France	2.2	2.2	2.7	3.9	0		1	0	0	3		on demand
Germany	∞	0.7	0.8	0.8	10		1	1	0	3		0.03% to 0.06%
Greece	4.6	0.9	1.4	1.7	0		1	1	0	2		0.025% (minimum)
Hong Kong, China	∞	0.4	0.0									
Hungary	4.9	2.3	1.6	4.0	0	87	1	1	1	2	1	0.30% maximum
Iceland	∞	0.4	0.7	1.5	0		1	1	0	1		0.15%
Ireland	∞	0.5	0.6	0.7	10		1	1	0	1		0.20%
Italy	3.9	3.9	4.6	8.6	0	62	1	0	1	2	1	<i>ex post</i> 0.4% to 0.8%
Japan	2.5	2.5	2.5	2.1	0	88	1	1	1	2		0.0408%
Korea	2.4	2.4	3.3	4.5	0	81	1	1	1	1		0.05%
Luxembourg	1.3	0.3	0.4	0.1	10		1	0	0	3		<i>ex post</i>
Mexico	3.5	3.5	489.1	1 955.0	0	81	1	1	1	1		minimum 0.4%
Netherlands	2.8	1.1	0.7	0.7	0		1	0	1	1		<i>ex post</i>
New Zealand	23.3	0.0	0.0									
Norway	3.8	3.8	5.8		0	76	1	1	1	3		0.015% of deposits
Poland	1.5	0.7	5.0	13.6	10		1	1	1	1		0.40% maximum
Portugal	6.4	1.6	1.9	2.1	0	53	1	1	1	1	1	0.1% to 0.2%
Russia	2.4	1.4	1.1	5.2	50	85	1					0.05%
Singapore	0.4	0.4	0.0									
Slovak Republic	0.0	0.1	4.3	7.4	10	47	1	1	1	2		0.1% to 0.3%
Spain	4.2	0.8	1.1	1.3	0	60	1	1	1	2		0.20%
Sweden	1.5	0.7	0.9		0	57	1	1	1	1	1	0.50%
Switzerland	1.4	0.4	0.5	0.4	0		1	0	0	3		on demand
Turkey	3.8	3.8	∞		0	100	0	1	1	1	1	1.0% to 1.2%
United Kingdom	2.2	1.5	1.9		10		1	0	0	3		on demand
United States	5.4	2.1	2.7	8.4	0	65/60	0	1	1	1	1	0% to 0.27%

Source: Schich (2008). World Bank Deposit Insurance Database.

23. Foreign banks' overall market share is low and had been growing only slowly prior to the onset of the global financial crisis. In 2008 this share fell slightly and it may fall further as foreign banks continue to offload assets to improve liquidity. Foreign banks have established a much greater presence in high-value and rapidly growing segments, such as investment banking, derivatives, and mergers and acquisitions. Their local-currency lending and other activities have expanded since China completed its fulfilment of its WTO commitments at end-2006 and a number of large multinational banks are developing retail banking services. Some have been highly profitable while others are making little or no profits. A survey by PricewaterhouseCoopers (2009a) paints a mixed picture for their near-term outlook. While foreign bank managers expect continued growth in the Chinese market, doubts were expressed as to the ability of foreign banks to increase their market share given the growing competitiveness of domestic banks.

Figure 3. Bank market shares



Note: Figures refer to share of total banking assets. SOCB- State-owned commercial banks; JSB- joint-stock commercial banks; CCB- city commercial banks and co-operatives; Fbanks- foreign banks. Total banking assets include assets of trusts and commercial finance and leasing companies.

Source: China Banking Regulatory Commission.

24. Foreign banks and other foreign investors have also established a significant presence as strategic investors in Chinese banks. By mid-2006, all four reformed SOCBs, eight of the JSBs, and 11 CCBs had foreign strategic investors. Foreign investments remain limited to no more than 20% of total equity for a single investor and 25% for all foreign investors combined (see Annex 1).<sup>9</sup> In most cases, however, the major foreign investors in a Chinese bank typically appoint one or two directors and do not take a management role, although they do provide much-needed technical support and training.

25. Overall, China's opening to foreign banks has had neither the adverse effects on the domestic banks that many observers feared nor the benefits that many hoped for. International experience suggests that foreign banks can bring substantial positive benefits to domestic banking systems through transfers of technology and expertise and increased competition (Leigh and Podepeira, 2006). Recent studies suggest

9. Foreign investors gained operational control of two JSBs: Shenzhen Development Bank in 2006 and earlier Guangdong Development Bank, although they continue to be limited to the regulatory ceilings on ownership shares. ("Citigroup Expected to Take Control of Guangdong Development Bank", *International Herald Tribune*, November 15, 2006).

that foreign strategic investments have brought benefits to Chinese banks (Garcia-Herrero and Santábarbara, 2008; Berger *et al.*, 2009). For China to reap greater benefits from foreign participation, foreign banks' presence is likely to have to rise considerably further; they will need greater scope to acquire controlling interests in now state-owned banks, and political influence over bank lending decisions will need to recede.

### ***Further improvements are still required***

26. Evidence as to whether and how reforms are remedying the traditional weaknesses of China's banks is so far limited. While most individual banks are becoming more efficient in their operations, the efficiency of the system as a whole is limited by its dominance by the SOCBs, which tend to lag behind the smaller commercial banks (Shen *et al.*, 2009 and Feyzioglu, 2009). The superior efficiency of the JSBs and many of the CCBs owes much to their greater exposure to market forces in the past. This suggests that more rapid growth in the share of these smaller banks would speed up the improvement in efficiency for the system as a whole.

27. A key question is the degree to which banks are now allocating credit according to strict commercial criteria. A study of Chinese bank lending covering most of the period during which reforms have occurred (1997-2004) concluded that "the pricing of credit risk remains undifferentiated and banks do not appear to take enterprise profitability into account when making lending decisions" (Podipiera, 2006). The traditional bias of banks, particularly the major ones, toward lending to larger SOEs seems to endure. Indeed, a case study based on interviews with SOCB bank managers suggested that giving SOEs greater priority in lending decisions was something ingrained and difficult to change (Yeung, 2009). Provinces in which SOEs account for a larger portion of total output also tend to have higher ratios of bank loans in relation to output (Dobson and Kashyap, 2006).<sup>10</sup> The proliferation of credits for local infrastructure projects effectively backed by local governments during 2004-06, which led the central government to outlaw the guarantees in April 2006, is another indication of continued government influence over bank lending decisions (Dobson and Kashyap, 2006). Indeed, the Chairman of the Board of one of the SOCBs complained of continued government interference in lending decisions.<sup>11</sup> Further evidence is provided by empirical studies reporting that even partial privatisation exerted a positive influence on access to bank lending for private firms (Firth *et al.*, 2009) and that a higher share of bank board directors appointed by SOEs was associated with a higher NPL ratio (Ferri, 2009).

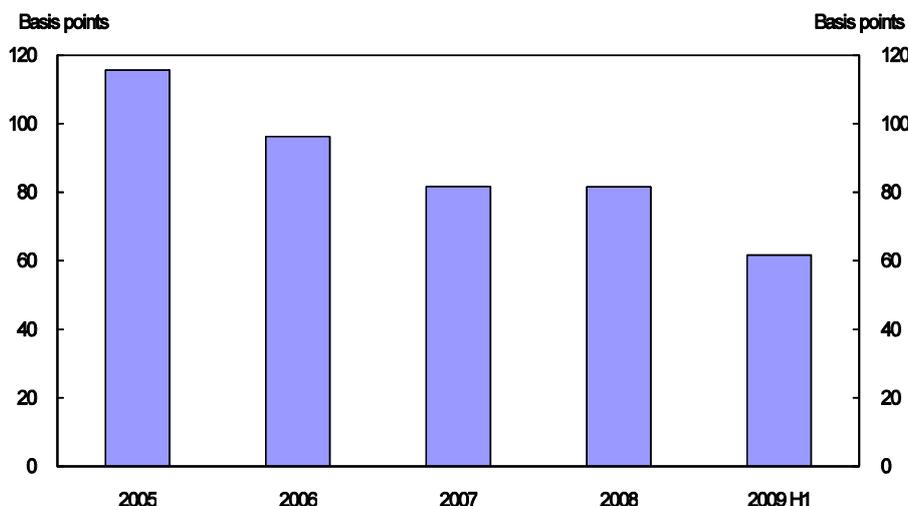
28. Banks initially made little use of the allowed range for their lending rates when interest rate liberalisation first began, with most loans being made at the benchmark rate or slightly below. Since then the dispersion of lending rates measured as the margin between the average bank lending rate and the benchmark rate has gradually decreased (Figure 4). On average the bank lending margin was a mere 63 basis points above the bank regulated lending rate in the first half of 2009 and only 12.9% of loans were for more than 159 basis points over the recommended rate in June 2009. It would appear either that risk is markedly less in China, or that banks prefer not to take risks and ration credit to their smaller clients. Such a practice may be linked to reports that personnel policies make loan officers responsible for loans over their lifetime, without regard to risk-adjusted return on their lending portfolios.

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10. Dobson and Kashyap (2006) also report interviews with officials of one of the SOCBs indicating that five of its 10 largest loans in 2005 went to large enterprises whose ratings on the bank's internal credit worthiness scale were only 5 out of a possible 10. They also cite the increasing concentration of bank lending to key government priority sectors, notably housing, infrastructure, and telecommunications as evidence of continued influence of government mandates in lending decisions, although this pattern could also simply reflect shifting loan demand.

11. "Chinese Government Interference Remains a Problem for the Nation's Banks, China Construction Bank (CCB) Chairman Guo Shuqing Said", Xinhua Financial Network, 29 June 2006.

Figure 4. Bank loan interest rate margins



Note: Figures refer to the spread between the weighted average interest rate on bank loans and the benchmark interest rate. Figure for 2009 based on data up to June.

Source: People's Bank of China and OECD estimates.

