FINANCIAL SYSTEM OF CHINA

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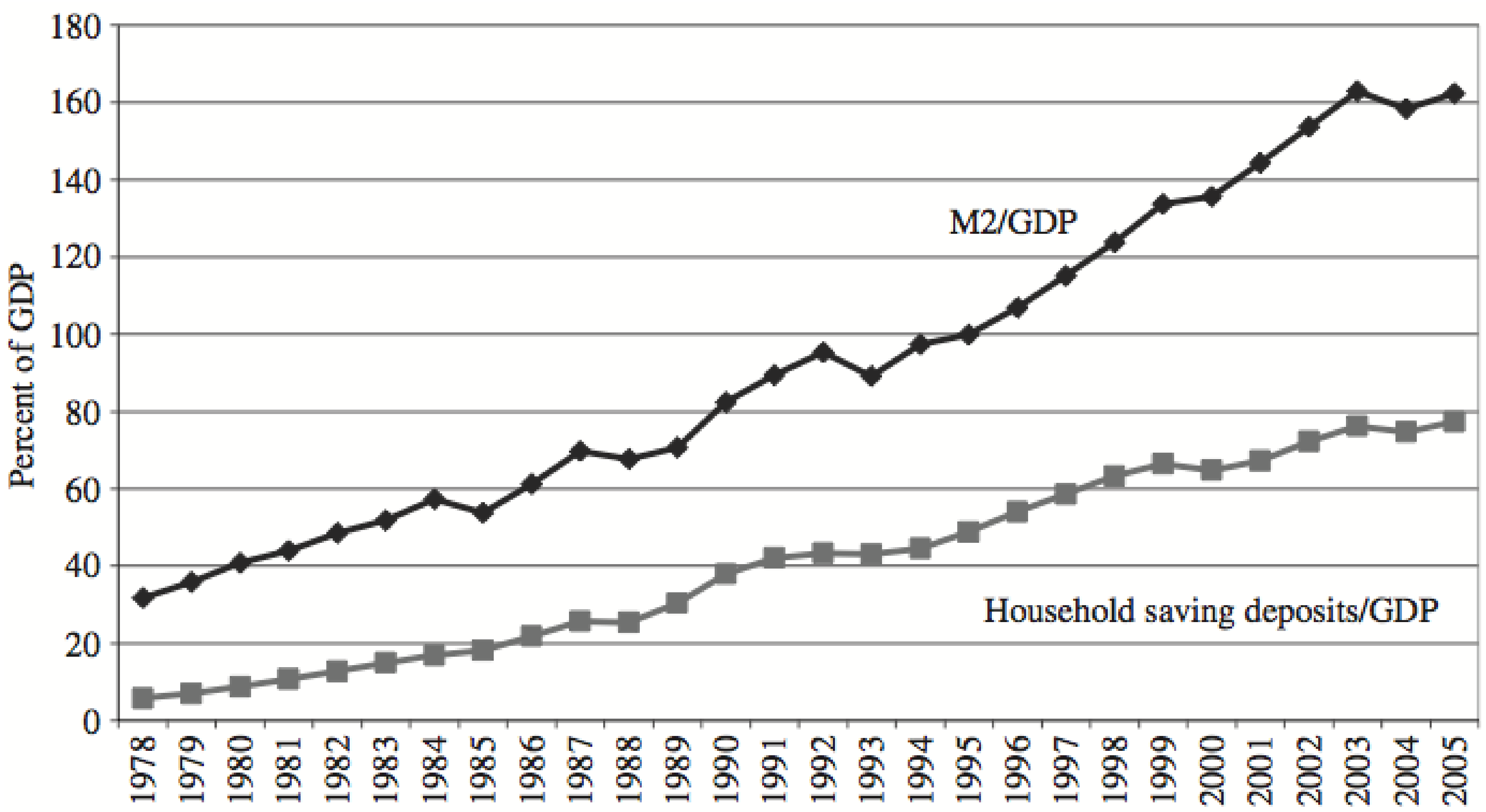
Contents

