

BUILDING “HEALTHY FINANCE AND BANKING SYSTEM”

--The perspectives of China finance and banking reform

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Preface

- ◆ In my opinion, the direction of Chinese finance and banking sector reform is to strengthen the risk management on global scale, nation scale and organization scale.
- ◆ In the globalization process of financial industry, it is urgent for China to build a healthy finance and banking system. The main problem is how to define the “healthy” degree and how to evaluate the potential risks precisely. Now we are conducting a research programme-”healthy finance and banking assessment”-aimed at building an analytical framework to quantify the evaluation factors.
- ◆ The next few years is a crucial time for Chinese banking sectors. On the one hand, the implementation of Basel II will provide a good opportunity to improve banking risk management. On the other hand, the tremendous risk culture changes, organization governance shocks and huge implementation cost will surely challenge our fragile banking industry.



Outlines

- ◆ The retrospect and main experience of China's finance reform
- ◆ Goal of future reform –to establish a healthy finance system
 - Evaluation indicators of healthy finance system
 - Healthy evaluation of Chinese finance system
 - The implicit risks of China's finance system
- ◆ The direction of healthy finance development



The retrospect and main experience of China's finance reform

1. The retrospect of China's finance reform

- ◆ Five stages in the progressive reform road
 - The reform of banking structure(1978-1984):central bank, four main state-owned specialization banks, rural credit cooperation network, non-bank financial institutions (trust company) started operation.
 - Further development of banks and non-bank financial institution (1984-1988) :great efforts had been made to develop the infrastructure of banks and non-bank financial institution so that the financial market came to a competitive state. There were 1200 city credit cooperatives and many non-state owned commercial banks (Bank of Communication, CITIC industrial Bank). Some foreign banks were allowed to open branches in china.
 - Financial stability and the development of capital market(1988-1991):government strengthened the management of financial market. Many non-bank financial institution experienced merger, acquisition and bankruptcy. Stock exchange came to existence.(Shang Hai-1990, Shen Zhen-1991)



1. The retrospect of China's finance reform

- Commercialization Stage(1992-1998): The establishment of policy bank had separated the policy-related business from banks, which meant the start of chinese banking commercialization process. Further development of financial legal system: law of the people's bank of China, Commercial Bank Law of China.
- Deeping stage of finance marketization (1998-now) : build the financial system according to the modern enterprise system and international banking standard.
 - The establishment of modern banking supervisory system
 - Asset divestiture and capital injection to improve banks' anti-risk ability
 - Shareholding system transformation to improve modern banking governance.
 - Introducing international strategic investment and turning to listed to catch up with the development trend of international finance industry.
 - The reform of policy banks to improve efficiency and create the fair competition environment.
 - Propelling the new capital accord implementation, aiming at the long-term sustainable development of banking and financial stability.

2. Experience sharing of China's finance reform

- ◆ **It is rather difficult to rebuild a modern financial system in a developing country which is at the primary stage of its market economy like China. It is necessary to:**
 - Specify the ultimate goal of finance reform
 - Serving nation's sustainable development strategy and social-economy development goal
 - Establishing the modern financial system meeting the needs of social economy development. Managing risks in a progressive way.
 - Effective equilibrium between the social objectives and banking reform objectives
 - The establishment should take the internal and external condition into consideration, and try to make a balance of goals of parties involved.

II、 Creating assessment process of Chinese financial sector

Note : sourcing form research paper 《 Financial sector “health” research report 》 (2006-2007) jointly finished by CDB and Institute of finance and banking, China academy of social science

1. Assessment indicators of “healthy financial system”

Absorbing deposit institutions	
CAR factors	regulatory capital /RWA
	regulatory capital Tier 1 /RWA
Asset quality factors	NPL ratio
	(NPL-provisions)/capital
	loans to different departments/total loans
Income and profitability factors	ROA
	ROE
	interest income/total income
	Non-interest income/total income
Liquidity factors	liquidity asset/total asset
	liquidity asset/liquidity liability
Sensitivity to market risk	net foreign currency exposure/capital