### Capital market development is accelerating on a firmer foundation

29. Significant progress has also been made since 2005 in strengthening the legal and institutional foundation of the capital markets and in removing major obstacles to their development (see Annex 2). A major achievement has been the completion of a modernised legal framework based on the *Guidelines on Promoting Reform, Opening Up and Steady Developments of the Capital Market* issued by the State Council in 2004. The much-awaited amended Company Law and Securities Law, which took effect in 2006, together with the Securities Investment Funds Law, which took effect in 2004, provide a comprehensive framework for the capital markets, supporting institutions, and institutional investors that previously had been scattered across many, sometimes incomplete or contradictory, laws and regulations adopted over a long period of time. Their effectiveness will be further bolstered by the implementation of the reformed bankruptcy law that became effective in June 2007 and by the amended *Law on Insurance*, that became effective in October 2009.

30. The two amended laws along with subsequent regulations and other decrees issued by the main capital market regulatory bodies define more specifically the conditions for listing and initial offerings (IPOs) on the stock exchanges; the scope and terms of entry for securities companies as well as accounting and other supporting institutions; and rules and regulations governing investment funds. The laws also codify and clarify the governance structures for companies generally and for listed companies along with the powers and responsibilities of senior management and the boards of directors and supervisors and their key committees. Far more emphasis is now put on improving disclosure of company conditions, combating insider abuses, and protecting the rights of minority shareholders.

31. The new laws go a long way toward bringing China's capital market framework in line with international practices. They have provided essential support for the non-traded share reform and restructuring of the securities industry discussed further below as well as for the development of new products and the gradual integration of the domestic capital markets with international markets. They further clarified responsibilities for the oversight of the capital markets, although it is still more divided among the major regulatory bodies than is usually the case in more advanced economies (CSRC, 2008b).

*The non-traded share reform was a breakthrough toward a more mature stock market...*

32. The plan announced in April 2005 for a phased ending of the prohibition of trading on the exchanges of state-owned and legal-person shares (Box 3) represented a major breakthrough in China's stock market development. By end-2007, 98% of listed companies had completed the reforms. In contrast to earlier reform efforts, the market reaction was positive.

33. Notable progress has also been made toward the goal enunciated in the 11<sup>th</sup> Five Year Plan of developing "multi-level" stock markets to serve a wider variety of needs. After a slow beginning following its inception in mid-2004, listings on the second, small-and-medium-sized company board of the Shenzhen stock exchange have proliferated, reaching 273 by mid-2009. A third board, ChiNext, focusing on smaller high-growth/technology companies and also based in Shenzhen, was launched in October 2009, with an initial listing of 28 firms. These boards mark an important first step toward expanding potential access of private companies to the capital markets. New market indices are also continuing to be developed and in August 2009 three indices comprising privately-owned enterprises were launched. Development of an over-the-counter market for equities trading, which could give access to a greater number and broader range of companies, would be an important further step.

34. Incremental steps have also been taken toward the development of markets for derivative instruments that will become increasingly important for effective risk management by institutional and other investors. While the value of derivatives trading has grown rapidly the range of products allowed remains relatively small and most activity is focussed on commodities futures. Delays in the opening of the China Financial Futures Exchange, which was established in 2006, and recent comments by regulatory officials suggest that further liberalisation in this area will continue to be slow.<sup>12</sup>

**Box 3. Reform of the non-traded shares**

The prohibition of stock market trading of state-owned and legal-person shares (together known as "non-traded shares"), which jointly constitute nearly two-thirds of the equity of listed companies, has been a long-standing and major obstacle to development of the stock markets. The authorities have long recognised the importance of making all shares tradable to market development and ownership reform of SOEs, as well as the utility of being able to sell state shares to help finance the fledgling pension system. Legal-person shares have been transferable on off-exchange facilities for some time and their sale has resulted in the privatisation of some listed companies that were state owned when initially listed (Green, 2003). However limited steps toward making state shares tradable in 1999 and 2001 were aborted following adverse market reactions and outcries from individual stockholders worried that sales of state shares would severely depress prices.

The latest reform has succeeded by making provision for compensation by holders of non-traded shares to owners of the tradable shares for the potential loss from the expected drop in the share price. Under the plan, owners of the state shares in a listed company were required to formulate a plan for conversion, including compensation, and obtain the approval of holders of at least two-thirds of the tradable shares (Inoue, 2005; Beltratti and Bortolotti, 2006). Most of the compensation has been made through transfers of state shares, although warrant issues and cash payments have also been used. To spread out the impact on market prices, the plan specified a "lockup" period prohibiting the market sale of converted shares for one year following the completion of a company's share reform, with the largest holders prohibited from selling for up to two further years. The authorities also took measures to forestall the near-term adverse market reaction that had attended prior share reforms by suspending new public offerings for one year.

12. See for example CSRC Chairman Shang Fulin, 2 June 2009 (<http://www.csrc.gov.cn/n575458/n4001948/n4002030/11347192.html>).

*...but more time and further steps will be needed to realise the full benefits*

35. The share reform, together with the earlier reforms to the listing approval process (OECD, 2005b), are essential steps toward the development of a more mature and representative stock market. However their effects will take some time to be manifest and more will need to be done to ensure that their potential is realised. Because of the “lockup” period imposed on trading of major blocks of converted shares, only a small proportion of state shares have become tradable in the past couple of years. However, this process is expected to accelerate and to be completed in 2012 (Ahn and Cogman, 2007).

36. Improvement of the quality of listed companies has become a key policy objective but more priority needs to be given to achieving greater diversity in terms of their regional and industrial distribution, size and especially ownership. Progress toward both goals is constrained by the pace of new IPOs. Due largely to the temporary suspension of IPOs imposed in mid-2005 to support the market in the wake of the non-traded share reform, very few new companies entered the market around that time although new listings have accelerated sharply since, with 183 companies entering the exchange between 2006 and 2008 (Table 5). This expansion covers both A-shares, which are of companies incorporated in mainland China and which can only be bought and sold by mainland Chinese and approved foreign investors, as well as H-shares, which are of companies incorporated in mainland China and traded on the Hong Kong and other international exchanges.

**Table 5. Stock market profile**

Number of listed companies	2000	2005	2006	2007	2008	2009H1
Total domestic (A- and B-share)	1 086	1 378	1 421	1 530	1 604	1 603
B-share listings	113	109	109	109	109	109
H-share listings	52	122	143	148	153	153
Listings on Shanghai Exchange	572	834	842	860	864	864
Listings on Shenzhen Exchange	514	544	579	670	740	739
Shanghai Stock Exchange :						
Total market capitalisation (CNY billion)	2 693	2 310	7 161	26 984	9 725	15 911
Tradable share market capitalisation (CNY billion)	848	675	1 643	6 453	3 231	6 524
Tradable share market capitalisation (% GDP)	8.5	3.7	7.8	25.1	10.7	21.1

Source: China Securities Regulatory Commission, Shanghai Stock Exchange.

37. The new IPOs have been dominated by state-owned companies in the financial sector (including the SOCBs that earlier listed in Hong Kong) and in the utilities and infrastructure sectors. A considerable backlog of companies have been approved but not yet listed.<sup>13</sup> However, the authorities continue to control the timing of the IPOs by approved companies, as well as the total amount that can be issued, and have tended to slow the pace of new listings when the market weakens. Moving in the near-term to a system that grants approved companies the right to decide when to carry out their IPO, similar to the registration system used in major foreign stock markets, would speed up improvement in the quality and diversity of listed companies.

38. The share reforms and the opening up of the IPO process, along with the development of the institutional investor base discussed below, should help to ameliorate long-standing weaknesses in the Chinese equity markets. Transactions fees are high, even compared to other emerging Asian markets such as Korea and India, and liquidity comparatively low (CSRC, 2008b). The Chinese markets have undergone

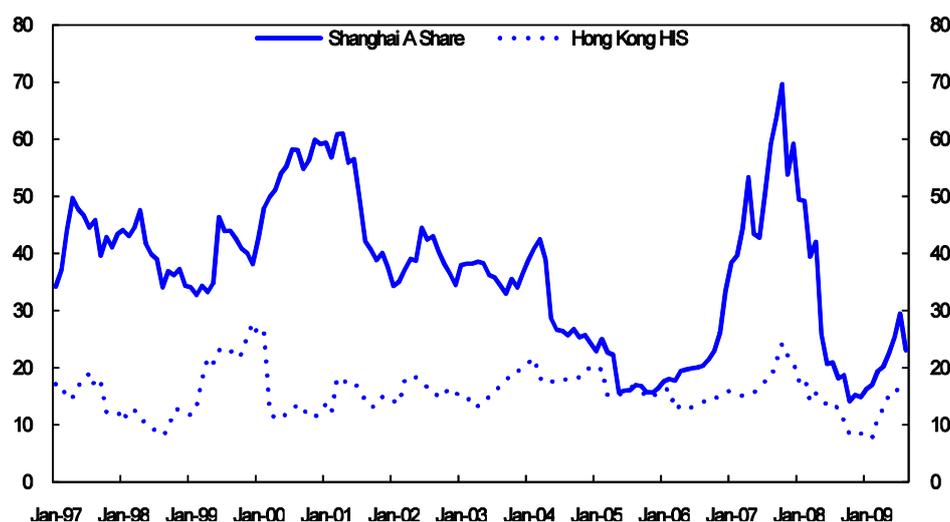
13. “China Has IPO Backlog up to 400 Companies, CITIC Says”, *Bloomberg*, 16 May 2009.

wide swings which have brought prices to levels that, in retrospect, were unsustainably high. There is evidence that individual share prices often poorly reflect company fundamentals (e.g. Mei, 2004; Feng, 2006). In particular, A-shares of companies listed on both the domestic and Hong Kong exchanges have generally traded at a noticeable premium over their H-share counterparts.