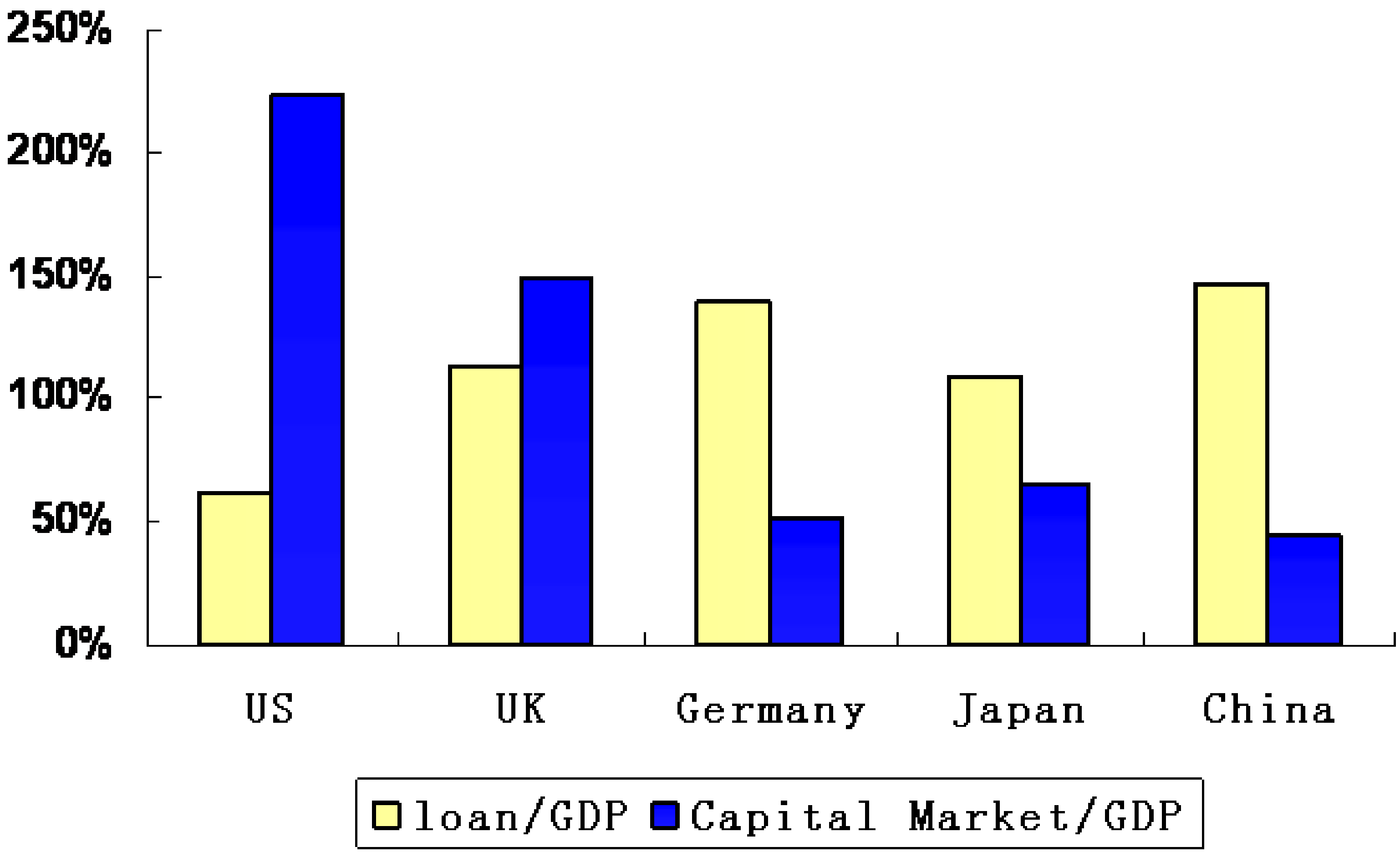
The financial system of China

- Disproportionally important to the global financial system
  - 30% of global financial assets
  - 60% of world's foreign reserves
- System design
  - To sustain an undervalued exchange rate
  - To maintain stability and Communist Party's control of the financial system
- Presumably the weakest banking system in the world

Financial deepening



Heavy reliance on bank financing (2006)



Banking system before 1978

PBOC

As central bank the People's Bank of China has an objective of promoting economic growth and price stability.

It focused on monetary policy issues and financial system liquidity.

CBRC

The China Banking Regulatory Commition (CBRC) managed the functions of supervision. It focused on the restructuring of the banking sector

PBOC remains still very influential, it has considerable regulatory power (common overlapping of functions)

Reforming Chinese banking system (1)

Phase One (1978-1994)

- 1978 - The People's Bank of China (PBC) was designated as a central bank and became independent of the Ministry of Finance resulting in more effective conduct of monetary policy
- A two-tier banking system was created in which the PBC emerged as the central bank, while the following banks emerged as the specialized banks
  - the Bank of China (BOC)
  - the China Construction Bank (CCB)
  - the Agricultural Bank of China (ABC)
  - the Industrial and Commercial Bank of China (ICBC)

Reforming Chinese banking system (2)

Other bank and Non-bank financial institutions

- Regional banks (partially owned by local governments)
- City commercial banks (with business restricted to home city)
- Cooperatives banks (Rural Credit Corp., similar to credit unions in the U.S. and Urban Credit Corp.)
- Non-bank financial intermediaries (such as the Trust and Investment Corporations ; finance companies, financial leasing companies, auto financing companies)

Reforming Chinese banking system (3)

Phase Two (1994-1998)

Three policy banks were set up to undertake the policy driven financing earlier assigned to specialized banks:

- the China Development Bank,
- the Agricultural Development Bank of China and
- the Export-Import Bank of China

Reforming Chinese banking system (4)

Phase Three (1998-2006)

