China Financial Stability Report 2013

Financial Stability Analysis Group of
the People's Bank of China

China Financial Publishing House

Members of Financial Stability Analysis Group of PBC

Head: LIU Shiyu

Members:

CHEN Zhi	FENG Juping
HE Jianxiong	JI Zhihong
LI Bo	LI Yue
MU Huaipeng	SHAO Fujun
SHENG Songcheng	WANG Yi
XIE Duo	XUAN Changneng
ZHANG Xiaohui	

Steering Group

LI Yong	WANG Zhaoxing
ZHUANG Xinyi	CHEN Wenhui

Contributors to This Report

Chief Editors:	XUAN Changneng	TAO Ling	LIU Xingya
	LIANG Shidong	HUANG Xiaolong	
Editors:	TAO Ling	YANG Liu	YANG Xiaojun
Authors:			
Chapter I:	DING Kang	QI Zhe	QI Fan
	FAN Shilei	LIU Xiangyun	MA Zhiyang
	CHEN Jun	ZHANG Shuangchang	
	WANG Zuogang	ZENG Yuanyuan	
Chapter II:	CHEN Jianxin	ZHAO Min	ZHAO Bingzhe
	HONG Bo	ZHANG Shuangchang	
Chapter III:	MENG Hui	LI Minbo	XU Yue
	CHEN Mian		
Chapter IV:	WANG Shaoqun	CHEN Min	
Chapter V:	LAI Yongchao	DONG Ziying	LI Lin
	JIAN Na	NIAN Siwu	
	ZHANG Shuangchan	MENG Hui	LI Minbo
	XU Yue	CHEN Mian	
Chapter VI:	LIU Ke	WEI Lijun	ZHAI Chun
	SHI Chunhua	YUE Dong	TANG Tao
	DING Kang		
Chapter VII:	ZHANG Weihua	WU Bin	SUN Yi
	HUANG Shanshan	DU Jing	CHU Xiaoyan
	WANG Xiaoqing	QI Jianhui	
Chapter VIII:	HU Ping	XIE Dan	LIU Jie
	WANG Yu	REN Qiuyu	LI Bin
	WU Ge	WEN Junwei	JIA Yandog
Special Topic I:	CHEN Jianxin	LIU Bo	LI Da
	XU Yue	ZHOU Juntao	
Special Topic II:	LIN Wenshun	WANG Wenjing	

Special Topic III:	CHEN Jiming	LI Jianqiang	LIN Wenshun
	HONG Bo		
Special Topic IV:	CHEN Jianxin	YANG Liu	HU Ping
	YE Mao		
Special Topic V:	OUYANG Changmin	LIU Qin	LIU Jie
	WU Da		
Appendix:	ZHAO Min	LIU Liu	GAO Huiying
	HAN Lu		

Other Contributors:

BAI Wenmei	GUO Dayong	LIU Beibei
MENG Shaoling	QU Tianshi	SHANG Xiao
SHEN Liming	TANG Jianbing	WANG Zunzhou
WU Yun	ZHU Yanyu	

Contributors to English Edition[1]

Chief Editors: XUAN Changneng TAO Ling

Editors: YANG Xiaojun HU Ping

Translators:

Executive Summary:	CAO Zhihong
Chapter I:	LIU Wenzhong
Chapter II:	ZHAO Bingzhe
Chapter III:	XU Yue CHEN Mian
Chapter IV:	QI Fan
Chapter V:	ZHANG Ling
Chapter VI:	PENG Chunhui
Chapter VII:	QI Zhe
Chapter VIII:	HU Ping
Special Topic I:	LIU Beibei
Special Topic II:	REN Hao
Special Topic III:	WANG Beijie
Special Topic IV:	YANG Guanyi
Special Topic V:	LIU Qin
Appendix:	LIU Beibei

Other Contributors:

CHEN Min	CHEN Ying	DAI Ze
LI Da	LIU Jie	LIU Liu
QU Tianshi		

[1] This English edition is an unofficial translation of the *China Financial Stability Report 2013*, which was published in June 2013. In case of any discrepancies, the Chinese version shall govern.

Executive Summary

In 2012, the global economic recovery was hard and sluggish. The fiscal and financial risks increased in major economies while growth in emerging market economies moderated. The financial markets around the world saw larger fluctuations and capital flow was frequent. In China, the good momentum in economic and social development continued. The growth of the economy moderated and stabilized. Reform of the financial sector was advanced, financial institutions became stronger and more resilient, financial markets developed rapidly, and the financial infrastructure building produced good results. Overall, the financial system was sound and stable. The year 2013 is the first year in the implementation of the decisions adopted at the 18th National Congress of the CPC and a very important year to lay a solid foundation for building a relatively well-off society. China is still in an important period of strategic development， and conditions remain favorable to support stable and rapid economic growth and good social development. Yet, both domestic and global environment are very complex. The financial system is likely to function in soundness but there are potential risks and concerns.

Economic growth became stable after a period of moderation. In 2012, China continued to implement a proactive fiscal policy and prudent monetary policy, strengthened reform measures to facilitate the transformation of growth pattern and adjustment of economic structure. The domestic demand contributed more to economic growth and fiscal revenues continued to increase. The overall price declined and employment was stable. The growth of money and credit was steady. However， the imbalances and unsustainable problems in the macro-economy remained unresolved. It is thus necessary to make monetary policy more forward-looking, targeted and flexible, and properly handle the relationship among pursuing stable economic growth, promoting adjustment of the economic structure, controlling inflation and fending off risks. The market-based interest rate reform and RMB exchange rate regime reform will be furthered. The credit structure will be continually optimized to improve the quality of financial services to the real sector.

The banking sector performed soundly. The balance sheet continued to expand, capital adequacy level steadily increased, provisioning was adequate, and profitability was improved. The reform of financial institutions deepened. The management and operation of financial institutions further improved. The banking sector further strengthened its capacity to provide services to the rural areas, agricultural sector and farmers. The effectiveness of financial regulation was enhanced. However, the credit risks built up in certain areas, industries and regions. The commercial banks faced challenges in their liquidity management and should pay attention to risks in wealth management products and off-balance sheet business. The risks associated with non-financial institutions with financing functions and private lending should be monitored on a continued basis. At the next stage, measures will be taken to deepen reform of financial institutions, promote financial innovation, improve the business structure and profit model, enhance pricing capability and risk management. And still improve regulation, enhance risk prevention in key areas, prevent risk contagion and hold the bottom line of preventing systemic and regional financial risks.