39. The near-doubling of the market index between early 2007 and the Fall of that year, when the average price-earnings ratio on the Shanghai A-share exchange reached nearly 70, suggests that the market remains susceptible to excessive speculation – especially in view of the sharp contraction in prices that has occurred since then (Figure 5). Macroeconomic conditions, notably abundant liquidity and low (and declining) real interest rates, probably encouraged the surge in prices.

40. The authorities have attempted to counter market swings through variations in the stamp tax on transactions and, more recently, by exhortations to securities firms to hold on to their shares as prices fell.<sup>14</sup> However, these and other official actions to influence the market are likely to have undesirable side effects, such as encouraging participants to underestimate the true risks of stock investments by encouraging a belief that the authorities will stabilise prices.

Figure 5. Price-earnings ratios



Source: CEIC.

41. Market discipline of listed companies has been limited by the predominance of SOEs with still close ties and backing from the government (especially local governments) and by the inability of outside investors to acquire controlling interests of companies due to the ban on sales of state shares. Whether the reforms will be sufficient to establish a genuine market for corporate control remains unclear since it will depend on the willingness of controlling state shareholders to sell their stakes to outside investors.

14. Authorities raised the stamp tax in the Spring of 2007 in order to restrain the surge in prices and then raised it in April 2008 in an attempt to stem the contraction. Conditions for selling large blocks of shares were tightened at the same time (*International Herald Tribune*, 24 April 2008). Prices initially surged by nearly 9% in the wake of the move before falling back.

***Bond market development is progressing but the corporate segment remains limited***

42. China's bond markets have continued to mature over the past three years, with total outstanding issues reaching around 45% of GDP by mid-2009 (Table 6). In overall size, the market compares favourably with those of other major emerging economies although it remains much more dominated by bonds issued by the central government and central bank. Central bank bonds, issued to absorb the expansion in bank reserves from the balance of payments surplus, have been the most rapidly growing component and are now around 25% of the total bond stock. Commercial banks remain the dominant bond holders while other institutional investors are less important than in OECD or some other emerging market economies. While shorter maturities – under three years – remain predominant, maturities of 10 years or longer are increasing in importance.<sup>15</sup>

**Table 6. Outstanding bonds by type**

August 2009

	Value (CNY Billion)	Share of GDP (per cent)
Treasury bonds	5 222	16.1
Central bank bonds	4 008	12.4
Policy bank bonds	3 953	12.2
Corporate bonds	352	1.1
Commercial paper	891	2.7
<b>Total</b>	<b>14 427</b>	<b>44.5</b>

Source: Chinabond, OECD estimates of shares and People's Bank of China.

43. There have been significant improvements in the inter-bank bond market, which accounts for more than 95% of secondary market trading.<sup>16</sup> The number and range of institutions participating in the market continues to expand and now includes most domestic financial institutions as well as foreign banks. Facilities for settlement of transactions continue to improve, with a growing portion of transactions carried out on a delivery-versus-value basis. Nevertheless, removal of the prohibition on bank trading of bonds on the stock exchange, which should no longer be needed, would help to improve the integration and overall efficiency of the market.

44. In June 2007, the CBRC adopted the China bond yield curve calculated by the China Government Securities Trust and Depository Company, the main bond custodian, as a reference for measuring market risk for banks. This should help to provide a long-needed benchmark to facilitate pricing of bonds of different maturities.

45. The variety of fixed-income instruments and related products is also expanding. Outright (uncollateralised) bond repurchases were authorised in 2004 and the market has grown rapidly. The introduction of interest rate swaps and futures has improved capabilities for hedging market risks on bonds.

15. Issues of bonds with maturities of 10 or more years rose sharply in 2007, to account for 28% of total new issues.

16. Bonds are also traded on the stock market, where banks are excluded from participating, and which mainly serves individuals, and in the bank over-the-counter market. However these accounted in 2007 for only 2.7% and 0.3% respectively of bond trading. Turnover on the interbank bond market is still relatively low in relation to outstanding issues compared to the stock exchange.

46. The inception in 2005 of a pilot programme for issue of asset-backed securities was a step toward development of more liquid debt instruments and the more flexible allocation of risks. The first asset-backed security was issued end-2005 by China Development Bank, followed by an issue of mortgage-backed securities by China Construction Bank. Initial regulations requiring government approval for each issue and effectively barring institutional investors from purchasing the securities meant that the market began slowly (Thurston, 2007).

47. The corporate segment remains the least developed bond market segment in China. It is much smaller than the others or than corporate bond markets in other Asian emerging economies. As discussed in OECD (2005b), the corporate bond market has been hampered by fragmented regulation, the imposition of industrial policy criteria for primary issue, restrictions on the interest rates on primary issues, and regulators' very limited tolerance of default risk.<sup>17</sup> Until recently, corporate issuers were required to obtain bank guarantees on their bank obligations. Not surprisingly, given these limitations, bond issuers have been largely limited to large SOEs.

48. The authorities have long acknowledged the importance of corporate bond market development to diminish the concentration of credit risk on the banking system and provide instruments needed by insurance companies and pension funds. The decision in August 2007 to transfer authority over bond market issues by listed companies to the CSRC represents an important step in this direction. The CSRC has indicated that industrial policy criteria previously applied to issues by listed companies will be dropped and that bank guarantees on the bonds will no longer be required.<sup>18</sup> However, a complete set of rules necessary for bond issuance was delayed by some months and, partly as a result, very few corporate issues had occurred by mid-2008.<sup>19</sup> The development of the corporate bond market was again stymied when authorities halted approvals for all new issuances between September 2008 and June 2009 (China Economic Quarterly, 2009).

49. Considerable progress will be required before the development of a mature corporate bond market is assured. Bond issues by unlisted companies remain subject to the approval of the National Development and Reform Commission (NDRC). The NDRC will need to considerably relax its procedures and harmonise them with those applied by the CSRC if the market is to develop fully, and particularly if smaller and medium-sized corporations, whose needs are particularly great, are to gain access. Consideration could also be given to allowing commercial banks to trade bonds on the stock exchanges, since the improvement in their governance, internal systems, and regulatory oversight makes the traditional prohibition increasingly unnecessary. This would further encourage the development of the corporate bond market by improving the integration of the exchange and interbank secondary markets.

50. Further development of supporting institutions and market practices will also be needed (China Economic Quarterly, 2009). Credit rating agencies are critical to ensure that bond risks are adequately known and priced but their development has been stunted by the requirement of a bank guarantee. Domestic credit rating agencies have been overly dependent on the companies they rate, compromising the

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17. Until the second half of 2007, the National Development and Reform Commission was the authority for approval for primary bond issues. However regulation of the secondary markets was (and continues to be) divided between the People's Bank of China (for the inter-bank market) and the CSRC and the two exchanges for the stock exchange component.

18. The CBRC subsequently issued rules banning commercial bank guarantees for corporate bonds.

19. "Yuan Bonds Won't Help Developers Much - Fitch", *Reuters*, 28 May 2008. The previous month, the PBoC extended the permitted maturity on commercial paper issues, which trade on the interbank market, to five years in an effort to broaden medium-term funding sources for enterprises.

credibility of their judgements. Bond underwriters have had limited incentives to disclose information to the markets because they are not required to make a market in the securities they underwrite. Relaxation on the participation of foreign credit rating agencies, which are presently barred in most cases from rating domestic firms, could help considerably in upgrading the quality of the industry.

***The securities industry has been restructured but remains largely state-owned***

51. The underpinning for capital market development will be further strengthened by the extensive reforms of the securities firm industry undertaken since 2004. They were intended to recapitalise and restructure the industry, which fell into severe financial stress during the 2001-05 stock market decline,<sup>20</sup> while addressing the main weaknesses that led to its problems. Securities companies had traditionally been confined to a narrow range of products, primarily based on cash trading, which left them heavily exposed to market fluctuations. Chronic weaknesses in governance of the firms, nearly all of which were originally state-owned and which continued to be effectively controlled by government entities even after being converted into corporations, were a major factor behind the problems. Inadequate governance led to poor management and periodic abuses that undermined investor confidence in the firms.

52. Reform of the industry entered a decisive phase following the transfer of authority over securities companies to the CSRC in 2004. The objectives, specified in the *Guidelines on Consolidation of Securities Firms* issued in July 2005, were to reduce the number of companies by weeding out unviable firms; to recapitalise viable firms, through government injections of capital and subsequent listing; to create stronger entities through restructuring, mergers and acquisitions; and to strengthen governance and tighten regulation to prevent future problems. The authorities also began to widen the range of securities companies' products, services and funding sources. Strong conditionality has been used to provide incentives for firms to pursue the reforms. Opportunities to enter new lines of business were given first to the group of most viable firms originally subjected to more stringent conditions than the others, but was made conditional on their progress in completing reforms.

53. The reforms were completed by end-2007. China's securities firms now are much stronger financially, although some further consolidation along with more diversification of their revenue sources is likely to be needed (CSRC, 2008b).

54. The securities companies are now operating under more stringent prudential rules specified by the *Risk Control Law* and *Rules for Net Capital* imposed by the CSRC effective November 2006. The new rules specify minimum capital ratios for each major business line<sup>21</sup> and consolidate and update risk management rules that had been scattered among a number of previous regulations. Investor confidence has been further underpinned by the creation of the China Securities Investor Protection Fund, created in September 2005 to compensate clients of securities firms for losses in case of firm failure or major malfeasance.

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20. Securities firms have undergone a number of boom-bust cycles during the reform era, with rapid expansion during stock market booms giving way to declining profits and rising financial strains during contractions. The most recent contraction phase began with the advent of the bear market in 2001, which led to a sharp fall in profits. By 2003, more than two-thirds of the industry – 98 of 131 firms – reported losses.

21. The separate capital ratios by business lines reflects the shift in regulatory approach instituted by the amended Securities Law, which abolished the previous separation of securities firms into full or limited service in favour of regulation by major lines of business.