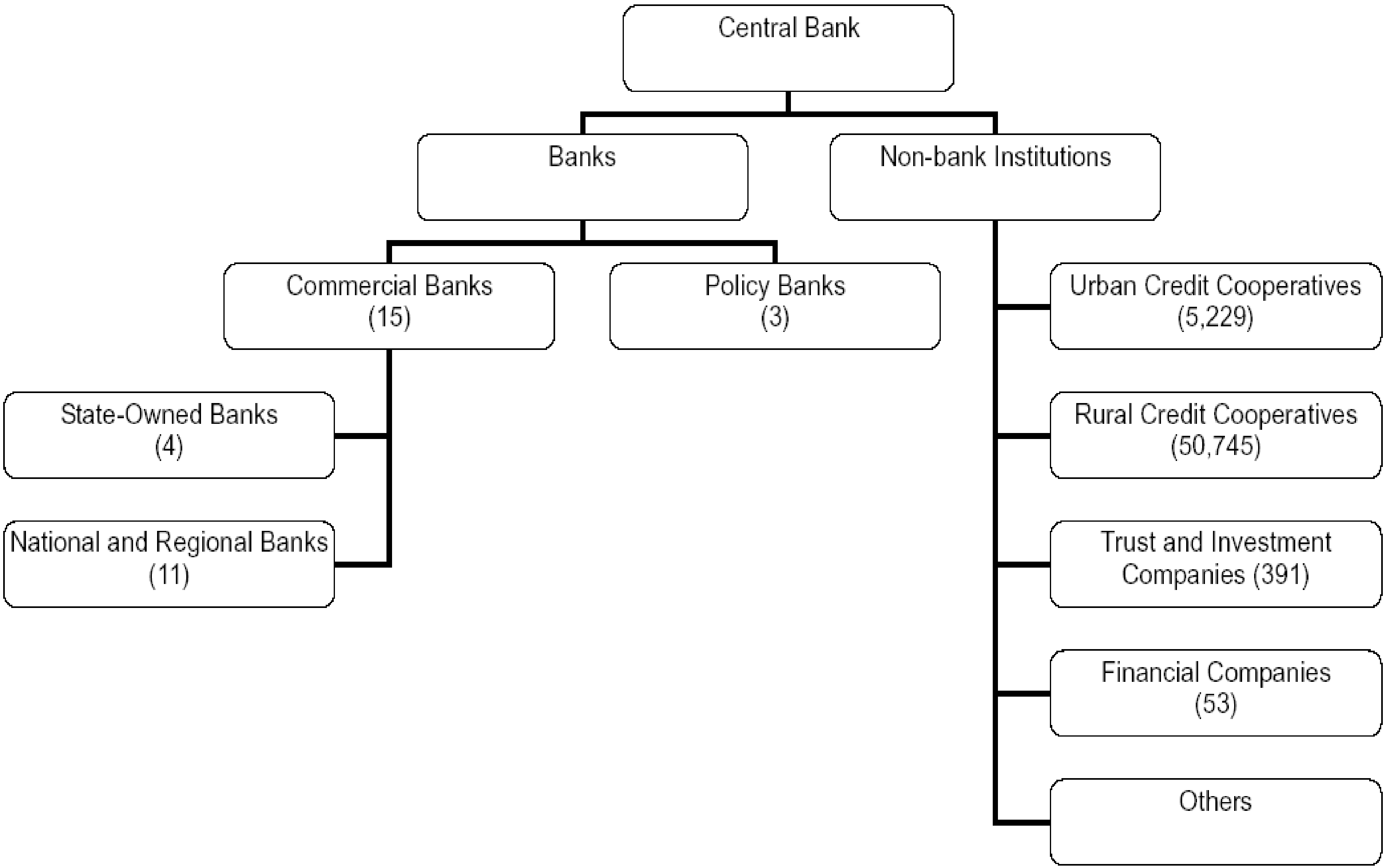
- Reform initiatives (as part of its WTO accession):
  - 13 cities have been opened for foreign banks to conduct “renminbi” business
  - 100 eligible foreign banks were permitted to conduct “renminbi” business
  - 55 of them were allowed to provide “renminbi” services to the Chinese enterprises
- Recapitalization of state banks
  - 4 asset management companies set up in year 2000 to take over US$1,600 billion of non-performing loans
  - US$1108 billion NPLs disposed up to March 2006,
  - cash recovery rate 20.8%
  - US$45 billion capital injection in 2004 for BOC and CCB
  - US$15 billion capital injection in 2005 for ICBC

Reforming Chinese banking system (5)

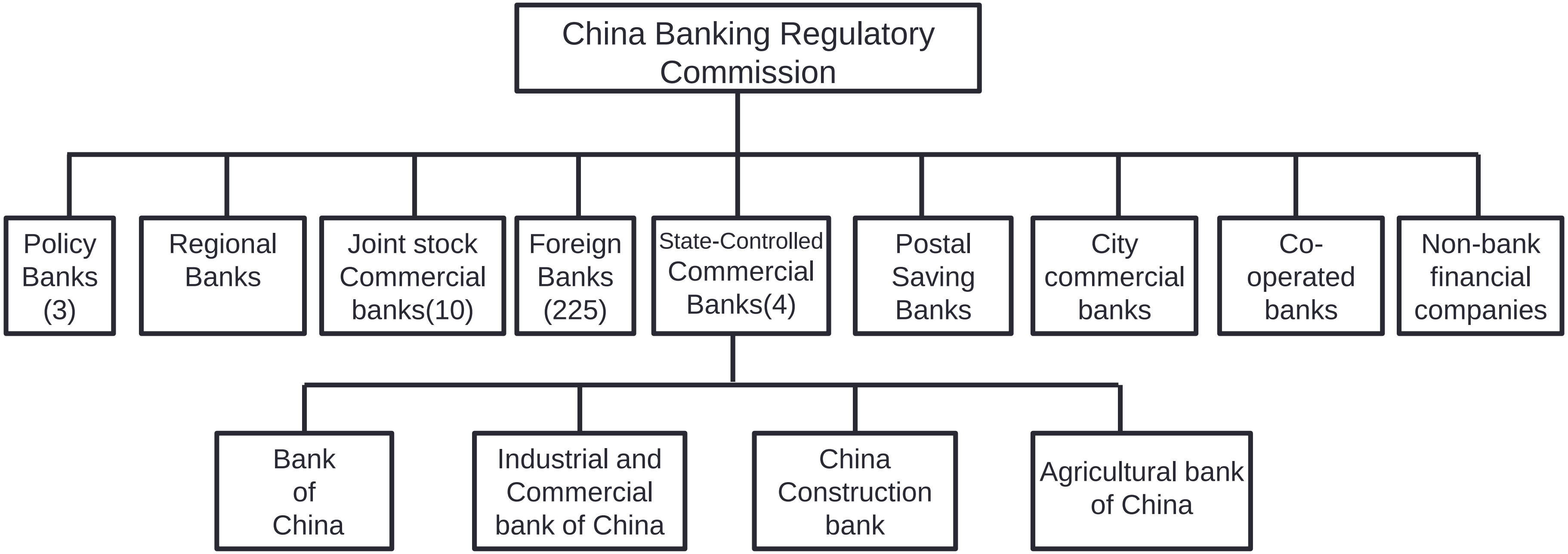
Phase Four (2006-?)