The securities and futures companies generally operated in a sound manner. Innovation of the sector enhanced and the efforts of building a multi-layered capital market made progress. Reform of the new stock issuing mechanism was advanced, corporate governance of listed companies and reform of delisting mechanism was pushed forward steadily. Regulation of the sector was enhanced and regulatory cooperation produced good results. However, due to the decline in the profit of public companies, there were potential risks in the rapid business expansion of some securities companies. Going forward, measures will be taken to encourage innovation, advance market institutional build-up, further strengthen regulation, improve corporate governance of listed companies, encourage securities and futures companies to develop in a sound manner and improve financial services to foster real economy.

Performance of the insurance sector was in general stable as evidenced in rapid asset expansion. Growth of premium income moderated. Reform of the insurance companies and institutional build-up made further progress.

However, the return on investment declined and the profit of life insurance shrank by a large margin, while liquidity risk was on the rise and product structure was imbalanced. Going forward, it is necessary to deepen reform and innovation, promote the transformation of growth pattern and structural adjustment of the industry, improve investment management, mitigate potential risks, and give a better play to the insurance sector as the stabilizer and catalyst of economic and social development.

Performance of the financial markets was stable in general and the markets were expanding steadily. Money market traded briskly and played a prominent role in adjusting the liquidity among financial institutions. The bond market grew in a healthy manner, with bond issuance volume rising, innovation reaching a new level, participants increasingly diversified. The bond market has become a major channel for direct financing and helped optimize resource allocation and support real economy. The stock market got stabilized during fluctuations. The stock market capitalization was at a historical low. Futures market became less buoyant, bill market expanded steadily, turnover on the gold market declined, and the trading on foreign exchange market became less brisk. The real estate market moved toward the direction as intended by the macro-economic management measures. Going forward, following market-oriented principle, efforts would be made to develop direct financing, encourage financial innovation, prevent risks and build an operating efficiently, well-functioned financial market system with full spectrum of products, proper scale, satisfying the need of economic development.

The financial analysis of the government, corporate and household sectors show that the growth of government expenditure and revenue both slowed down, government indebtness was at a low level, but health service, pension and other social security issues deserved attention. The domestic sale recovered but overseas orders remained tepid. Growth of revenue from major business of corporate sector declined significantly, growth rate of total profits continued to decline and debt repayment capability weakened. The deposits of the household sector started to recover, and the sector’s overall level of indebtedness was fairly low. The household sector had a stronger demand to diversify their portfolio of financial assets to gain decent profit. Their purchase of wealth management products increased rapidly.

The building of financial infrastructure made progress. The payment, clearing and settlement system operated in a stable and safe way and non-cash payment instrument market was in a boom. The payment environment in rural China continued to improve and supervisory system became stronger. Laws and regulations were improved and became more compatible with the reform and opening-up of the financial sector. Accounting standards and rules were improved as several accounting regulations were adopted and became effective. The legislation for the credit information industry made a breakthrough. The social credit system made headways. The risk prevention and control system of anti-money laundering (AML) was further improved and China became the first developing country to comply with all the FATF recommendations. At the next stage, measures will be taken to improve financial market infrastructures, improve the safety and efficiency of the retail payment service market, continue the reform and development in the legal system and accounting system of the financial sector, implement *Administrative Provisions on Credit Information Industry*, and strengthen risk-based AML supervision.

Macro-prudential regulation was further enhanced. The international community continued to improve macro-prudential policy framework, strengthened regulation and supervision over systemically important financial institutions and shadow banking system, continued the efforts to build an effective resolution regime. Major economies furthered their financial regulatory reform and improved prudential regulation standards. In China, macro-prudential regulation was strengthened. The dynamic adjustment of differentiated reserve requirement has been implemented. Research was taken on counter-cyclical capital instruments and measures to reduce the risks in systemically important financial institutions. In order to maintain the soundness of financial system, the monitoring and early warming on systemic risks was strengthened, on-site soundness assessment on financial institutions and financial stability stress testing was conducted, crisis management and systemic risk resolution regime was improved, and the set-up of deposit insurance regime was pushed forward.

Abbreviations and Acronyms

ABC	Agricultural Bank of China
ABS	Asset-Backed Securities
AML	Anti-money Laundering
BaFin	Deutsche Bundesbank and Federal Financial Supervisory Authority
BCBS	Basel Committee on Banking Supervision
BOC	Bank of China
BOCOM	Bank of Communications
BOP	Balance of Payments
CABD	Country Area Banking Division
CAR	Capital Adequacy Ratio
CBO	Congressional Bugget Office
CBRC	China Banking Regulatory Commission
CCAR	Core Captial Adequacy Ratio
CCB	China Construction Bank
CCP	Central Counter Party
CDB	China Development Bank
CEPA	Closer Economic Partnership Arrangement
CET1	Common Equity Tier 1
CFTC	Commodity Futures Trading Commision
CGFS	Committee on the Global Financial System
CIRC	China Insurance Regulatory Commission
CISS	Composite Indicator of Systemic Stress
CMGs	Crisis Management Groups
COAGs	Cross-border Cooperation Agreements
CPC	Communist Party of China
CPSS	Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CSRC	China Securities Regulatory Commission

D-SIB	Domestic Systemically Important Banks
ECB	European Central Bank
ECFA	Economic Cooperation Framework Agreement
ECTR	Extended Collateral Term Repo Facilit
ESRB	European Systemic Risk Board
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FED	Federal Reserve
FMI	Financial Market Infrastructure
FPC	Financial Policy Committee
FSAP	Financial Sector Assessment Programme
FSB	Financial Stablity Board
FSOC	Financial Stability Oversight Council
GDP	Gross Domestic Product
GEM	Growth Enterprise Market
G-SIBs	Global Systemically Important Banks
G-SIFI	Global Systemically Important Financial Institution
G-SIIs	Global Systemically Important Insurers
HAF	Housing Accumulation Fund
HICP	Harmonized Index of Consumer Prices
HKMA	Hong Kong Monetary Authority
HLA	Higher Loss Absorbency
HQLA	High-Quality Liquid Assets
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Boards
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
JSCBs	Joint-stock Commercial Banks
LCBs	Large Commercial Banks
LCR	Liquidity Coverage Ratio
LEI	Legal Entity Identifier
LGFP	Local Government Financing Platform
M&A	Mergers and Acquisitions