55. Further strengthening of the reforms and experience with the changes will be required before their effects on performance are fully manifest. The authorities have instituted a ratings system for the securities companies to encourage strengthening of the reforms. In late 2008 ten firms were reported to have received a rating as high as AA, up from two a year earlier (KPMG, 2007 and KPMG, 2008). A more immediate indicator will be provided by the behaviour of securities firms' profits during the present stock market cycle.

56. The industry remains overwhelmingly dominated by state-owned firms. The three state-owned investment companies that provided the capital injections and which now are major shareholders of many of the securities companies, along with the "pilot" companies, have the predominant position in the industry. Greater participation by foreign securities companies would help improve industry capabilities. The foreign presence is still modest, with eight joint-ventures in operation at end-2008. Foreign investors' participation has been discouraged by their restriction to joint-ventures and by their exclusion from trading A-shares (although they are allowed to underwrite) and other limits on their business. These limits have been relaxed somewhat in recent years. The authorities intend to gradually lift the restrictions on foreign securities companies, although no timetable has been specified (CSRC, 2008b).

### *Institutional investors are becoming a major presence*

57. Spurred by regulatory reforms, institutional investors, particularly insurance companies and collective investment funds, have grown rapidly since 2004 and are becoming major presences in the stock markets. The portion of tradable A-shares held by all institutional investors reached 54% by end-2008, more than double the share in 2004 (CSRC, 2009). The portion of total equity (non-tradable as well as tradable) held by institutional investors is still relatively low compared to more advanced OECD countries, as is the share held by insurance companies and pension funds, but these are likely to continue to increase as the markets develop.

58. China's insurance industry continues to grow rapidly and the range of products and services is broadening. Total premiums increased at an average annual rate of 23% during 2005-08 and assets at a 30% rate. Market penetration, measured by the ratio of premiums to GDP, is now comparable to that of lower-income OECD countries.

59. The product mix is becoming more diversified, due in part to relaxation of regulatory constraints.<sup>22</sup> Automobile and health insurance are growing particularly rapidly. The authorities are encouraging development of agricultural insurance, which traditionally has been very limited, and have taken steps to stimulate the reinsurance sector, which has been lagging the industry as a whole and whose development is important to enabling insurance companies to deal with especially large risks.

60. The authorities have considerably expanded the range of investment choices for insurance companies in recent years. The 2005 decision to allow the companies to invest directly in the stock market, following their authorisation in 2004 to invest in equities through asset management subsidiaries, are important steps, both toward allowing the companies to diversify their portfolios into longer-term higher yielding assets more in line with the structure of their obligations and toward development of the capital markets. Direct holdings of equities were initially limited to 5% of total assets but the ceiling was raised to 10% in 2007. Together with their holdings via their asset management subsidiaries, insurance companies are now allowed to hold up to 25% of their total assets in stocks. By end-2007, total holdings of A-shares were about CNY 220 billion (\$ 32.3 billion), making insurance companies the second largest institutional

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22. Notably, the traditional regulatory approach of model contracts and prices along with requirements that companies obtain approval for each new product has largely been replaced by procedures requiring only notification (OECD, 2005).

investor segment in the stock market (CSRC, 2008a). The ceiling on corporate bond holdings was raised in 2005 from 15 to 30% of total assets, and the range of fixed-income instruments permitted was expanded.<sup>23</sup> As a result, insurance company portfolios are becoming more diversified and more similar in composition to those of counterparts in other countries.<sup>24</sup> The amended *Law on Insurance* will provide further avenues for insurance companies to diversify their investment portfolios, including into real estate (China Law and Practice, 2009a).

61. In parallel with the expansion of investment opportunities, efforts have been made to improve the regulatory scrutiny of insurance companies and to bring standards for their governance and internal systems more in line with international best practices. In 2006, the China Insurance Regulatory Commission (CIRC) issued guidelines to strengthen corporate governance of insurance companies, followed by implementing measures concerning appointment of independent directors; rules governing connected transactions and the liability of senior management and directors; and guidelines on risk management and the conduct of internal audits (Allens Arthur Robinson, 2007). The amended *Law on Insurance* will also provide the CIRC with new sanctions to deter unregulated activities (China Law and Practice, 2009a).

62. Despite considerable progress to date, a number of long-standing industry features continue to limit its performance. The industry remains fairly concentrated and almost entirely state owned. Although there has been some decline in the dominance of the top two domestic insurers, China Life Insurance and The People's Insurance Company of China (due mainly to the latter), they still have 40% and 44% of the life insurance (Figure 6) and non-life insurance segments (Figure 7), respectively; and the top three domestic firms have nearly two-thirds and three-quarters of the two segments, respectively.

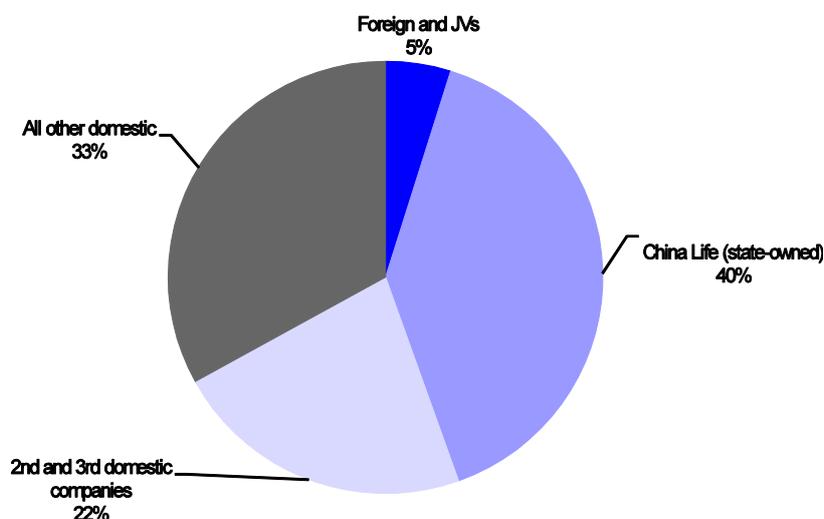
63. China has fulfilled its WTO commitments on opening the insurance market to foreign participation, but foreigners' market share is still quite small. While foreign insurers are now permitted to operate nationwide, foreign life insurers remain confined to branches or joint-ventures in which they can have no more than a 50% equity share (non-life insurers are limited to a 51% share in joint-ventures but have the additional option of establishing wholly-owned domestic subsidiaries). The amended Law on Insurance further relaxes restrictions on access by foreign reinsurers but retains a requirement that Chinese reinsurers are offered at least 50% of reinsurance risks (China Law Insight, 2009). Overall, China remains a very attractive market to foreign insurers (KPMG and Reuters, 2007) and allowing them greater scope could bring substantial benefits to the industry as a whole in terms of new products and greater competition.

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23. Permitted instruments were expanded to include commercial paper, subordinated debt issued by policy banks, central bank bills, and local currency denominated debt issued by international organizations.

24. Bank deposits, which used to be the dominant component of insurance company assets, have fallen from 42% of total assets at end-2004 to 22.5% at end-2007. As discussed in the last section, the authorities have also been relaxing limits on insurance companies' investments in foreign assets.

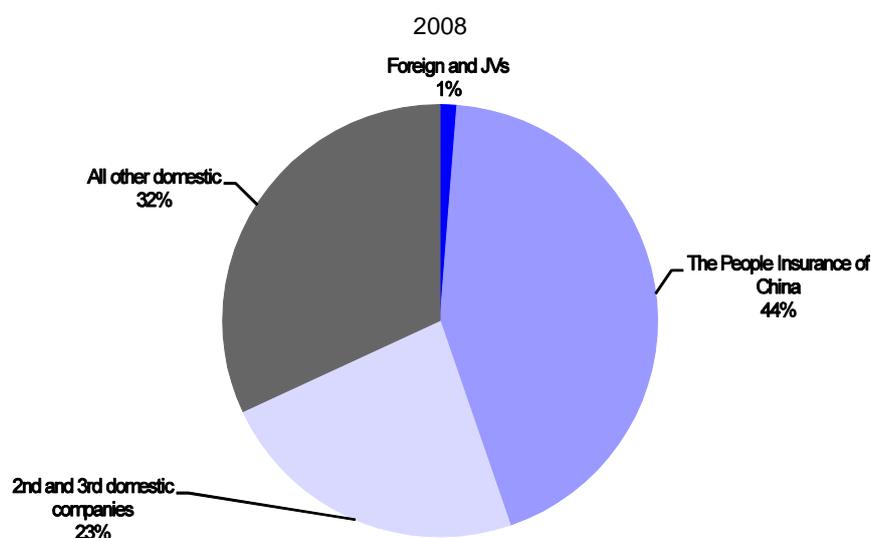
Figure 6. Life insurance market shares



Note: Shares of premiums at end- 2008. For life insurance the second and third largest domestic companies are Ping An Insurance of China and China Pacific Insurance.

Source: China Insurance Regulatory Commission.

Figure 7. Property and casualty insurance market shares



Note: Shares of premiums at end- 2008. The second and third largest domestic companies are China Pacific Insurance and Ping An Insurance of China.

Source: China Insurance Regulatory Commission.

### ***Mutual funds are developing rapidly but prevention of abuses remains a challenge***

64. Collective investment funds (or mutual funds) have grown rapidly on the foundation created by the 2004 law and spurred by the 2006-07 stock market boom. By end-2008, there were 61 licensed fund management companies – nearly double the 35 companies in operation at end-2003 – managing more than 439 individual funds with total holdings of CNY 1.94 trillion (\$ 284.5 billion) (CSRC, 2009). Mutual

funds held 26% of all tradable A-shares by end-2007 (CSRC, 2008a), making them the largest holders among the major institutional investors.

65. The funds are also becoming more diverse and liquid. Open-end funds increasingly dominate the market as closed-end funds are maturing and generally are not being replaced. Trust and investment companies remain the major owners of domestic fund management companies but a number of banks and insurance companies have established presences since 2004.