- 2006 – removing of all geographic and (most) business restrictions for foreign banks. Foreign Banks allowed to provide 12 categories of services in China. Nevertheless they play rather small role
- The permitted equity holding in Chinese financial institutions by a single foreign investor has been raised from 15 to 20%, while the maximum foreign equity holding remains at 25 %
- CCB listed in Hong Kong in 2005, BOC and ICBC in 2006
- Reorganization and recapitalization of China Agricultural Bank and Postal Savings Bank for listing

Design of the banking sector

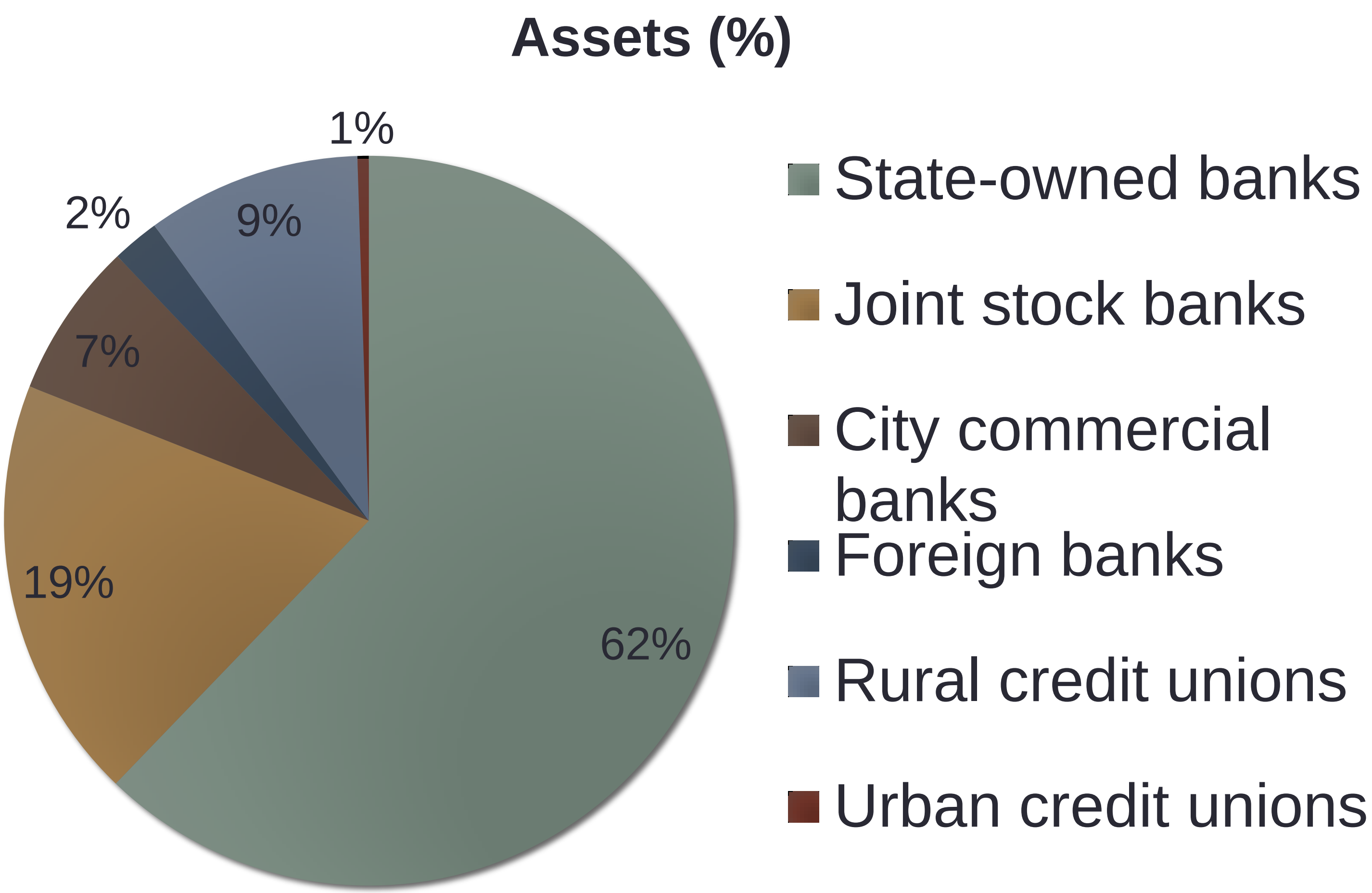


Chinese banking system



- The assets of the banking sector account for around 95% of the total assets of all financial institutions in China.
- 62% of the fixed-asset investment in China are funded by banking Sector.
- The big four SOE banks are the major players in the Chinese financial market, with their assets accounting for 52.7% of the total bank assets in China.

State dominance in the banking industry (2006)



Banks in China

- State-owned banks: ICBC, CCB, BOC, ABC
  - 70% of all assets in the Chinese financial system
  - Among the largest 25 banks in the world (in total assets)
  - Owners of large amounts of equity in Chinese corporations
  - Hold over 70% of all bonds issued in China
- Joint stock banks: Bank of Communication, China Merchants Bank, Guangdong Development Bank, Minsheng Bank
- City banks and credit unions: Bank of Shanghai, Bank of Nanjing, Ningbo Commercial Bank
- Foreign banks: HSBC, Citibank, Standard Chartered

Weak bank performance creates vulnerabilities

Root causes of weak performance

- Lack of transparency
- Weak governance and lack of commercial mindset
- Operational weaknesses in lending and risk management
- Decentralized structure with local autonomy
- Underground lending