MBS	Mortgage-Backed Securities
MMFs	Money Market Funds
MOF	Ministry of Finance
MOU	Memorandum of Understanding
MPIs	Macro-Prudential Instruments
NBS	National Bureau of Statistics
NPL	Non-Performing Loan
NRAs	Non-Resident Accounts
NTD	New Taiwan Dollar
OCC	Office of Comptroller of Currency
ODSG	OTC Derivatives Supervisors Group
OMT	Outright Monetary Transaction
OTC	Over the Counter
P/E	Price/Earnings Ratio
PBC	People's Bank of China
PICC	People's Insurance Company of China
PLAC	Primary Loss-Absorbing Capacity
PMI	Purchasing Managers Index
POS	Point of Sales
PRA	Prudential Regulation Authority
PSBC	Postal Savings Bank of China
QDII	Qualified Domestic Institutional Investors
QE	Quantitative Easing
QFB	Qualifying Full Bank
QFII	Qualified Foreign Institutional Investors
R&D	Research and Development
RCCs	Rural Credit Cooperatives
RMB	Renminbi
ROI	Return on Investment
RQFII	RMB Qualified Foreign Institutional Investors
SEC	Securities and Exchange Commission
SIFIs	Systemically Important Financial Institutions
SIVs	Structured Investment Vehicle
SMA	Separately Managed Account
SME	Small and Medium-sized Enterprise

SSF	Social Security Fund
SSM	Single Supervisory Mechanism
TICs	Trust and Investment Corporations
TRs	Trade Repositories
UCCs	Urban Credit Cooperatives
USD	U.S. Dollar
VAT	Value Added Tax
WB	World Bank
y-o-y	Year-on-year

CONTENTS

Boxes

Chapter Ⅰ

Macroeconomic Performance

In 2012, the growth of world economy continued to slow down amid ongoing deep transformations and adjustments. In line with the principle of “making progress while maintaining stability”, China accelerated its economic restructuring, transformed its economic development pattern, and continued to implement an active fiscal policy and a prudent monetary policy, while the economy growth decelerated but gradually stabilized. In the period ahead for 2013, the global economy will still face a complex and volatile situation, and the prospect of low growth will continue; the Chinese economy will still enjoy the favorable condition for sustainable and healthy development, though the environment for economic activities performance will be more complicated, and the task of macroeconomic management will face some difficulties and challenges.

I. Global Economic and Financial Situation in 2012

Global recovery continued to slow down in 2012 and registered an annual growth of 3.2%, down 0.8 percentage point from the previous year. In particular, growth of the developed world and emerging economies stood at 1.2% and 5.1% respectively, down 0.4 and 1.3 percentage points from the previous year. Volatilities on the international financial markets heightened, the exchange rates of major currencies fluctuated within a wider range, risk aversions in debt markets increased, stock indices shored up amid fluctuations, and commodity prices saw large swings.

1. Economic developments in the major economies

The U.S. economy saw a moderate recovery but with stalled progress in fiscal consolidation. In 2012, the U.S. housing market turned better, and the financial sector continued the deleveraging process, the energy and high tech sectors grew robustly, and trade deficit narrowed. The U.S. GDP grew 2.2% y-o-y, representing an acceleration of 0.4 percentage point from the previous year. The CPI recorded a y-o-y rise of 1.7%, and inflation pressure was lessened. Unemployment rate in December 2012 registered 7.8%, the lowest since February 2009, and down 0.5 percentage point from the year beginning. However, the U.S. economy remains vulnerable to policy uncertainties stemming from the negotiations over government expenditure reductions and debt ceilings, and the unemployment rate still hovers at an elevated level.

Development of the European sovereign debt crisis was full of twists and turns, weighing on the recovery of the real economy. Due to the sovereign debt crisis, economies in the euro area were again plunged into recession, and the GDP registered a y-o-y decline of 0.6%. The December PMI in the euro area declined to 47.2, below 50(the threshold level between prosperity and depression) for 11 consecutive months. The HICP fell to 2.2%, and the unemployment rate climbed to 11.4% in December, a record high since the creation of the euro zone. Among euro member countries, the growth of Germany slowed down and posted a negative growth fourth quarter on fourth quarter; France suffered a lack of growth momentum, and its long-term structural problems became more acute; the Italian economy was back in recession again, and its unemployment rate continued to rise; and the Spanish economy remained sluggish, and its unemployment rate hovered at an elevated level.

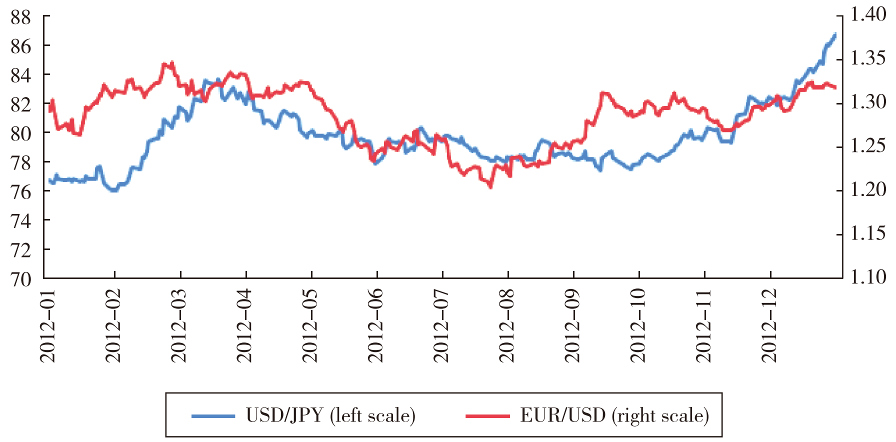
Recovery in the Japanese economy was unstable, and the Japanese trade and fiscal condition continued to deteriorate. The Japanese economy declined sharply after a robust rebound in the first quarter of 2012, and the GDP growth in 2012 registered 1.9% y-o-y. The fading effects of the reconstruction efforts after the earthquake and tsunami and the falling household consumer confidence index pointed to insufficient domestic demand in the Japanese economy. Meanwhile, declining external demand and higher demand for energy imports led to a significantly large trade deficit. The accumulation of government debt added to fiscal risks. Total outstanding debt of the Japanese government registered 997.22 trillion yen at end-2012, accounting for 209.6% to its GDP in the same period.

The majority of the emerging markets experienced slower growth and higher inflationary pressure. In 2012，due to declining external demand and downward cyclical trends, growth of major emerging markets slowed down and registered 5.1% in 2012, down 1.3 percentage points from the previous year. In particular, growth of Brazil, India, and Russia were down 1.8, 3.7 and 0.9 percentage points respectively from the previous year. The impacts of quantitative easing policies in the advanced economies on cross-border capital flows into some of the emerging markets unwound, shoring up imported inflationary pressure for the latter. As a result, CPI in India and Brazil registered 9.3% and 5.8% respectively in 2012, complicating macroeconomic policymaking in these economies.