Supplementary factors	
	Capital/asset
	financial market transaction income/total income
	salary, payment expenditure/non-interest expenditure
	margin between deposit and loan
	saving deposit/total deposit (excluding interbank deposits)
	foreign currency loan/total loan
	foreign currency deposit/ total deposit
	equity investment/capital
	loan regional distribution and concentration
	deposit regional distribution and concentration
Other financial institution	asset/total financial asset
	asset/GDP
Non-financial enterprise department	
	liability/capital
	ROE
	income/interest and principal expenditure
	net foreign currency exposure/capital
	times to seek support form obligee
Family department	family department's debt/GDP
	interest and principal expenditure/income
Market liquidity	mean bid-ask spread in stock market
	daily switch ratio in stock market
Real estate market	real estate price

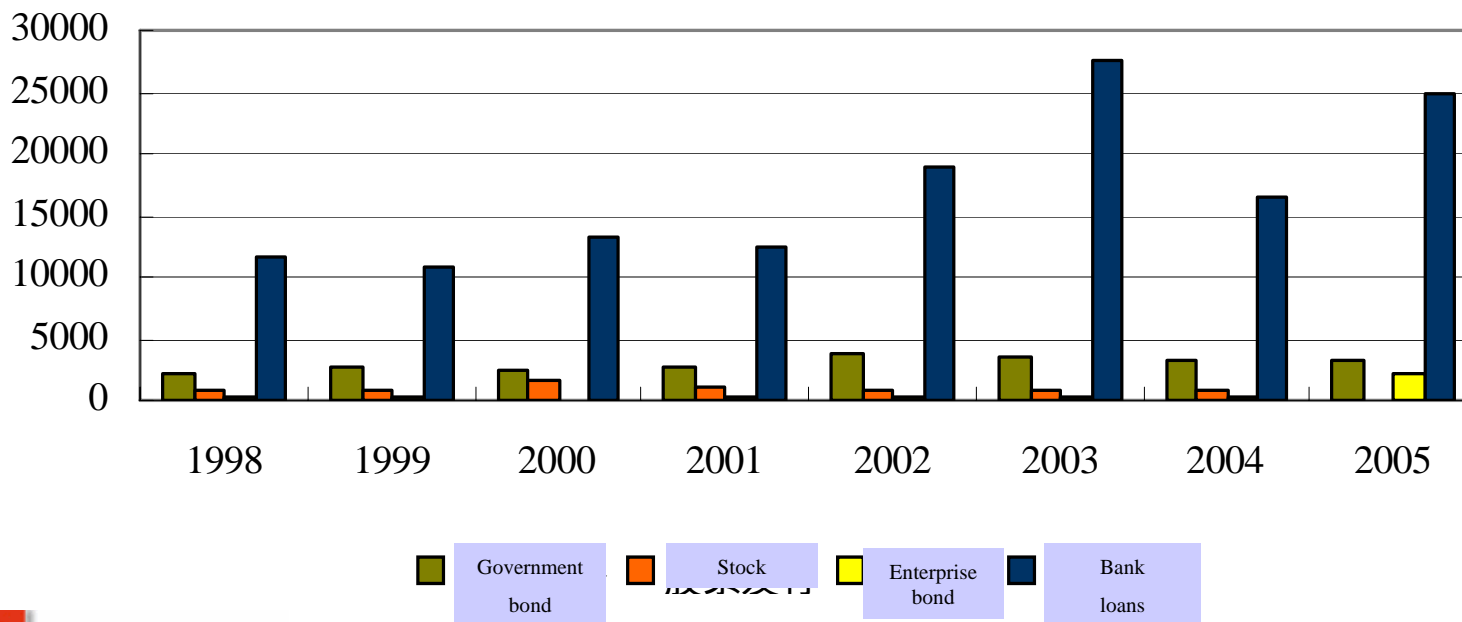
2. Healthy evaluation of China's financial system

- ◆ Evaluation methodology:
 - Based on the Financial Soundness Indicators (FSI) of IMF, we build the assessment indicator framework as above.
 - Certain model are built by means of Analytic Hierarchy Process (AHP) to determine the indicator weight.
 - Evaluation of the financial system and conclusion explanation.
- ◆ Overall evaluation: Relative healthy status. Financial system operation are relative stable. There is no obvious risk or fluctuation, and the driving effects to the real economy is quite positive. But there are many partial problems in the financial system. Structural imbalance limits the function and efficiency of the system. Furthermore, in the long-term, the accumulation of the imbalance may lead to the erupt of financial risks.
- ◆ To be specific, there are different imbalances in China's financial system such as the imbalance in financial structure; the imbalance in money regional allocation; the imbalance in financing subject structure; the imbalance in the financial market structure. This condition can be precisely described as sub-health.