Key vulnerabilities

- Renewed NPL build-up
- Sharp reductions in liquidity and profitability, due to concentration of profits, from:
  - Foreign bank entry
  - Corporate bond market development
  - Real estate exposure

The non-performing loan problem (NPL)

- A residue of casualties of economic reform
- The Government's response a combination of:
  - Worst loans moved to asset management companies ("bad banks")
  - Capital injections
  - Enhancement of recovery rates
  - Restrictions of "political" lending

Key challenges for Chinese banking system

Fundamental banking industry reform is far from complete

- Ensure large state-owned banks, that have been cleaned up and recapitalized, do not repeat past mistakes
  - Upgrade management expertise
  - Improve risk management and internal control
  - Adopt risk-based pricing
  - Implement proper incentive system
- Further lower high NLP ratios and address thin capitalization of other underperforming banks
- Eliminate influence by central and local governments (introduce real competition, reduce corruption)
- Further improve regulatory/legal framework (for example, deposit insurance)
- Improve retail banking

Financial markets

- Two domestic stock exchanges:
  - Shanghai Stock Exchange Market (SHSE)
  - Shengzhen Stock Exchange Market (SZSE)
- At the end of 2005, the combined total market capitalization of the SHSE and SZSE ranked 15th among the largest stock exchanges in the world, 2007 – the 5th.
- Bond Markets: government bonds, “policy financial bonds”, corporate bond
- Private Equity/Venture Capital
  - In years 2000-2007 the performance of the stock markets has been volatile
  - This is somewhat surprising given the robust performance of the real economy

Chinese capital market

- 1540 publicly listed companies on domestic exchanges, 143 on overseas (Feb 2007)
- Equity market capitalization of around US$3 trillion (2007)
  - State Shares 33.1%, (non-tradable until 2005)
  - Legal person shares 16.7% (non-tradable until 2005)
  - Tradable individual shares 50.2%
- Government bond market cap US$ 364 billion
- Corporate bond market cap US$35 billion

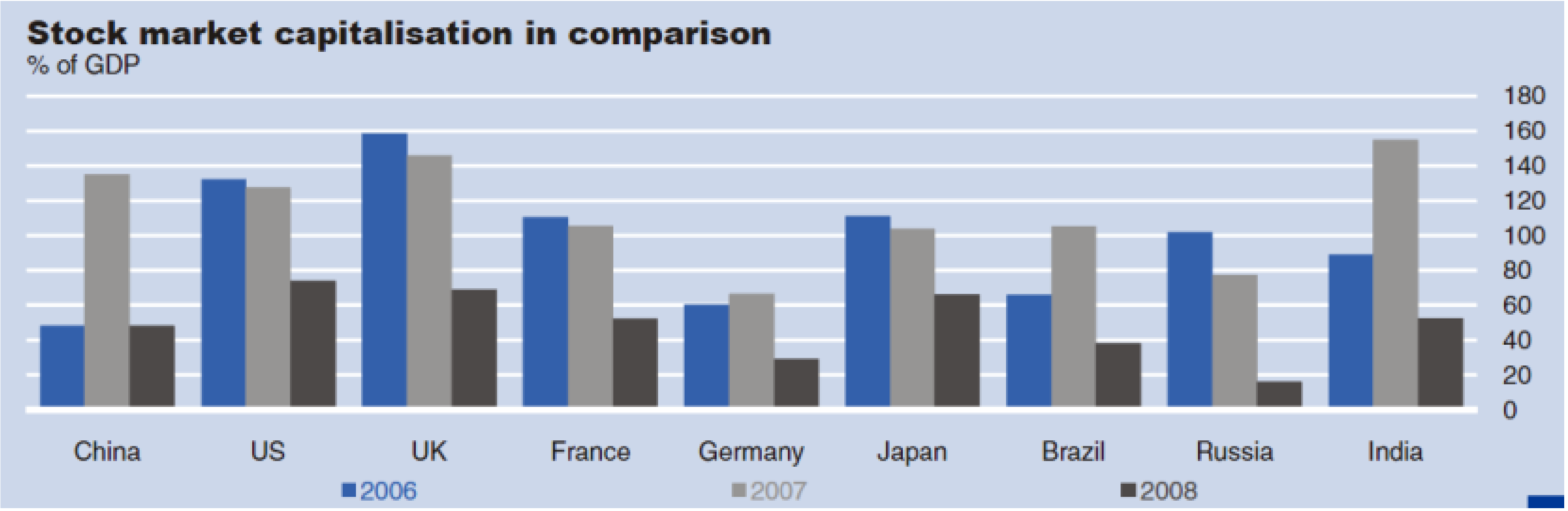
Equity market

- Great Leap Forward in Equity Market
  - An average of US$9 billion raised per year from 1991 to 2006
  - In 2007, $50 billion new A-shares were issued, taking the first place in the world (the second place US equity markets raised less than $40 billion in 2007)
  - Shanghai Stock index increased by almost 100% in 2007
- Private Equity
  - Size estimated around 620 billion RMB in 2007, much of it comes from abroad
- Enormous Potential
  - Great demand in a vibrant economy for private equity
  - High risk and cost due to poor legal and financial infrastructure

Chinese stock market reform

- Before 2005, state-owned and legal person-owned shares could not be traded on stock exchanges. Large shareholders paid little attention to the prices of tradable shares held by the public
- In 2005, the government initiated reforms that made non-tradable shares tradable.
- This aligned the interests of large shareholders with that of outside shareholders