2. International Financial Market

The exchange rates of the major currencies fluctuated within a wide range, and there were large volatilities in the cross-border capital flows. At end-2012, the exchange rates of euro and the yen against the U.S. dollar were 1.3194 dollar per euro and 86.74 yen per dollar, representing an appreciation of 1.92% and a depreciation of 11.30% y-o-y. Developments in the currencies of the emerging markets diverged: the Korean won, Chilean peso, and Mexican peso appreciated by more than 8% against the U.S. dollar in 2012, whereas the Argentinean peso and the Brazilian real depreciated against the U.S. dollar by more than 9%. For the whole year of 2012, in January and February as the European debt crisis was temporarily under control, major currencies appreciated against the U.S. dollar; from March to June, as risk aversions increased, international capitals flew from Europe and emerging countries to the U.S. and Japan, and the euro and emerging market currencies depreciated against the U.S. dollar and the Japanese yen; from July to September, as major developed economies launched a new round of quantitative easing, capital re-flew from the U.S. to emerging markets, and a majority of currencies appreciated against the U.S. dollar; and since October, due to impacts of policies including enlarged asset purchase by the Bank of Japan, the Japanese yen saw a sharp depreciation against the U.S. dollar (Figure 1.1).

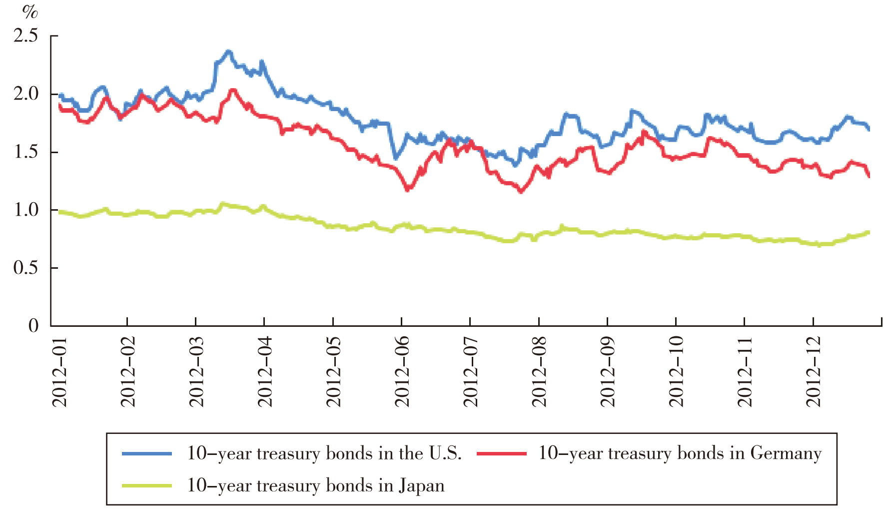
Figure 1.1 Exchange Rate Movements of Major Currencies in 2012



Source: Reuters.

Yields of traditional safe-haven treasury bonds remained subdued, and those of heavily-indebted sovereigns were on a decline. As the lackluster global recovery fanned up risk aversion, T-bond yields in the U.S., Germany, and Japan were subdued. The yields of major safe-haven treasury bonds rallied in December 2012 due to a series of uncertainties, including the fiscal cliff negotiations in the U.S.. Affected by domestic banking crisis, the yield of ten-year government securities in Spain hit a high point of over 7.5% in 2012. For the whole year, the easing of the European sovereign debt crisis caused the yields of government securities of major economies to decline amid fluctuations. At end-2012, the yields of ten-year treasury bonds in the U.S., Germany, and Japan closed at 1.70%, 1.30%, and 0.80% respectively, down 0.18, 0.53 and 0.19 percentage point from the previous year (Figure 1.2).

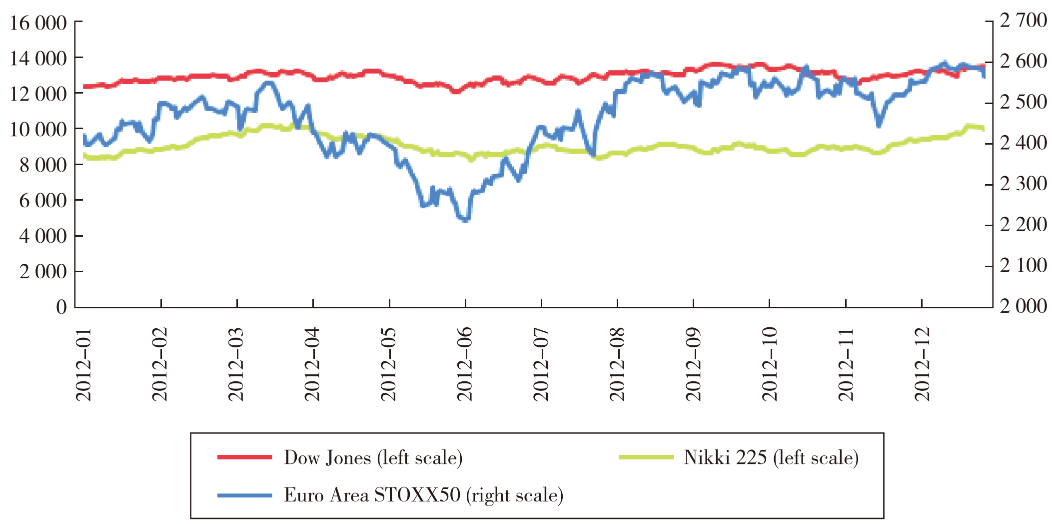
Figure 1.2 Yields of T-bonds in Major Economies in 2012



Source: Reuters.

Major stock indices went up amid fluctuations. At end-2012, the Dow Jones Industrial Average, the STOXX 50, and the Nikkei 225 closed at 12 938.11, 2 568.91, and 10 395.18, up 5.90%, 8.41%, and 22.94% perspectively from the end of last year. In the first quarter, with the adoption of a series of rescue measures in Europe, stock indices rallied in the U.S., European, and Japanese markets. In April and May, due to the worsening European debt crisis, major stock indices plunged. In the second half of the year, with the fiscal cliff looming in the U.S., uncertainties about negotiations over the Greek rescue plan, and the changes of governments in major countries, the fluctuation of global stock markets aggravated. By the end of the year, with further easing of monetary policies in major advanced economies, the stock markets in the U.S., Europe, and Japan rebounded (Figure 1.3).