66. Foreign companies have established a significant presence in the industry despite being limited for now to joint-ventures. At end-2008, there were 33 foreign joint-venture fund management companies (CSRC, 2009), with a market share of 45.4% (PricewaterhouseCoopers, 2009b). The ceiling on foreign investment in fund management companies was raised from 33% to 49% in 2005. Allowing foreign mutual fund companies greater access, either by permitting them to acquire controlling stakes in domestic firms or to establish domestic subsidiaries, would help to dilute the now dominant role of state entities as owners in the sector as well as help to upgrade the skills and effectiveness of the industry as a whole.

67. Protecting investors in funds from abuses, who are mainly individuals, is increasingly a priority and a challenge for the regulatory authorities. The 2004 *Law on Collective Investments* requires the investment fund companies to adopt sound governance and internal management and risk controls comparable to those adopted by other financial institutions. The law prohibits insider transactions, such as the purchase of securities by a fund issued by the controlling shareholder of the fund manager. To suppress misleading claims to attract investors, funds are prohibited from including projections, offers of guaranteed returns, or guarantees against losses in their public disclosures.

68. The authorities' enforcement powers were further augmented by the 2005 Amended Securities Law, which allowed the CSRC to freeze the financial accounts of serious violators without first obtaining a court order and to suspend trading by individuals being investigated for insider trading or other insider abuses. Effective implementation of these powers, however, depends on the limited resources of the chief regulators of the firms (the CSRC along with the major exchanges). To make better use of these resources, consideration might be given to relaxing the current legal requirement on the CSRC to assign a minimum of two staff members to investigate a specific abuse by a fund or its officials. The enforcement authorities capacities will need to increase over time in order to keep up with the new incentives and opportunities for abuse that will arise as the markets develop and novel and more complex instruments are introduced.

69. Private investment funds pose another and possibly more difficult challenge. They typically manage the assets of one or several very wealthy individuals and are in most cases unlicensed, operating largely outside the regulatory net. A 2006 survey by the People's Bank of China estimated that holdings of private investment funds were nearly double those of the licensed fund management companies and accounted for nearly one-third of the trading activity on the domestic stock exchanges (Mu, 2007). As underscored by the failure of D'Long Holdings in 2004, the borrowing and investment relations between these funds and other financial institutions can pose serious risks (Hirson, 2005). A proposal to grant the CSRC new regulatory authority over private funds is due to be considered by the National People's Congress in late 2009.<sup>25</sup>

### ***Pension funds will be a major force shaping future capital market development***

70. Although in an early stage of development, China's pension funds are already a significant presence in the capital markets and are likely to be a major force shaping their future expansion. The two main segments are the National Social Security Fund (NSSF), created in 2000, and the locally managed

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25. "Overhaul of Fund Regulations Looms in China", *Asian Investor*, 10 July 2009.

Enterprise Annuity Funds, which hold the contributions from the second (occupational) tier of the pension system (OECD, 2010). Individual pension accounts are the least developed component but are expected to become much more important over time.

71. Due largely to regulatory restrictions, pension fund management has been quite conservative until fairly recently. While the NSSF was permitted in 2001 to invest up to 40% of its assets in domestic equities (and up to 10% in corporate bonds), it did not start investing in the stock market until 2003. Enterprise annuity funds were limited to bank deposits and government bonds until 2004. These restrictions, along with falling stock prices, led to low returns (around 3% on average for the NSSF) during 2002-05. However authorities have significantly relaxed the limits on capital market holdings of pension funds in recent years, although the funds remain subject to minimum shares invested in bank deposits and government bonds. By end-2007, the NSSF holding of domestic A-shares was nearly CNY 71 billion (\$ 10.4 billion), or 35.7% of total assets, while enterprise annuity funds held nearly CNY 50 billion (\$ 7.3 billion) (CSRC, 2008a).

72. In recent years, a number of OECD countries have moved away from quantitative limits on pension fund allocation toward more flexible rules requiring fund managers to act “prudently”, as if they were investing their own funds (“prudent person approach”). This regulatory strategy allows funds greater scope to adjust their allocations to changing market conditions and thereby achieve, in principle, a better return-risk outcome. In China’s case, the present use of quantitative restrictions for pension funds is reasonable given the limited experience with such funds, their governance and their internal systems.

73. Once they are able to handle the risks, pension fund performance could be improved by relaxation of the limits to allow greater diversification. OECD analysis (Hu *et al.*, 2007) indicates that allowing the funds to invest more in domestic equities, a broader range of other domestic assets including real estate, and in overseas equities could boost overall returns and reduce their volatility. The authorisation given to the NSSF in 2006 to invest a limited amount in foreign assets is an important first step toward allowing pension funds to take advantage of the benefits from diversification beyond the domestic market. Enterprise annuity funds should also be allowed to make such investments as they demonstrate their ability to manage their investments prudently. In the nearer term, consideration might also be given to eliminating or at least lowering the minimum amounts required to be invested in bank deposits and government bonds.

### **Greater priority is being given to improving credit access for underserved segments**

74. China’s small and medium-sized enterprises (SMEs) and rural sector borrowers are subject to all the handicaps in obtaining credit that exist in other countries as well as additional obstacles arising from the transition to a market economy. These include legal ambiguities concerning property rights, collateral and bankruptcy; the financial problems of the traditional rural lenders; the tighter credit standards adopted by commercial banks as a result of financial reforms; and the withdrawal of local government backing for privatised SMEs (OECD, 2005b). As in other emerging economies, lack of access to formal credit has led to the development of a large informal financial sector, much of which operates outside of the law and regulatory net (Box 4). Improving access of SMEs and the rural sector to credit is recognised as essential to the authorities’ broader goals of developing the private sector, fostering the growth of high-tech companies, and promoting rural development. Initial efforts focused on mandates to commercial banks to improve their lending facilities for these sectors and the development of credit guarantees.<sup>26</sup> The reforms have broadened in recent years to place primary emphasis on the development of commercially-viable

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26. In 2006, a special fund was set up to provide subsidized lending and technical assistance to promote development of SMEs.

institutions, with capabilities to serve SMEs and rural borrowers, and on improving the legal and other infrastructure to facilitate their borrowing.

#### Box 4. China's informal financial facilities

Informal financial facilities are the main sources of external financing for China's SMEs, farmers and others lacking access to commercial banks and other formal lenders. A survey conducted by Beijing's Central University of Finance and Economics estimated that informal lending reached CNY 2 trillion in 2007 (\$ 290 billion), or 28% of total bank loans.<sup>1</sup> Much of the lending is funded by bank deposits channelled into the informal sector. This inflow was an estimated CNY 80 billion (\$ 11.7 billion) per month in 2004 (McKinsey Global Institute, 2007).

Informal financial facilities encompass a wide range of arrangements including lending among individuals, businesses and business associations, borrowing through pawnshops, and lending by unlicensed banks. Some of these are legal, although unregulated, while others are "underground", that is wholly or partly outside the law. Informal lending is most important (as a share of total financing) in rural areas, in the western regions and in Heilongjiang and Liaoning provinces in the north-east (OECD, 2005b). The overall dependence of China's SMEs on informal lending appears to be in line with that of other major emerging economies, such as India, Indonesia and the Russian Federation, but there is some evidence that underground lending may be more important in China (Ayyagari *et al.*, 2007). Underground facilities are most prominent where the private sector is most developed, notably Guangdong and Zhejiang provinces.

Low overhead costs, the ability to charge interest rates above regulatory ceilings, and knowledge of their customers have allowed informal lenders to serve small borrowers that have been shut out from formal credit channels. Informal lenders rely heavily on the community reputation of their prospective borrowers and default rates are reportedly low. This may help explain why informal lenders seem to place less emphasis on past performance in making their lending decisions compared to banks and other formal financial institutions (Tanaka and Molnar, 2008).

While informal lending is important, indeed often critical, to the survival of many SMEs, its overall contribution to the economy is less clear. A recent study based on a survey of 2 400 Chinese businesses found that firms that borrowed from formal sources had higher reinvestment rates, higher productivity, and faster growth than firms reliant on informal finance (Ayyagari *et al.*, 2007).

The authorities have not attempted to curtail informal financial facilities altogether, despite their unregulated status, although they have at times acted vigorously against underground lenders when serious abuses have occurred. The provincial government of Zhejiang has announced a pilot programme to license a limited number of informal small lending companies.<sup>2</sup> Well-performing companies will be eligible for conversion into commercial banks. This programme may signal a shift in official policy toward recognising sound informal lenders while subjecting them to regulatory supervision.

1. "Informal Financing Channels Rampant", *China Daily*, 2 July 2008.

2. "Government Moves to Legitimize Underground Lending in Zhejiang", *China Stakes*, 14 July 2008.

#### *Lending to SMEs is being encouraged*

75. For a number of years, the government and regulatory authorities have encouraged financial institutions, particularly commercial banks, to improve their lending to SMEs. In February 2005, the State Council issued *Guidelines on Encouraging and Supporting the Development of the Non Public Sector including Individual and Private Enterprises* calling for expanding SME access to both bank and capital market finance. Banks were required to establish separate departments for SME lending. Government and regulatory authorities have periodically issued statements urging commercial banks to increase their lending to SMEs while at the same time cautioning that such lending must be based on sound credit assessments. These efforts were probably useful in helping offset commercial banks' traditional bias

toward lending to state-backed enterprises and to develop better capabilities to assess SME loans. However they may have sent mixed signals to banks as to whether they should follow government mandates or strict commercial principles in SME lending.

76. In parallel with these efforts, a number of major commercial banks, with the encouragement of the Chinese authorities and in conjunction with several multilateral institutions, have instituted programmes to improve SME access to bank loans and to the capabilities of smaller financial institutions to carry out SME lending.<sup>27</sup>

77. ICBC and CCB lending to private enterprises - mostly SMEs - had risen to 15.1 and 17.2% respectively of total corporate loans by 2007, up from 11.5 and 11.8% respectively in 2005.<sup>28</sup> More recently, the authorities have been stepping up pressure on the commercial banks to increase lending to SMEs and by mid-2009 SMEs accounted for just over half of all outstanding enterprise loans.<sup>29</sup> Over the longer term, further development of the CCBs would help to improve SMEs credit access since these banks are generally more oriented toward such businesses than the SOCBs or JSBs (Tay, 2006).