2.1 Healthy evaluation of China's financial system-- the imbalance in financial structure

- ◆ There are two main financing methods: direct financing and indirect financing. General speaking, banks dominate in indirect financing, while financial market dominates in direct financing. In global scale, financial structures in different countries are quite different and there is no best objective standard. But in general, the development of financial market and direct financing seems to be a global trend. The financial market and direct financing scale has experienced a fast development during past decades even in countries where banks dominate (German and Japan), and its status and function has been strengthen substantially. Compared to developed countries, China's direct financing level is rather low. The number of direct financing tool is far behind that of bank loans.



2.2 Healthy evaluation of China's financial system--the imbalance in money regional allocation

- ◆ Financial development imbalance of town and countryside : the development is quite imbalance and is becoming more worse. Rural financial restraint is serious.
 - The merging of financial institutions in country-level led to the shrinking even the “hollowing” of country-level financial system. Many regions only have one financial institution-the rural credit cooperatives.
 - Credit funds from banks is insufficient, and money flows out from rural continuously.
 - Financial function is weak in rural areas. Basically, there is only tradition deposit-loan business. The financial product and service such as intermediate and foreign exchange business is few.
 - Capital market can hardly reach the rural areas.
- ◆ The finance development imbalance among East, Middle and West region.
 - On the one hand, in the state-owned equity dominated financial system, the financial institution is set in regionalism. As a result, the organizational structure in developed region is almost the same as that in less-developed region. It inevitably led to a waste of financial resource.
 - On the other hand, credit is over-allocated to the East region. The credit allocation in middle and west region increased slowly or even in a decline trend. This can not help to reduce the disparities in regional economy. “Matthew effect” in market economy comes to existence.



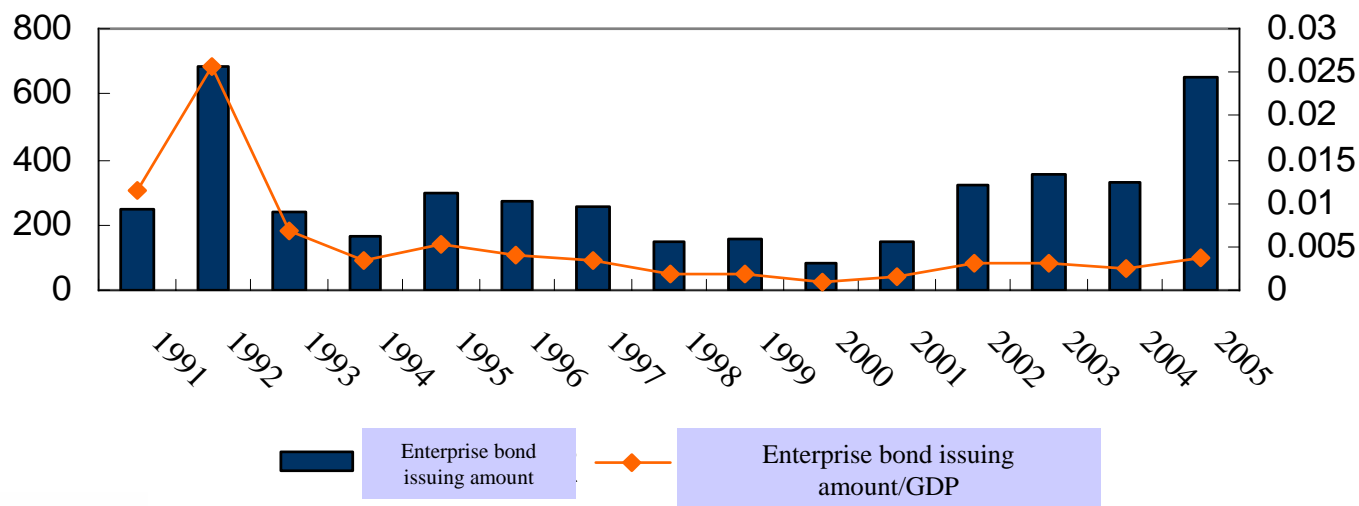
2.3 Healthy evaluation of China's financial system-- the imbalance in financing subject structure