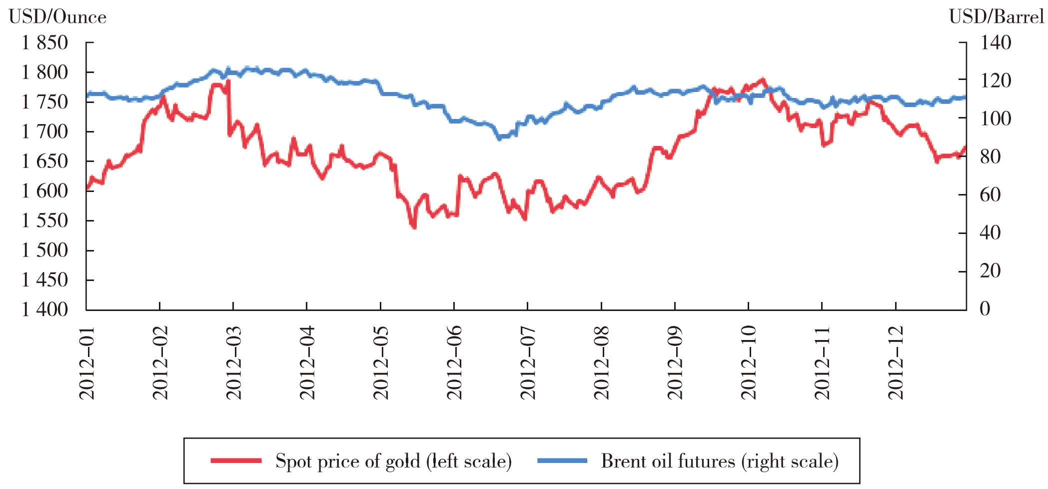
Figure 1.3 Major Stock Indices in 2012



Source: Reuters.

The price of crude oil rose after a period of decline, while the price of gold fluctuated at an elevated level. At end-2012, the price of Brent oil futures remained flat, while the price of spot gold closed at USD1 674 per ounce, up 7% over the beginning of 2012. Throughout the year, the prices of international industrial metals fluctuated within a wide range due to the impact of global economic situations, the prices of agricultural produce surged as a result of the extreme weather conditions, and the U.S. Commodity Research Bureau index comprised of 19 commodities on the global market fell by 3.37% cumulatively (Figure 1.4).

Figure 1.4 Price Indices of Crude Oil and Gold on the International Market



Source: Reuters.

3. Monetary Policies of the Major Economies in 2012

The U.S. Federal Reserve further eased its monetary policy. The Federal Reserve kept the federal funds rate at the target range of 0-0.25%, and announced in June to extend Operation Twist to end-2012. In September, the Fed announced the decision to purchase MBS at a pace of USD 40 billion per month, known as QE3. In December after the Operation Twist matured by the year end, the Fed decided to increase the size of long-term Treasury bond purchases by USD 45 billion per month and broke ground to link interest rate policy with specific economic indicators, including the unemployment rate and inflation rate. It is expected that the Fed will keep the interest rate at an extremely low level as long as the unemployment rate is above 6.5%, inflation rate does not exceed 2.5%, and long-term inflationary expectation is well-anchored.

The ECB, the Bank of England, and the Bank of Japan continued to reinforce their easy monetary policies. In June, the ECB further lowered the collateral standard against which banks in the euro area can acquire liquidity from the ECB. In July, the ECB announced a cut in the major refinancing rates to a record low of 0.75%. In September, the ECB launched the OMT program by which the ECB would purchase, without an ex-ante quantitative limit, government-issued bonds with a maturity of no more than 3 years on the secondary market. The Bank of England kept the benchmark interest rate unchanged at the record low of 0.5%. It announced in June the launch of auctions under the Extended Collateral Term Repo Facility (ECTR). In July, it announced to further increase the size of asset purchase to 375 billion US dollars. The Bank of Japan continued the zero-interest-rate policy and on several occasions expanded the size of available funds for asset purchases.

The majority of emerging markets adopted a loose monetary policy stance. In 2012, the Central Bank of Brazil cut benchmark interest rate on seven occasions to 7.5%. The Reserve Bank of India lowered the repurchase rate by 50 basis points to 8.0% in April, and reduced the cash reserve ratio by 25 basis points to 2.75% in September. The Bank of Korea cut the benchmark interest rate in July and October to 2.75%. In addition, benchmark interest rates were lowered as well in South Africa, the Philippines, Vietnam, Kazakhstan, and Hungary.

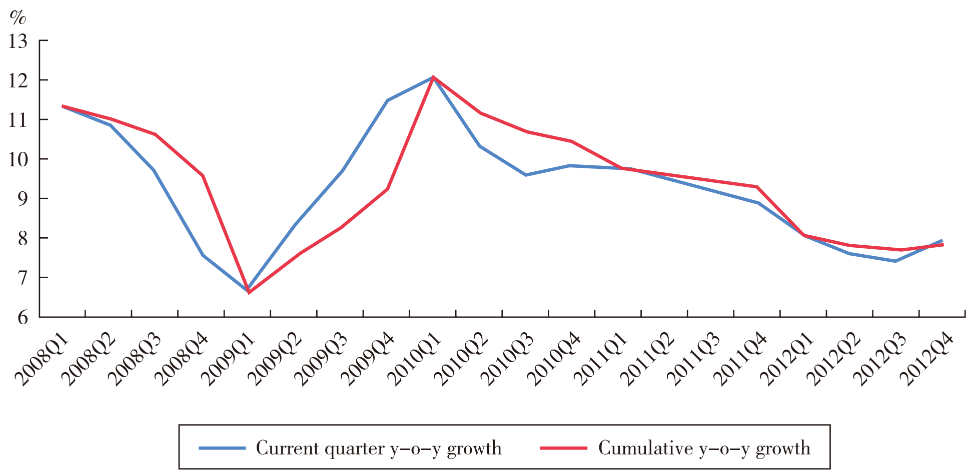
II. Features of China's Economic and Financial Performance in 2012

In 2012, on the international side, the global recovery was sluggish; and on the domestic front, cyclical factors were interwoven with long-term structural factors. In the principle of "making progress while maintaining stability", China continued to implement an active fiscal policy and a prudent monetary policy, carried out preemptive adjustments and fine-tuning measures in a timely and appropriate manner, intensified reform measures, and strived to transform the pattern of economic development. The economic operation has gradually stabilized, corporate profitability improved, and the price level was in general stable. The role of domestic demand in driving economic growth has been enhanced, industrial structure was further optimized and upgraded, and the transformation of growth pattern made new progress.