78. The second stock exchange board, opened in 2004 on the Shenzhen Exchange, and the more recent ChiNext high-tech board marked important steps towards giving some SMEs access to the capital markets. However, they can assist only a limited segment of SMEs. Moreover, reforms that would boost SME access to the bond market, which is now essentially out of reach for them, have yet to be undertaken.

79. Lack of collateral is a problem for SMEs everywhere but more so in China (International Finance Corporation, 2007). Antiquated legal provisions have in most cases prevented inventory and receivables from being used as collateral.<sup>30</sup> The use of land as collateral is often limited by ambiguities over property rights. Use of equipment and other moveable property that are in principle eligible as collateral is hampered by cumbersome registration procedures and lengthy, costly, and uncertain legal treatment by the courts in the event of default. As a result, only an estimated 4% of bank loans are collateralised, versus nearly 70% in the United States (Han, 2007). The authorities have recognised the need to improve the utility of collateral and key reforms, including allowing the use of receivables as collateral and a reformed property registry system, were incorporated in the reformed Property Law that took effect in October 2007 (China Law Reporter, 2007).

80. The authorities, along with a number of Chinese scholars, have viewed credit guarantees as key to improve SME access to bank loans (Liu, 2007). Credit guarantee facilities (CGFs) began to develop in the late 1990s under the sponsorship, and usually the control, of local governments (OECD, 2005b) but have proliferated since 2003. By 2005, an estimated 5 000 CGFs were in operation. However most were

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27. For example, in September 2005 the Industrial and Commercial Bank of China began a programme to make it easier for SME suppliers of larger, well rated, companies to put up collateral and use their association with these companies to more easily obtain loans (Xiang, 2007). In August of that same year, China Construction Bank announced agreement with Zhejiang provincial government to provide CNY 60 billion in credits to provincial SME over three years.

28. *Annual Report* of ICBC and CCB for 2006 and 2007. The figures exclude corporate loans to foreign invested enterprises. Loans to private enterprises from the two banks are the fastest growing component (by ownership type) of corporate loans.

29. "Credit for SMEs Leads Lending for First Time", *China Daily*, 21 September 2009.

30. Under the Securities Law, whose provisions govern collateral, an asset can be used as collateral only if its type, amount, nature and location can be precisely specified at the time the loan contract is validated (Han, 2007).

devoted to segments other than SMEs, such as housing, and most facilities were quite small. Nearly 90% were reported to be in financial difficulties (Asian Development Bank, 2007b).

**Box 5. International experience with credit guarantees for SMEs**

Credit guarantee facilities are most advanced in Japan, Korea, and Chinese Taipei in Asia and in a few European countries, notably Germany (Asian Development Bank, 2007b; Liu, 2007). Programmes in these economies have been able to cover as much as 40% of SMEs. Guarantee multipliers – the ratio of the loan principal to the amount guaranteed – are of the order of 10 to 20, much higher than in China.

International experience strongly suggests that large-scale successful credit-guarantee programmes are not viable without substantial ongoing government financial support. None of the most advanced programmes relies exclusively or even mainly on privately-funded companies and indeed there are relatively few examples of exclusively privately-funded CGFs that have remained viable over time. In effect, SME credit guarantee programmes involve substantial government subsidisation, which needs to be justified by the existence of market failures that cannot be remedied by other means.

The successful credit guarantee programmes also operate within a broader and coherent legal and regulatory framework for SME development. Guarantee facilities are usually incorporated as financial institutions and operate under national banking laws or laws specifically applying to the industry. The programmes operate under specific mandates targeting smaller and micro-sized firms that have the greatest difficulty in accessing commercial credit.

81. Overall, guarantees for SMEs remain underdeveloped in China. Less than 1% of SMEs in China receive guaranteed loans, compared with nearly 20% in Korea and Chinese Taipei, and nearly 40% in Japan, the Asian economies with the most developed loan guarantee programmes (Asian Development Bank, 2007b). Chinese banks tend to demand that all or nearly all of a loan issued under guarantee be covered by the insurance. This limits the amount of loans CGF capital can support and reduces the incentives of the banks to monitor guaranteed loans. International experience suggests that to have a significant impact on SME access to credit, credit guarantee programmes need to have substantial ongoing financial assistance from the government and a more advanced legal and regulatory framework for SME development than now exists in China (Box 5). Accordingly, credit guarantees are unlikely to be a panacea for SME financing problems in at least the medium term.

***Comprehensive reform of the rural credit system is underway***

82. By around 2005, China's rural credit system was facing serious financial difficulties. The rural credit cooperatives (RCCs) – the backbone of the system – had a reported average NPL ratio exceeding 30% (OECD, 2005b). They were hampered by incoherent ownership structures, weak governance and poor internal capabilities to assess and manage risk, problems greatly aggravated by pervasive political interference (OECD, 2005b; Scott and Jun, 2006). Commercial banks had largely withdrawn from rural lending in response to banking sector reforms. The financial institution lending that was occurring was going mainly to larger businesses and infrastructure. Rural households had very limited access to formal credit facilities, and limited knowledge about the products and services that were available (Asian Development Bank, 2007a). The situation was aggravated by intensification of the net outflow of funds from the rural sector through the Postal Savings System and other channels (Huang *et al.*, 2006; OECD, 2005b). These conditions have aggravated the rural sector's long-standing limited access to formal credit compared to urban areas: loans per capita in rural areas were only CNY 5 500 (\$ 806) (in 2006 compared to CNY 40 000 (\$ 5 865) in urban areas.<sup>31</sup>

31. "Rural Banks Lend Hope to Country Businesses", China Government Web Portal, 8 January 2008.

83. The experimental reforms of rural credit cooperatives in several provinces begun in 2003 have since been refined and extended nationwide. Efforts to improve rural finance have also been broadened considerably to develop a range of commercially viable institutions that can meet the heterogeneous needs of rural borrowers, from micro-finance to large-scale financing for infrastructure. As stated in various government pronouncements, rural financial reforms include the following specific objectives (People's Bank of China, 2007, CBRC, 2009):

- Extension of the rural credit cooperative pilot reforms to the nation as a whole;
- Continuation and strengthening of the key role of the China Development Bank in financing rural infrastructure;
- Strengthening of the capabilities of the Agricultural Bank of China to support rural and agricultural development;
- Entry of more diverse sources of capital, including private and foreign interests, to invest in and develop local (county-level) rural financial institutions;
- Development of micro-finance institutions, using the assistance of non-government organisations and foreign micro-finance enterprises.

84. Although not yet complete, the reform of the rural credit cooperatives (RCCs) has made considerable progress since 2005. It involves essentially the same steps taken in the reform of other commercial banks. Most of the RCCs deemed to be salvageable have been or are in the process of being converted into banks (rural commercial banks or rural cooperative banks) and incorporated with ownership and governance structures comparable to those of other commercial banks. The rural banks were required to adopt reformed loan assessment, loan classification, and other management systems previously mandated for other commercial banks by end-2007. The authorities, mainly through the People's Bank of China, have provided substantial funds to remove or write down RCC NPLs and to raise their capital. However, the institutions are required to "match" the financial assistance by raising an equal amount of capital on their own and by implementing reforms.<sup>32</sup> As a result, the RCCs' average NPL ratio had fallen to 9.3% (down from 37% in 2002) and their CAR had been restored to 11.2% (People's Bank of China, 2007).

85. The establishment in 2007 of the Postal Savings Bank and its separation from the Postal Savings and Remittance Bureau marks a potentially important step to at least reduce the net outflow of funds from the rural economy. The new bank will be able to make loans to rural customers and could significantly augment the supply of loans to rural customers. The Agricultural Bank of China is also in a much stronger position to serve rural customers following its recapitalisation and restructuring.

86. To improve the quality of rural financial institutions and to increase competition, new domestic and foreign entrants are being encouraged. In 2006, the authorities lowered minimum capital requirements for rural lending institutions to facilitate entry. A number of foreign banks and micro-finance businesses have set up rural lending joint-ventures with Chinese partners. Hong-Kong and Shanghai Banking Corporation became the first foreign bank to establish a rural lending subsidiary in China (Hubei province) in December 2007. These new entrants are tiny in the aggregate and it is unlikely that foreign investors will

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32. Specifically, a reforming RCC is required to raise half of the funds necessary to attain minimum capital adequacy, with the People's Bank of China providing the remaining half through special PBoC bills that cannot be sold. The bills are to be subsequently redeemed after two years if the RCC meets targets for further improvement in its capital adequacy and in governance reforms.

gain any major share of the market. However, they may have a broader beneficial impact by providing examples of new and improved practices.

87. The greater reliance in the current programme on creating commercially-viable rural lending institutions (rather than subsidies and official mandates, although these have not completely disappeared) and the emphasis on developing a range of institutions from the very small to the very large represent a significant improvement over past, less comprehensive, efforts. However, such reform is a massive task (in any country) and there are a number of questions about how effective China's measures ultimately will be. While the reforms to the (former) rural credit cooperatives have clarified their ownership, the degree to which their prior ties to local governments and consequent vulnerability to interference in lending decisions, which was endemic in the past, has been ended is less clear.<sup>33</sup> This is particularly the case given that party officials often still occupy key positions on the boards and in management and as ownership of a given institution tends to be relatively dispersed, reducing incentives for shareholders to monitor performance (Scott and Jun, 2006). As noted above, there are indications that lending decisions continue to be driven by political or other non-commercial mandates. Moreover, because individual rural credit institutions are usually confined to a restricted geographic area, competition is often limited despite the large number of institutions.