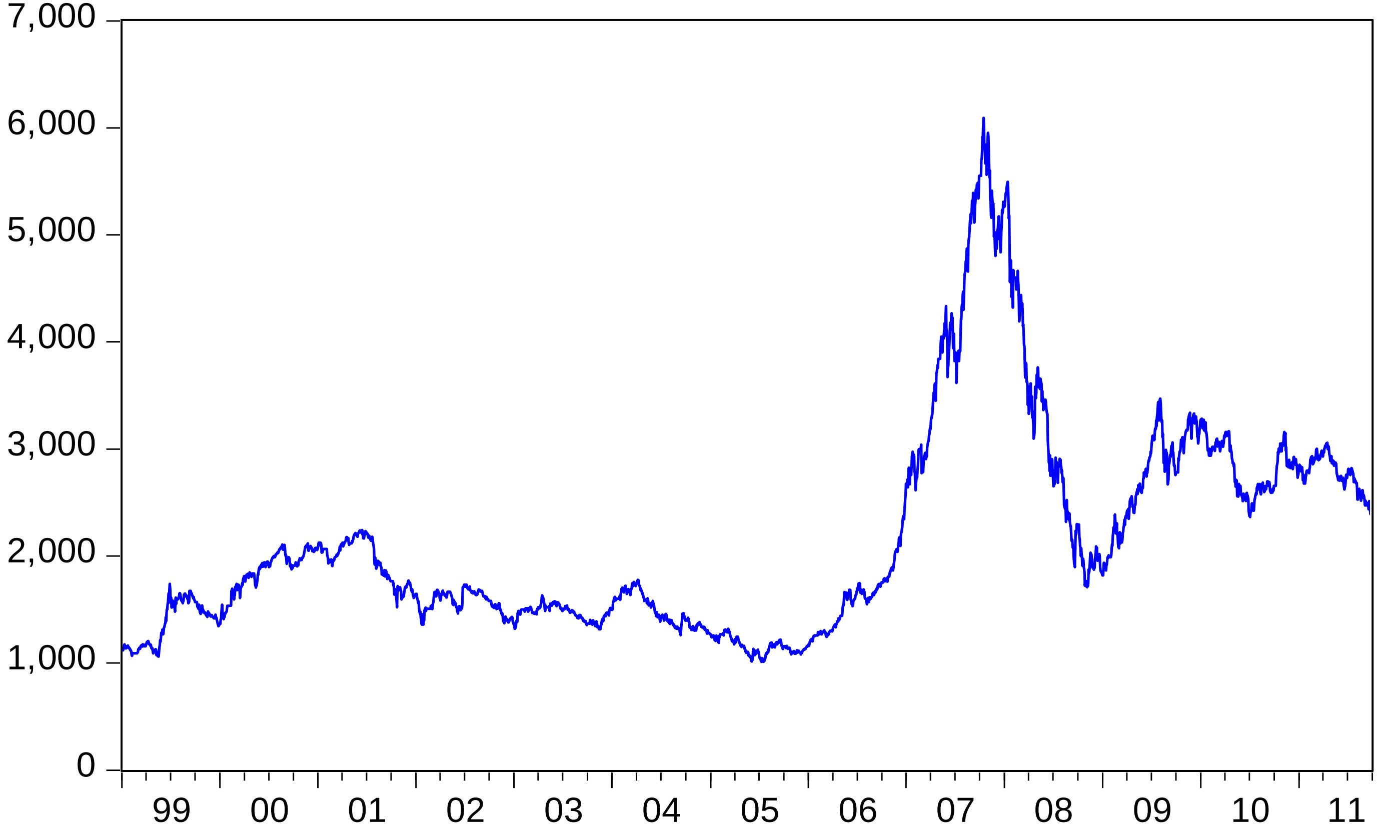
Equity market



- Starting in 2006, China's stock markets witnessed a stellar rise. Average daily trading volume reached USD 26 bn, making it one of the most actively traded markets worldwide.
- After the stock market started to correct in October 2007, market capitalization declined to around 50% of nominal GDP as of end-2008. Trading activity also dropped, reaching USD 17 bn on a daily average basis