1. The economic growth decelerated but gradually stablized with good progress in industrial restructuring

According to preliminary statistics of the National Bureau of Statistics(NBS), China's nominal GDP totaled 51.93 trillion yuan in 2012, up 7.8% in terms of comparable prices and 1.5 percentage points lower than the growth recorded in the last year. GDP growth in the four quarters registered 8.1%, 7.6%, 7.4% and 7.9% respectively, showing a decelerating but stabilizing trend (Figure 1.5). Broken down by industry, the value-added of the primary, secondary, and tertiary industries was 5.24 trillion yuan, 23.53 trillion yuan, and 23.16 trillion yuan respectively, up 4.5%, 8.1%, and 8.1% over the previous year. The shares of the three industries in GDP were 10.1%, 45.3%, and 44.6% respectively, up 0.1 percentage point, down 1.3 percentage points, and up 1.2 percentage points from that in the last year. As the market demand picked up, corporate earnings recovered. In 2012, profits of statistically large enterprises posted 5.56 trillion yuan, up 5.3% y-o-y.

Figure 1.5　Y-o-y Growth of Cumulative and Current Quarter GDP



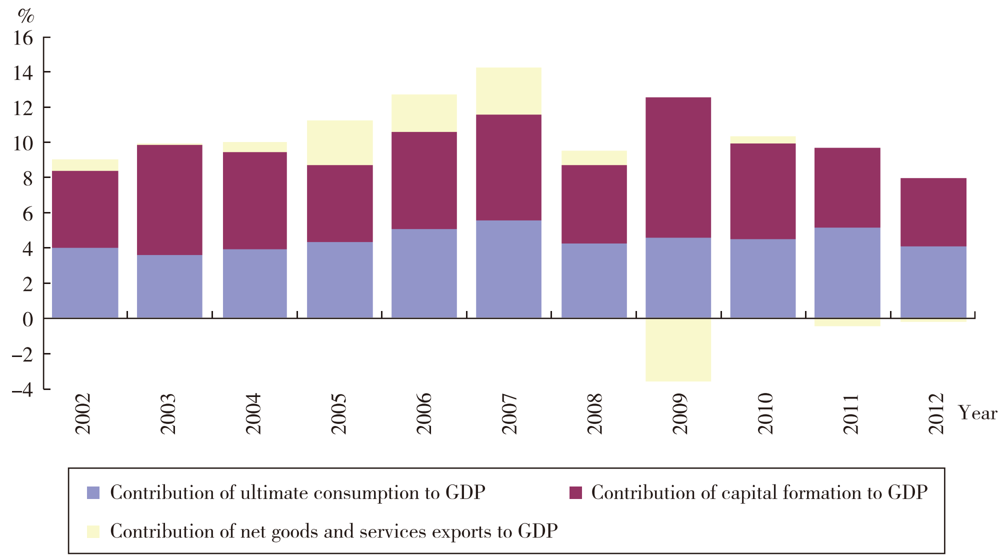
Source: The NBS.

2. Domestic demand increased at a relatively rapid pace while external demand slowed down

In 2012, investments in fixed assets totaled 36.48 trillion yuan, up 20.6% y-o-y in nominal terms and 19.3% in real terms. Among this total, investment in real estate development totaled 7.18 trillion yuan, up 16.2% y-o-y. Retail sales of consumer goods totaled 21.03 trillion yuan, representing a y-o-y growth of 14.3% in nominal terms, or 12.1% in real terms. Total imports and exports posted USD 3.87 trillion, up 6.2% y-o-y. In particular, exports registered USD 2.05 trillion, up 7.9% y-o-y; imports posted USD 1.82 trillion, up 4.3% y-o-y. Due to declining import prices, the trade surplus posted USD 231.1 billion, up 50% y-o-y. In 2012, the contribution of ultimate consumption, capital formation, and net goods and service exports to GDP growth was 4.1, 3.9 and −0.2 percentage points, in particular the contribution of ultimate consumption was larger than that of capital formation, and net exports of goods and service continued to have a dragging effect on GDP growth since 2011 (Figure 1.6).

The balance of payments (BOP) further improved, the current account remained surplus, while the capital and financial account posted a net outflow. According to statistics of the SAFE, the overall balance of payments in 2012 registered USD 176.3 billion, representing a decline of 56% y-o-y, among which the current account surplus increased 42% from the previous year to USD 193.1 billion, accounting for 2.3% of the GDP, and the capital and financial account witnessed a deficit USD 16.8 billion, the first time since the Asian financial crisis, whereas there was a surplus of USD 265.5 billion in the previous year. The growth of foreign-exchange reserves was at a much lower pace, and the stock of foreign-exchange reserves in the BOP statistics (excluding the impact of non-trading valuation changes such as exchange rates and prices) grew only USD 98.7 billion, representing a deceleration of 74% y-o-y.

Figure 1.6 Contribution of Consumption, Investments and Net Exports to GDP Growth



Source: The NBS.

Box 1 The Progress of Cross-border Use of RMB

In 2012, the PBC continued to promote the RMB settlement in cross-border trade and investment activities. As a result, the role of RMB in settling cross-border trade and investment activities was enhanced significantly, rendering potent support to the cross-border trade and investments as well as the real economy.

Continued to improve the policy framework of cross-border RMB business. First, all enterprises that are eligible to engage in trade in goods and services and other C/A items can choose to price, settle, and pay/collect their transactions in RMB. In March, the PBC, jointly with other government departments, issued a notice to expand the participants in RMB settlement of goods exports from the pilot enterprises to all enterprises that are eligible to engage in export/import business. In June, about 9 500 RMB settlement enterprises for goods exports were put under special supervision. Second, continual efforts were made to standardize the management of direct RMB investment by foreign enterprises and the non-resident accounts (NRAs). In June, the PBC issued operating rules for RMB settlement of foreign direct investment to standardize relevant businesses. In July, the PBC made regulations on the opening, use and management of the NRAs.