#### **The financial system is gradually opening up internationally**

88. China's participation in the international financial system has grown considerably over the past decade as a result of its economic development and accession to the WTO. As noted earlier, foreign financial institutions have gained a significant, if still small, foothold in China's banking, insurance, and securities sectors. Many of China's nationwide banks have had overseas branches and offices since the 1990s and in recent years the largest banks, major insurance, and a number of securities companies have markedly stepped up their expansion into foreign markets through acquisitions or strategic investments. The creation in September 2007 of a sovereign wealth fund, the China Investment Corporation, to invest part of China's huge foreign exchange reserves, will further increase China's financial presence in international markets. Steps have also been taken recently to internationalise the renminbi: the PBoC has signed currency swap agreements with several foreign counterparts and in July 2009 it announced a pilot programme to allow the settlement of international trade transactions in renminbi; moreover, in September 2009 the Ministry of Finance announced that for the first time it would issue renminbi-denominated bonds in Hong Kong.

89. Nevertheless, China's capital control regime remains relatively restrictive compared with other economies in the region and to emerging economies generally (Kimbell and Xiao, 2006). Nearly every category of flow is subject to ceilings, limits on the type of instrument and other restrictions (Box 6). Inward foreign direct investment (FDI) flows are most liberalised and foreign-invested companies are relatively free to repatriate profits, liquidate their holdings and bring in additional funds. Otherwise, the pattern of restrictions is similar to that in many other emerging economies. Outflows are more restricted than inflows and portfolio flows (and direct investment) are less controlled than short-term capital flows.

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33. The PBoC has warned of the risk of undue "administrative" influence on mergers and acquisitions of rural credit institutions and emphasized the need to observe market principles and protection of rights of shareholders and legal persons (People's Bank of China, 2007).

### Box 6. Sketch of China's capital control regime

China's capital control regime has a number of distinctive features (American Chamber of Commerce in China; Prasad and Wei, 2005; Prasad *et al.*, 2005):

- Inward FDI is generally permitted except in several “strategic” sectors and, in some cases (certain financial activities) subject to limits on the extent and form of foreign ownership. Foreign companies are free to withdraw from their foreign exchange accounts or convert local currency to make external current account payments consistent with their business scope (e.g. profits and dividends). Foreign-invested financial institutions are subject to prudential limits on their conversion of foreign currency into renminbi.
- Purchase of foreign currency for outward FDI is allowed for projects approved by the National Development and Reform Commission and the Ministry of Commerce, for imports of materials for processing, and for foreign-aid related projects. Establishment of foreign bank accounts requires approval by the State Administration of Foreign Exchange (SAFE).
- Capital account transactions by businesses and individuals are much more controlled and classified into several categories with separate rules. Purchase of domestic money and capital market instruments by non-residents is generally confined to the Qualified Institutional Investors (see text) except for B equity shares, which are open to non-residents generally.
- Non-residents are generally prohibited from issuing securities in the domestic Chinese market, with certain exceptions, notably several multilateral lenders.
- Purchase of foreign money and capital market instruments by resident businesses and other entities has been mostly prohibited until recently, but now is allowed for participants in the Qualified Domestic Institutional Investor (QDII) Programme. The range of permitted instruments does not include foreign real estate or most derivatives. Domestic residents are allowed to maintain accounts denominated in foreign currency with domestic banks for use domestically.
- Sale or issue abroad of securities or money market instruments by resident banks, other financial institutions and non-financial businesses are subject to approval by the relevant financial regulatory agency in the case of financial institutions and by SAFE.
- Individuals are now permitted to purchase up to \$ 50 000 of foreign currency annually and more upon documentation of special needs. Individuals may use their foreign currency to purchase stocks and bonds on foreign markets through the QDII programme.

### *Vehicles for opening have been established but the process continues to be quite gradual*

90. China achieved full current account convertibility in 1996 and has long been committed to ultimate capital account convertibility. However, in the wake of the 1997 Asian financial crisis the authorities adopted a rather cautious and gradual approach to opening. Liberalisation since then seems to have been driven by China's WTO commitments to open the financial system to foreign participation and by the need to afford domestic businesses the flexibility in foreign currency transactions necessary for their growing international activities.<sup>34</sup> Reforms are being deliberately phased as a function of domestic

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34. In that year, domestic investors were authorised to purchase B-shares on the domestic exchange. Chinese businesses were authorized to purchase foreign currency for projects designated as “strategic” by the State Council and for investments to facilitate the import of materials for processing. Restrictions on foreign currency purchases for early repayment of foreign currency loans were also relaxed in 2001. Subsequently, notably in 2005, the authorities have made periodic changes to streamline procedures and relax quotas to make it easier for domestic and foreign invested enterprises as well as individuals to obtain the currency

financial reforms to ensure that Chinese financial institutions have the capabilities to manage the risks of cross-border transactions before they are permitted to do so. No target date has been officially specified for full convertibility.

91. The adoption in 2002 of the Qualified Foreign Institutional Investor (QFII) programme was the first major step toward the liberalisation of portfolio capital flows. The programme allows a limited number of long-established foreign institutional investors to bring in funds to invest in a specified range of domestic financial assets, subject to quotas for each institution as well as the overall amount. Seventy six foreign institutional investors were licensed to participate in the programme by end-2008 (CSRC, 2009).

92. The QFII programme has been managed rather cautiously. The original global ceiling of \$ 10 billion was maintained until end-2007, when it was raised to \$ 30 billion, while the limit for each institutional investor was increased from \$800 million to \$1 billion in August 2009. At the end of August 2009, approved investment quotas totalled \$15.3 billion. The authorities have imposed significant restrictions aimed at encouraging QFIIs to make longer-term investments in the capital markets and to discourage sudden outflows. The QFIIs were initially permitted to offer only closed-end funds, although this was later extended to open-end funds. Their investments were subject to a three-year lockup period before the full amount of the amount placed could be repatriated, with shorter delays before specified portions were withdrawn. While the repatriation restrictions were relaxed considerably in 2006, the authorities continue to attempt to influence the composition of the flows by requiring a higher minimum investment by banks and securities companies compared to mutual funds and insurance companies.<sup>35</sup> The effectiveness of this discrimination is doubtful, however, since differences in activities and strategies among institutional investors are much less pronounced than they were several decades ago.

93. The introduction in 2006 of the Qualified Domestic Institutional Investor (QDII) programme to allow domestic financial institutions to invest abroad represents an important step in broadening China's capital account liberalisation. While similar in structure to the QFII program, the QDII has expanded more rapidly in size and scope. Investments were originally limited to fixed-income instruments but in 2007 this was broadened to include equities. Investments have been concentrated in instruments traded on the Hong Kong exchange but are likely to diversify into other markets as a result of agreements between Chinese financial supervisory authorities and their counterparts in other countries. By September 2009 a total of 56 institutions had obtained QDII licenses and the global authorised total was \$ 55.9 billion. However, the authorities appear to have been concerned by losses incurred by Chinese investors under the QDII during the global downturn and recently halted new approvals.<sup>36</sup>

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needed for their authorized activities. By themselves, these changes do not represent any fundamental change in the capital control regime, however.

35. As of June 2008, insurance companies, pension funds, mutual funds and endowments and charities were subject to a three-month lockup period on repatriation while banks and other institutions were subject to a one-year lockup period. SAFE retains the right to impose revised regulations on repatriation if and when it deems appropriate. QFIIs are presently allowed to invest in exchange trade stocks, bonds, and warrants and mutual funds, but not real estate.

36. "China Keeps Global Investment Quota Curbs, Funds Say", *Bloomberg*, 28 July 2009.

94. With the advent of the QDII programme, the authorities have started to relax constraints on foreign investments by other domestic financial institutions and individuals. Insurance companies are now authorised to invest up to 15% of their assets in selected foreign securities. The NSSF began to invest in foreign instruments in late 2006 following its authorisation in 2005. This represents an important step toward diversifying NSSF assets and should provide experience for allowing foreign investment by enterprise pension funds at some future point.<sup>37</sup>

***The pace of liberalisation could be accelerated***

95. China is well advanced in establishing the macroeconomic preconditions for capital account liberalisation. Both the budget deficit and government debt are moderate in relation to GDP and inflationary pressures have been contained. The large current account and balance of payments surpluses have generated strains on domestic monetary policy and upward pressures on the exchange rate (OECD, 2010), but they are better addressed through greater exchange rate flexibility than through capital controls. External debt is moderate and the exceptionally large foreign exchange reserves provide a considerable cushion against even large sudden capital outflows.

96. China's capital controls seem to have been effective enough to avoid major losses by domestic financial institutions and major businesses from unauthorised foreign currency transactions. The control regime has also given monetary authorities significant latitude to vary domestic interest rates independently of those abroad despite limited exchange rate flexibility (Ma and McCauley, 2007; Cheung *et al.*, 2006).<sup>38</sup>

97. However, international experience indicates that capital controls, particularly on outflows, are almost inevitably subject to substantial evasion (Kar and Cartwright-Smith, 2008). In China's case, the opportunities for misreporting of flows through legal channels and outright evasion are greatly enhanced by the proximity and close links between the Mainland and Hong Kong, China, as well as other Asian countries with large Chinese populations. China experienced large unrecorded capital outflows during the late 1990s and early in the 2000s, driven in part by the slowing economy and the possibility of a devaluation of the renminbi in the wake of the 1997 Asian crisis. These unreported outflows have since been reversed to become substantial unreported inflows. Enforcement of capital controls is likely to become progressively more difficult as China's financial system becomes more sophisticated and the involvement of Chinese businesses in international markets increases.

98. The most important constraints on the pace of China's capital account liberalisation are the incentives and capabilities of domestic financial institutions and non-financial businesses to prudently manage the risks of cross-border transactions and the ability of supervisory authorities to monitor external exposures sufficiently to contain systemic risk.<sup>39</sup> As the prior discussion has indicated, these capabilities

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37. Other recent measures include: authorisation in 2007 for brokerages and mutual funds to invest client funds in certain overseas assets; permission for individuals to invest in the Hong Kong stock market; and a substantial increase in the amount of foreign currency individuals can purchase for overseas travel or study. Individuals will be able to purchase stocks on US exchanges under a 2008 memorandum of understanding between the authorities of the two countries.