- ◆ There are two points in the imbalance in financing subject structure. First, most society credit flows to enterprise departments. The proportion of financing amount in resident section is rather low. Second, in the enterprise departments, large enterprises get most of the credit. SME are still facing serious credit limit.
- ◆ Enterprise department has the largest credit need in China. One reason is enterprise has substantial credit need. Another reason is that under the old financial system, banks are more likely to operate wholesale business with enterprise by purchasing short-term profit. While the credit that resident section can get is rather limited. However, more and more banks pay attention to the retail financial market and adjust their business strategy according to the fast increase of the financial need of resident section.
- ◆ From the interior of enterprise departments, credit from banking institutions is still concentrated in large-middle size enterprises. Large enterprises are dominated in the issuing of direct financing tools (enterprise bonds, stock, short-term financing bills) . In a word, the SMEs which need credit support most can not find proper financing channels. The structure of financing supply and demand is in serious imbalance. To some extent, this may hurt the potential of long-term economy development.



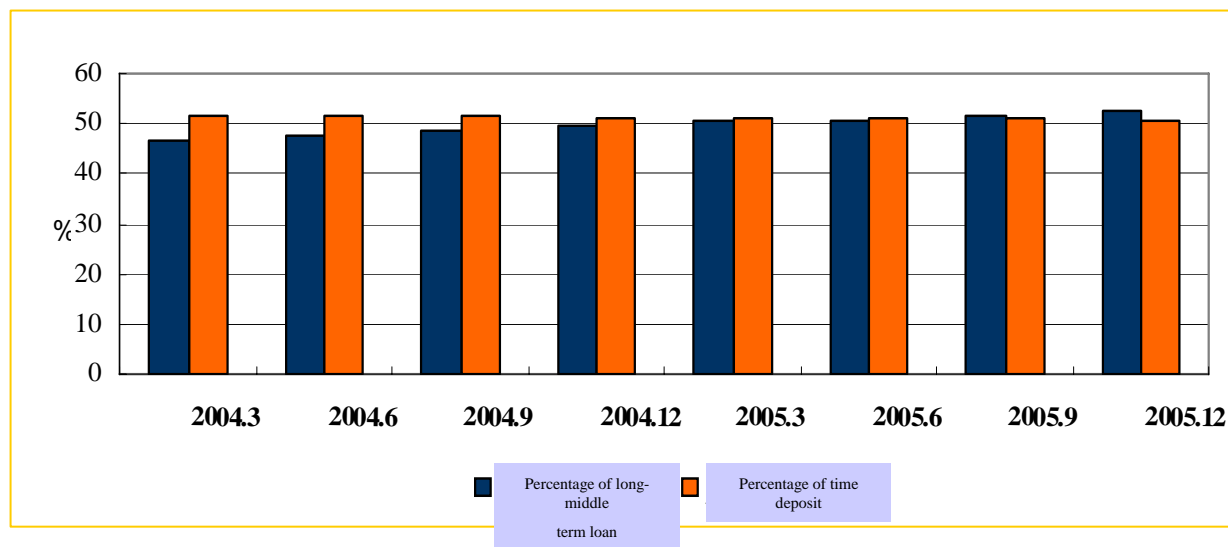
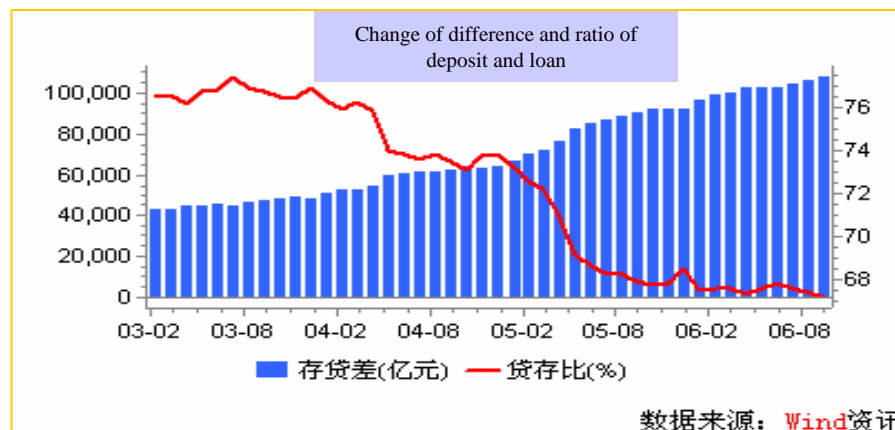
2.4 Healthy evaluation of China's financial system-- the imbalance in the financial market structure