Shanghai Stock Exchange

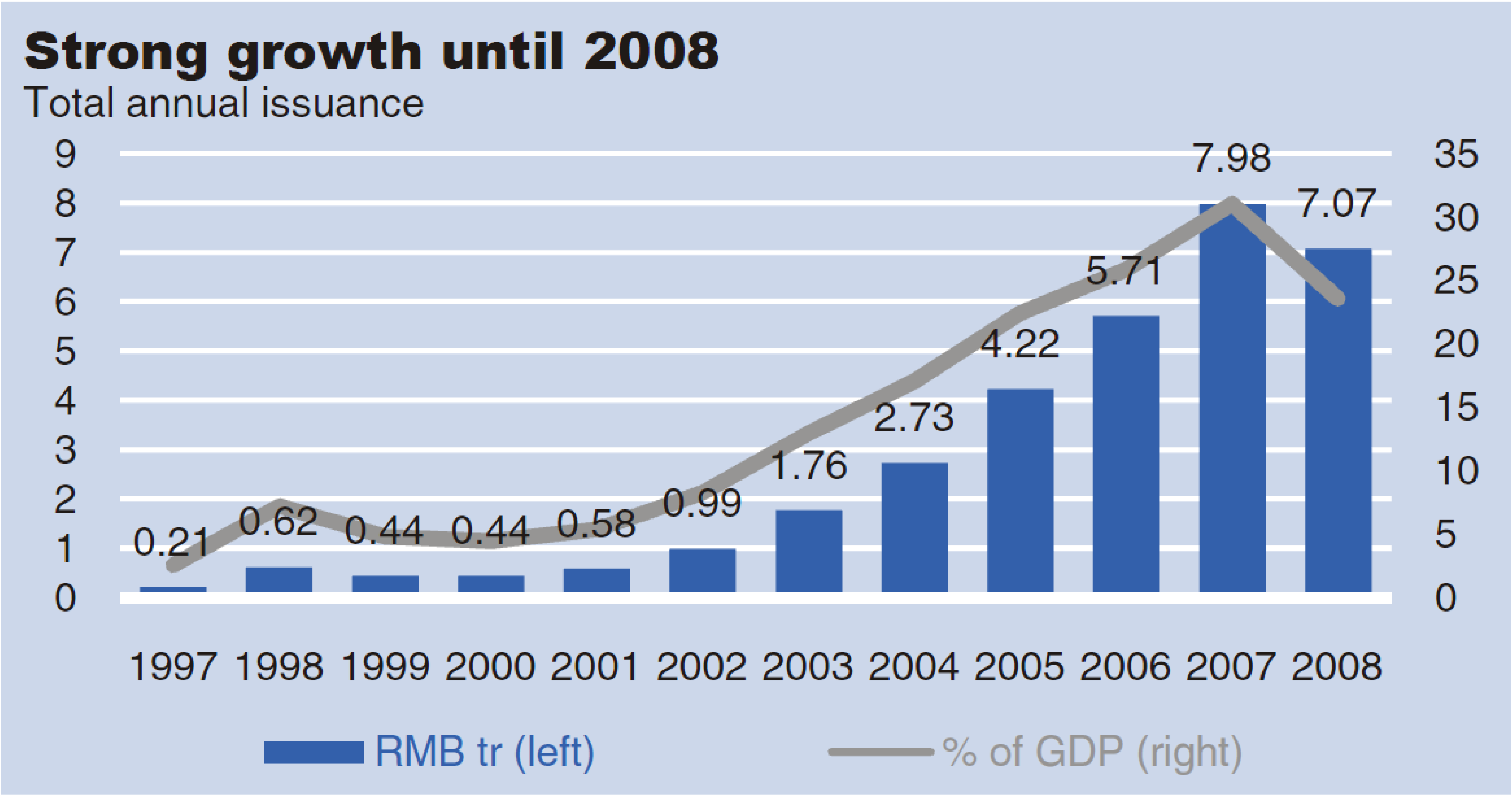
- Founded in 1891, closed in 1949, reestablished in 1990



Share categories

- Non-tradable shares (until 2005)
  - Legal person shares
  - State-shares
- Tradable shares
  - A-shares: denominated in RMB
  - B-shares: denominated in US$ and HK$
  - H-shares: PRC-registered listed in HK$
  - Red-chips: Chinese companies registered overseas and listed in Hong Kong

Bond market



Strong growth until 2008
Total annual issuance
9
8
7
6
5
4
3
2
1
0
35
30
25
20
15
10
5
0
0.21
0.62
0.44
0.44
0.58
0.99
1.76
2.73
4.22
5.71
7.98
7.07
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
RMB tr (left)
% of GDP (right)

Bond market

- Although total annual issuance has surged since the early 2000s China's bond market is still relatively small as a share of nominal GDP (35% in 2007) especially when compared to mature economies
- Public sector issuance dominates. People's Bank of China (PBC) and treasury bonds accounted for almost 80% of total issuance in 2007
- Domestic commercial banks are the major players in China's local bond market, holding close to 60% of the total amount outstanding

Financial regulations (1)

- **Entry regulations**
  - Geographic and business restrictions for foreign banks and insurance companies
  - Foreign stake in commercial banks capped at 25%
  - Foreign partners can take up to 33% in brokerage firms and fund management companies
  - Approval required for branches & offices
  - License required for domestic institutions
  - Private individuals can only have a minority position

Financial regulations (2)

- **Interest rate regulation**
  - Both lending and deposit benchmark rates are set by the central bank (one year lending rate is now 7.47% and deposit rate is 4.14%)
  - Lending rate has no upper limit and the lower bound is 90% of the benchmark rate. The rates for mortgage loan can be 85%.
  - Deposit rate has the benchmark rate as the upper limit and is allowed to float downward.
  - Interbank rate SHIBOR was introduced on Dec. 1, 2006 and determined by market forces

Financial regulations (3)