38. Kimbell and Xiao (2006) present evidence that China's controls did reduce the volatility of cross-border capital flows during 1996-2004, and helped shape the composition of inflows toward FDI.

39. Other considerations, including the desire to shelter domestic financial institutions from foreign competition during their early stages of development may also have influenced the pace of liberalisation in the past. However, as argued earlier, further opening to foreign competition is more likely at this point to foster the development of the financial system to the benefit of both domestic and foreign actors.

have improved considerably in recent years but they are still developing and their effectiveness has yet to be tested. This suggests that a phased approach is still preferable to a one-time complete liberalisation.

99. Nevertheless, more rapid capital account liberalisation would bring tangible benefits and could be achieved without serious risk to financial or macroeconomic stability. It would foster development of the foreign exchange market and make it easier to increase the flexibility of the exchange rate. Reduction in the extent of capital controls would reduce incentives for evasion, helping reduce misreporting and potentially improving the ability of the authorities to enforce remaining limits and to monitor the exposure of the domestic economy to foreign exchange and other external risks.

100. The QFII programme could be expanded considerably by increasing the overall quota to as much as twice the present level. The current restrictions on repatriation and the discrimination among types of investors could also be ended without serious risk. Such steps could significantly improve the institutional investor support for capital market development and should not add more than modestly to the already large capital inflows China is now experiencing.

101. Similar considerations suggest that foreign-invested businesses, including financial institutions, where qualified by the same criteria applied to residents, could in the near term be granted eligibility to list on the stock exchanges and to issue bonds. This would help develop domestic equity and bond markets.

### **Conclusions and recommendations**

102. China has recorded major achievements since 2005 in restoring financial solvency to the banking system and securities companies, establishing a firmer foundation for capital market development, and improving the legal and regulatory framework and the capabilities of regulators. Compared to as little as five years ago, financial institutions are in much better financial shape and have improved capabilities to function prudently and profitably. However, especially given the legacy of the planning period and the continued dominance of state ownership, further experience with the governance, internal control, and supervisory systems that have been put in place will be required before the full effects of the reforms are manifest.

103. Future progress will depend increasingly on broader economic reforms. The macroeconomic environment has been supportive of financial reforms during the high-growth era but has recently become more problematic. The possibility of a rise in NPLs from the recent rapid expansion in lending is perhaps the most significant near-term risk to the improvement in the profits and balance sheets of the financial institutions. Prudential norms are now much more closely aligned with those in OECD countries but some of them may need to be tightened further to deal with the special risks entailed by China's development. In the longer term, the degree to which private, or at least more market-oriented, interests replace state ownership in the financial system may influence how strong China's financial institutions ultimately become.

104. The discussion points to a number of further reforms in the near to medium term:

- Active efforts by the authorities to promote greater private control of financial institutions would help to improve the financial system's capabilities to serve the private sector and to eliminate interference by government entities, particularly local governments, in lending decisions. Consideration should be given to requiring local authorities to reduce their ownership stakes in commercial banks over a reasonable period.
- In addition to promoting greater private control, raising the ceilings on foreign investment in banks and other financial institutions would help to improve their governance, management, and technical capabilities.

- Institution of a formal deposit insurance system for commercial banks within the next several years is key. It would help equalise competitive opportunities between larger and smaller banks and clarify the authorities' commitment to backing of those institutions.
- Resources for enforcement by financial authorities need to be augmented to ensure that they are able to keep up with market development and innovation. Strengthening the CBRC's capacity to conduct annual on-site examinations of a larger portion of commercial banks would help speed up implementation of banking reforms.
- Priority should be given not only to improving the overall quality of listed companies but also to increasing their diversity. Private companies need to be better represented in new listings. To that end, companies approved for listing should be given the sole latitude to determine when they make their offering.
- Alignment of criteria for corporate bond issues by non-listed enterprises with the rules and procedures for listed companies specified by the CSRC will be needed to complete the foundation for a sustained development of the market. Allowing foreign rating agencies to rate domestic issues could help foster greater diversity in issuers and bonds.
- Consideration should be given to accelerating capital account liberalisation, especially with respect to controls on portfolio inflows. The rapid development of the QDII programme is a good step in this direction. The QFII programme could be expanded further in the near term, and restrictions on repatriation, investment options and the differential treatment of institutions eliminated or at least substantially relaxed with little if any cost to other objectives.
- Allowing foreign-invested companies and financial institutions to issue in the bond and stock markets would boost capital market development without prejudice to other policy objectives.

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### Annex 1. Ownership limits on foreign investment in major financial segments

Institution type	Maximum foreign share (individual investor; total foreign investment)	Permitted activities	Permitted forms	Remarks
Commercial Banks	20;25	In principle same as domestic banks ('national treatment') from end-2006 forward	branch; joint-venture; subsidiary	Relatively high capital requirements for bank branches (RMB 300 million/branch) compared to domestic banks. The authorities encourage foreign banks to incorporate locally
Mutual fund companies	49% maximum share in joint-venture with domestic partner		joint-venture	
Securities Firms	33% maximum share in joint-venture	Underwriting A,B,H shares and bonds; trading in all except A shares; brokerage, proprietary investment or portfolio mgt for others prohibited	Foreigners may invest in an existing firm or form a new joint-venture with Chinese partner	Moratorium on licenses for new securities firms, including foreign j-vs., imposed December 2005 but lifted in 2H2007; Authorities also announced in May 2007 intention to allow foreign j-vs to engage in brokerage, property investment and funds management
Brokerage Firms	20; 25			
Insurance Companies	24.9% maximum for foreign investment in a Chinese company. Foreign life insurers may form joint-venture with Chinese partner with maximum equity state of 50%. Foreign investors in principle are allowed to take a controlling interest in non-life joint-ventures		Branch or Investment in existing companies or in new joint venture. Foreign non-life insurance company branches in China are allowed in principle to convert into a subsidiary.	Relatively high capital requirements for branches (RMB 200 mn/sub; 20 mn/branch up to 500 mn total) compared to other countries; authorities agreed in 2007 to expedite processing of applications to convert branches to subs and to allow for foreign invested life insurance companies to offer enterprise annuities.

Source: *Is China's Financial System as Open as the U.S.?*, [http://www.engagechina.com/research/Is\\_China\\_As\\_Open\\_As\\_US.pdf](http://www.engagechina.com/research/Is_China_As_Open_As_US.pdf).

### Annex 2. Major laws concerning the financial system enacted since 2003

Law	Effective date	Main purpose
Law on Bank Regulation and Supervision, Amended	1 February 2004	Specifies updated prudential standards and strengthens powers and responsibilities of commercial banking supervisors (CBRC)
Securities Investment Funds Law	1 June 2004	Specifies, for the first time, a comprehensive set of regulations governing the formation, governance, and supervision of mutual funds.
Company Law, Amended	1 January 2006	Major reform of legal framework for corporations, specifying rules for incorporation, corporate governance, responsibilities of board members and senior management
Securities Law, Amended	1 January 2006	Major reform of legal framework governing listing, securities issues, disclosure, powers and responsibilities of CSRC and exchange authorities
Enterprise Bankruptcy Law	1 June 2007	Comprehensive modernised and reformed legal framework for bankruptcy, applying to all legal persons, and specifying procedures in the event of failure, the powers of bankruptcy courts and their agents, and other provisions. The Law brings China's bankruptcy framework more, although not completely, in line with international practices
Property Law	1 October 2007	Major transformation of legal framework for property rights, including recognition of and protection of private property. The law also broadens the range of property that can be used as collateral
Insurance Law, Amended	1 October 2009	Major reform of regulations governing insurance aimed at strengthening the insurance sector and providing increased protection to consumers while also widening the range of investment opportunities open to insurance companies.

### **Annex 3. Evolution of the bank asset management companies**

In 1999, four bank asset management companies (BAMCs) were created to take on and work out the CNY 1.4 trillion (\$ 205.3 billion) of non-performing loans transferred from the four state owned commercial banks (OECD, 2005b). They were Cinda Asset Management Company (China Construction Bank), Orient Asset Management Company (Bank of China), Huarong Asset Management Company (Industrial and Commercial Bank of China) and Great Wall Asset Management Company (Agricultural Bank of China). Their mission was to maximise the value of the recovery of the assets. To achieve this goal, the companies were authorised to use a range of measures, including foreclosure, restructurings, debt-equity swaps, and outright sales (including to foreigners) through auctions and other means. The companies faced a daunting task posed not only by the very large size of the assets to be disposed but, even more, by institutional and social constraints involved in restructuring or closing state owned enterprises and by limitations on bankruptcy, property rights, and other key elements of the legal framework.

Progress in disposing of the assets was fairly slow into 2005. The companies were hampered externally by government interference compounded by the fact that their transactions were subject to multiple government agencies. An audit by the National Audit Office in 2004 revealed serious internal problems, including insider abuses. Following reforms to deal with these problems, asset disposal accelerated dramatically and the task was largely completed in 2007.

Both the speed and recovery rate of the China BAMCs have lagged somewhat behind those of those of the companies in other Asian economies that underwent the 1997 financial crisis. Overall asset recovery for the Chinese BAMCs averaged 21% at end-2006, about half of that recorded in Korea and Malaysia (where recovery rates were highest) and below that in Indonesia. However there was noticeable variation in the performances of the Chinese companies, with Cinda asset management company (China Construction Bank) recovering nearly 34% while Great Wall company (Agricultural Bank of China) managed to recover only about 10%.

With their original task completed, the BAMCs have begun to diversify their operations as part of a transformation into full service financial group companies providing services including asset management, investment and trust banking, and financial leasing. Huarong Asset Management (Industrial and Commercial Bank of China) led the way in early 2007 with the establishment of a securities company subsidiary focusing on the securities business. Cinda followed with the acquisition of a securities company license in September 2007, followed by China Orient several months later.

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