Further expanded the use of RMB in cross-border trade and investment settlement. First, the volume of RMB settlement of cross-border trade increased steadily. In 2012, RMB settlement of items under the current account totaled 2.94 trillion yuan, representing year-on-year growth of 41%. In particular, settlement of trade in goods registered 2.06 trillion yuan, accounting for 8.4% of total value of exports and imports of goods reported by the General Administration of Customs, up 1.8 percentage points from the previous year. At end-2012, domestic enterprises had actual cross-border RMB receipts and payments in 206 countries and regions. Actual RMB receipts and payments in 2012 registered 1.3 trillion yuan and 1.57 trillion yuan respectively, with a net outflow of 269.17 billion yuan. The receipt-to-payment ratio reached 1 : 1.2 compared to 1 : 1.7 in 2011. Second, RMB settlement of cross-border investments progressed in an orderly way. In particular, outward direct investments settled in RMB totaled 30.44 billion yuan, representing a year-on-year growth of 51%, in particular the total actual outflows of RMB outward investments by non-financial institutions accounted for 4% of the aggregate outward investments. Foreign direct investments settled in RMB totaled 253.58 billion yuan, representing a year-on-year growth of 1.8 times, in particular the actual inflows of RMB foreign direct investments by non-financial institutions accounted for 16% of total FDI received by domestic non-financial institutions. As the end of 2012, the approved loan quota of overseas RMB project financing registered 101.12 billion yuan, and the outstanding loans stood at 43.76 billion yuan; a total of 100 overseas institutions were allowed to participate in the interbank bond market, with the approved quota of 474.7 billion yuan. Third, the number of RMB accounts opened at domestic banks by foreign institutions increased steadily. By the end of 2012, domestic agent banks had opened 1 592 interbank RMB accounts for participating overseas banks, 404 more than that in the end of 2011, and with a total outstanding balance of 285.20 billion yuan. Overseas enterprises had opened 6 197 RMB settlement accounts at domestic banks, 1 985 more than that in the end of 2011, and with a total outstanding balance of 50.02 billion yuan.

Overseas RMB markets developed steadily. First, RMB business in the Hong Kong market continued to play a leading role. In 2012, the amount of settlement of actual RMB receipts and payments between the Mainland and Hong Kong accounted for 56% of the total receipts and payments. According to the statistics of the HKMA, at end-2012, the outstanding balance of RMB deposits in Hong Kong posted 603 billion yuan, accounting for 9% of total deposits of all financial institutions in Hong Kong, or 18.2% of all foreign-currency deposits. Participants in the Hong Kong offshore RMB market were increasingly diversified with increased depth of participation, and the market provided a large variety of products including the certificates of deposit, stocks, insurance policies, futures denominated in RMB, and "dual currencies and dual stocks" denominated in both RMB and Hong Kong dollar. Second, the issuance of RMB treasury bonds in Hong Kong advanced steadily. To promote the development of the RMB bond market and the RMB offshore market in Hong Kong, since 2009 the Ministry of Finance has issued RMB treasury bonds for four consecutive years, with cumulative amount of 57 billion yuan. In 2012, the Ministry of Finance issued 23 billion yuan of RMB treasury bonds in Hong Kong, among which 15.5 billion yuan were issued to institutional investors, 5.5 billion yuan to individual investors, and 2 billion yuan to overseas central banks. Third, RMB business in Taiwan market made breakthrough. In August, the *Memorandum on Cross-Straits Currency Clearing Cooperation* was signed by monetary authorities on the each side of the Taiwan Straits to build the currency clearing mechanism between the two sides. Thereafter, the Shanghai Branch of the Bank of Taiwan was selected by both sides as the clearing bank for NTD business in the Mainland, and the Taipei Branch of the Bank of China acted as the clearing bank for RMB business in Taiwan. In January 2013, the PBC and the Bank of China Taipei Branch signed an agreement on RMB clearing business. Third, the RMB business was launched in Singapore. In July 2012, the Ministry of Commerce of China and the Ministry of Trade and Industry Singapore changed letters, specifying that after the Singapore side gave Qualifying Full Bank (QFB) licenses to two Chinese-funded banks in Singapore, the China side would select one Chinese-funded bank as the clearing bank for RMB business in Singapore. In October 2012, Bank of China Singapore Branch and Industrial and Commercial Bank of China Singapore Branch acquired a qualified full bank(QFB) license. In February 2013, the PBC appointed the Commercial Bank of China Singapore Branch as the RMB clearing bank in Singapore.

3. The growth of fiscal revenue slowed down, and the structure of fiscal expenditure was tilted towards livelihood sector

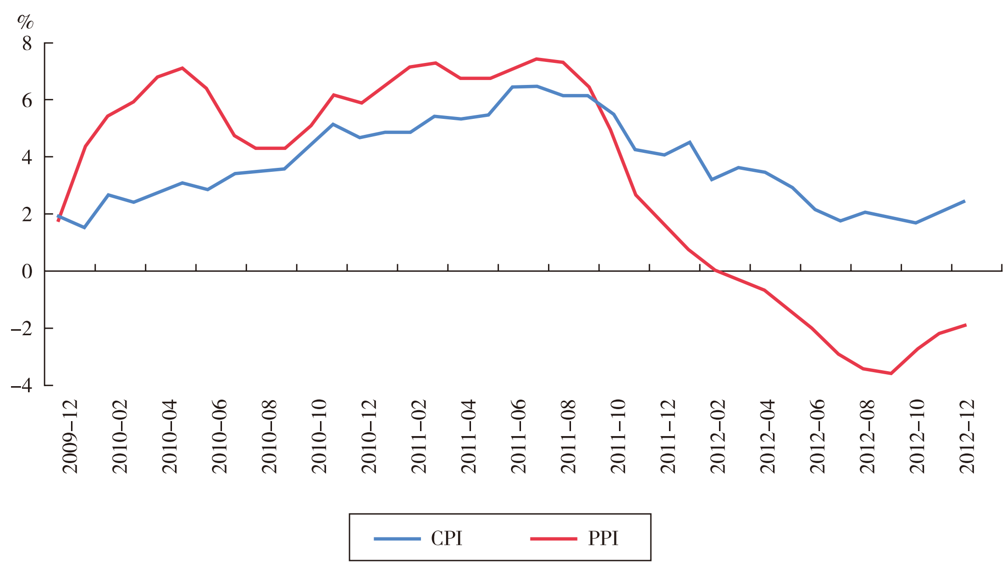
In 2012, fiscal revenue registered 11.72 trillion yuan, up 1.33 trillion yuan, or 12.8% y-o-y, and representing a deceleration of 12.2 percentage points from the previous year. The deceleration of fiscal revenue was mainly due to the slowdown in the economic growth, the decline in corporate profits and particularly the decline in factory prices, the structural tax reduction policies, and etc. Fiscal expenditures registered

12.57 trillion yuan, up 1.65 trillion yuan, or 15.1% y-o-y, representing a deceleration of 6.5 percentage points from the previous year. Expenditures on priority items directly related to people's livelihood① further increased, accounting for 66.9% of total expenditure compared to 65.2% in 2011.