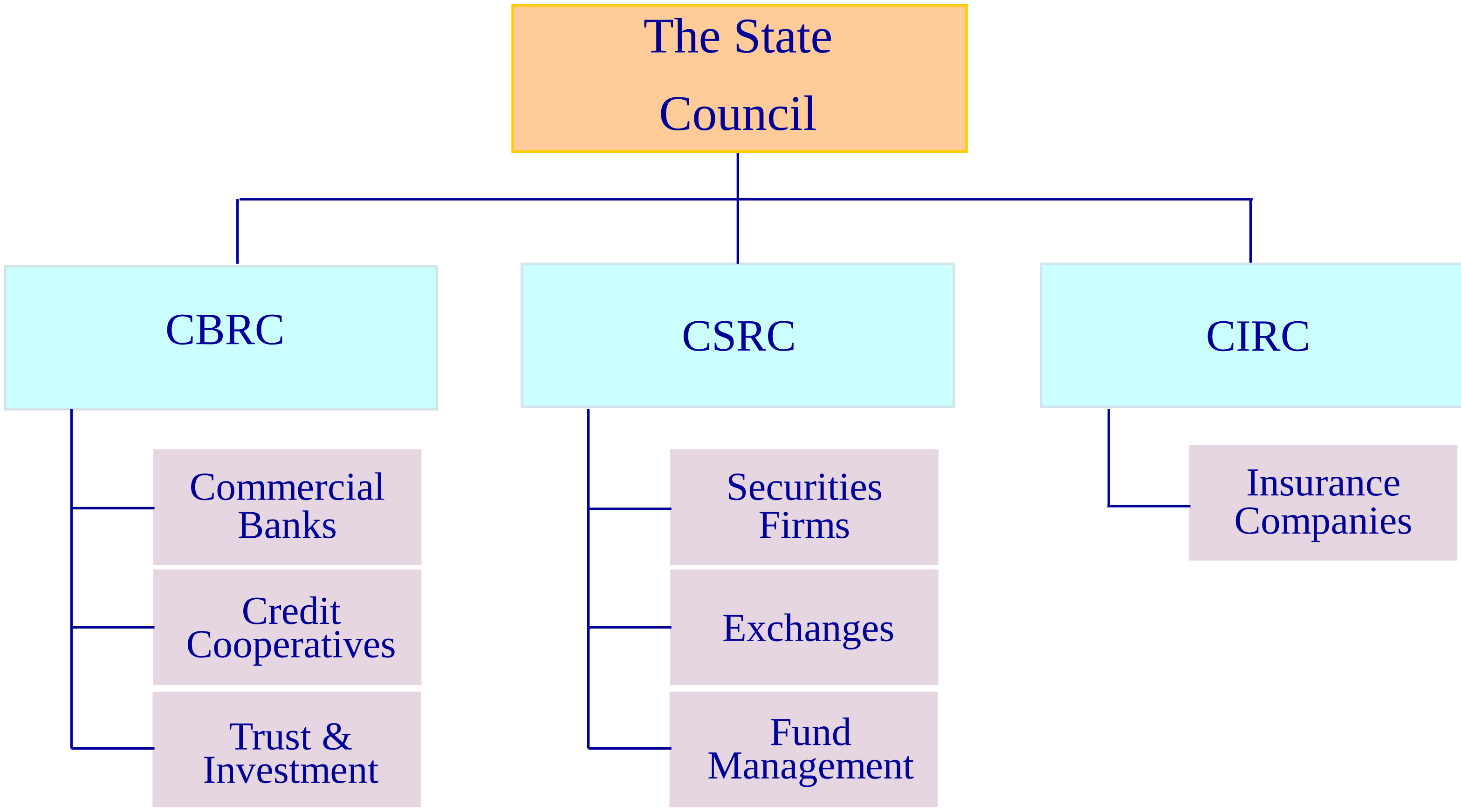
- **Regulation of international accounts**
  - Current account deregulated
  - Closed Capital/Financial account with a few exceptions
- **Managed floating exchange rate regime**
  - The RMB pegged to USD at RMB 8.27/USD from mid-1990s to 2005
  - It is supposed to be pegged to a basket of currencies since July 21, 2005
  - The RMB/US$ exchange rate allowed to float no more than 0.5% of the previous day’s closing, 1.5% against other currencies
  - No timetable for full convertibility

Financial supervisory bodies

- The China Securities Regulatory Commission (CSRC in end of 1992)
- The China Insurance Regulatory Commission (CIRC in 1998)
- The China Banking Regulatory Commission (CBRC in 2003)

A joint mechanism has been developed among the CBRC, the CSRC and the CIRC for co-operation among themselves

Financial regulatory structure



Key challenges for Chinese financial markets

- Availability of information for investors (information disclosure / transparency)
- Institutional investors' involvement in the market development
- Problem of insider trading
- Monitoring and control of credit rating institutions
- Minimization of the financial panic
- Encourage small banks to raise capital
- Development of the corporate bond market
- Government intervention

China's financial system (1)

- Financial institutions
  - Policy banks
  - Commercial banks
    - state-owned
    - partially state-owned
    - private-owned and foreign
  - Non-bank financial institutions
    - RCC, UCC, Postal Savings
    - TIC, Mutual Funds, Finance companies
- Non-standard financial sector
  - Informal Financial Institutions

China’s financial system (2)

- Financial Markets
  - Stock market (SHSE, SZSE, HKSE)
  - Bond market
    - Government bond
    - Corporate bond
  - Venture capital
  - Real estate
- Foreign sector (FDI)

Main characteristics of China’s financial system

- China has made steady advances in modernizing its financial system and in mobilizing savings, reflected in the doubling of China’s stock of financial assets relative to GDP over the past ten years
- China’s banking sector plays a large role in its financial system
- Capital allocation in the system is poor: wholly and partially state-owned companies continue to absorb most of the funding from the financial system, while private enterprise, the engine of China’s growth, receives a disproportionately small share. As a result, China’s investment efficiency is declining
- China’s financial system’s remaining problems are intricately linked across its component markets, and will therefore require an integrated approach to reform

Is China’s financial system sound and safe?

China’s economy is experiencing the fastest growth in the world, and is expected to maintain a relatively high growth in a considerable long period. With further implementation of financial sector reforms and liberalization of the sector, China’s financial sector has the potential to achieve the fastest growth in the global context

Financial crisis in China?

- Possible spike in NPLs
- General inefficiency of the banking system
- Potential asset bubbles
- Sovereign default risk
- Crisis of confidence caused by endemic corruption

Key challenges for financial system

- Banks still serve as the primary channel for corporate financing with very limited ability to lay off risks outside the banking system
  - Domestic stock market is growing
  - Domestic bond market remains underdeveloped
- Emerging universal banking trend poses increasing complexity for regulation
  - Banks are allowed to set up asset management companies
  - Underground lending
- The biggest issues are probably cultural
  - Credit focus, not formula lending allocations
  - Creative tensions within banks, and between banks and regulators
  - Institutional loyalties

Readings for the next topic

1. Perotti, E.C. (2002). Lessons from the Russian Meltdown. The Economics of Soft Legal Constraints. *CEPR Policy Paper No. 9*.
2. Guriev, S. and A. Rachinsky (2005). The Role of Oligarchs in Russian Capitalism. *Journal of Economic Perspectives*, vol. 19(1), pp. 131–150