- ◆ China has established relative comprehensive financial market system now. But there are rather imbalance internally. Long-term capital market develops slowly and can hardly satisfy the economy development needs. To be specific, it refers to the slow development of enterprise bonds market and the lack of municipal bonds market.
- ◆ The enterprise bonds. The issue amount has been at a low level since 1992. there is almost no increase in this period. The ratio to GDP has remained very low too. The enterprise plays a limited role to support the economy development. In 2005, the issue amount increased substantially, but still lower than that in 1992.
- ◆ The municipal bonds. With the urbanization process acceleration, local government takes large duties to provide public service and improve basic infrastructure. As most of the basic infrastructure is capital-density, the credit that local governments can get can't meet the construction needs. As a security issued by governments and deputies to fund local basic infrastructure and public project, municipal bonds is a widely applied tool by western governments to financing the basic infrastructure. But in china, the issue of municipal bonds still lacks of support of relative law and policy. Hence, the market is absent now.



3. Implicit risk in financial system

- ◆ Macroeconomic operation
- ◆ Banking department
 - Risk concentration
 - Single asset structure
 - Single payoff structure
- ◆ Enterprise department
 - High debt ratio
- ◆ Resident section
 - Unreasonable funds application
- ◆ Regional economy
 - Growth gap
 - Growth mode gap
 - Urbanization level gap



III、 The future perspectives of Chinese financial system reform

1. Establishing financial system with the core of investor protection and market orientation

- ◆ Transformation from producer-dominated to investor-dominated
 - State-owned enterprises, state investment, state ownership , unclear property
 - Modern commercial banks should maximize shareholder's value and configure resource reasonably.
 - To maximize shareholder's value is to protect investors in maximal degree
 - As the intermediary between deposit and investment, banks should be investor-protection oriented.
- ◆ Marketization business mode and management concept need to be strengthened.
 - Governance structure needs to be improved.
 - Sensitivity to market and business expanding ability need to be improved



2. Improve the overall risk management ability at the moment of the new capital accord implementation

- ◆ The new capital accord implementation in China will greatly improve chinese banks' risk management ability, at the same time greatly challenge chinese banking industry.
 - Challenge to governance structure
 - Challenge to risk management policy and management structure
 - Challenge to risk management method and standard
 - Challenge to risk management culture
 - Challenge to business operation and profitability mode
 - Adjustment to asset-liability structure
 - Adjustment to income structure
 - Adjustment to resource allocation mode
 - Risk management tools innovation

3. Increase financial accessibility and provide better service to rural, retail and SME

- ◆ Financial accessibility should be improved both in width and in depth to meet the need of equity and harmonious development of society
 - Rural finance : establishment of rural banks and the improvement of cooperative banks and rural credit cooperatives will help to develop rural finance. But new operation mode should be innovated to reach the equilibrium between risk and profit.
 - SME: Banks' SME business mode should be improved, with the development of social credit system, development of core technology and network of SME loan, and data accumulation.
 - Retail banking: The expanding of consumption credit has been a difficult problem in China, to some extent will influence the direction of Chinese finance. Great efforts should be made to guide the business.





Thank You !