4. The general price level edged down and picked up slightly by the year end

Starting from the beginning of 2012, as economic growth slowed down and the impacts of the prudent monetary policy gradually unfolded, major prices indices continued the trend to slow down. Since September, the growth momentum gradually stabilized, major price indices picked up slightly. In 2012, the CPI grew 2.6% y-o-y, down 2.8 percentage points from the previous year. In terms of food and non-food items, food prices gained 4.8%, a deceleration of 7 percentage points from the previous year, and prices of non-food items increased 1.6%, a deceleration of 1.1 percentage points from the previous year. The PPI and the PPIRM fell 1.7% and 1.8% respectively (Figure 1.7).

Figure 1.7 Movements of CPI and PPI



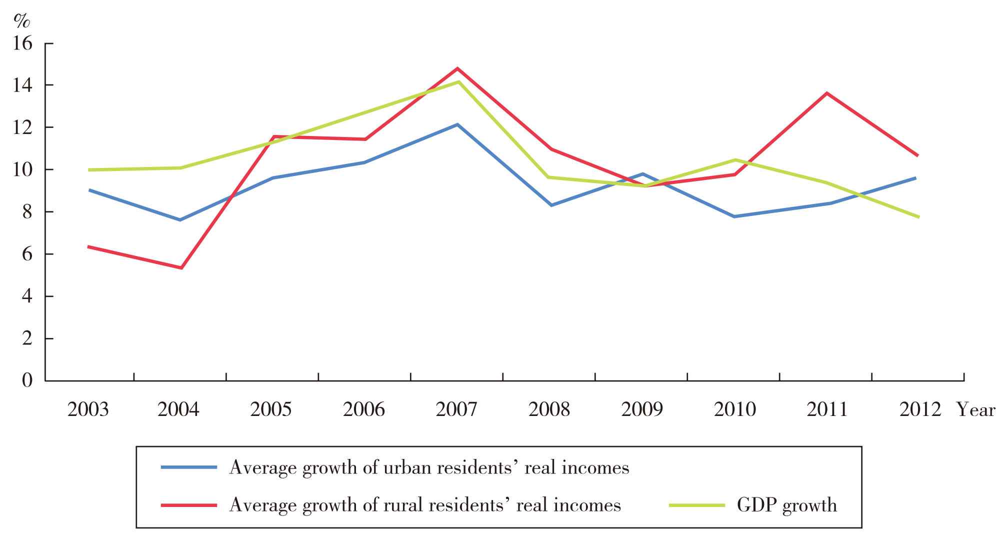
Source: The NBS.

① Including expenditures on 10 items, i.e., education; science and technology; culture, sports and media; medicine and public health; social security and employment; government-subsidized housing projects; agriculture, forestry, water conservation; urban and rural community affairs; energy-conservation and environmental protection; and transportation.

5. The job market remained stable, and household income increased rapidly

In 2012, the number of people on the payroll in urban areas increased by 12.66 million, which was 450,000 more than that in the last year. Per capita disposable income of urban households posted 24,565 yuan, representing 9.6% real growth, up 1.2 percentage points from the last year and 1.8 percentage points higher than the growth of GDP. This was the second time that the growth of income outpaced that of GDP since 2003. The per capita net income of rural households registered 7,917 yuan, representing 10.7% real growth, down 0.7 percentage point from the last year and 2.9 percentage points higher than the growth of GDP. The growth of rural household income has outpaced that of GDP in two consecutive years (Figure 1.8).

Figure 1.8 The Growth of Urban and Rural Residents' income and GDP



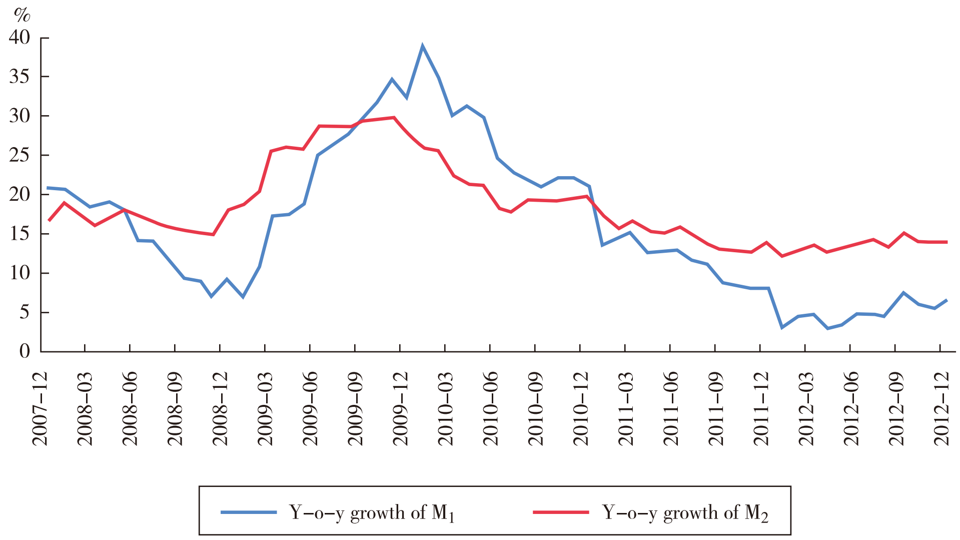
Notes：For average rural residents' income, the data for 2012 refers to net average income for rural residents in that year, while data for other years refers to average net cash income; the average urban residents' income refers to disposable average income for urban residents.

Source: The NBS.

6. Money and credit grew in a stable way, and the market-based interest rate reform and foreign exchange regime reform were pushed ahead steadily

At end-2012, outstanding M_2 stood at 97.42 trillion yuan, up 13.8% y-o-y, up 0.2 percentage point from the end of the last year; outstanding M_1 stood at 30.87 trillion yuan, up 6.5% y-o-y, and representing a deceleration of 1.4 percentage points from the end of the last year (Figure 1.9). The total social financing reached 15.76 trillion yuan, representing y-o-y increase of 2.93 trillion yuan. Among the total, new RMB loans registered 8.20 trillion yuan, representing an increase of 732 billion yuan y-o-y. The PBC timely lowered the deposit and lending rate, and further widened the floating band of the RMB deposit and lending rates. The RMB exchange rate regime was further improved, and the flexibility of the RMB exchange rates increased significantly. Effective from April 16, 2012, the PBC widened the floating band of the RMB trading price against the US dollar on the spot interbank foreign-exchange market from 0.5% to 1%, and the spread between the RMB/USD selling and buying prices offered by the foreign-exchange-designated banks to their clients shall not exceed 2% of the central parity, instead of 1%, while the PBC also adjusted modalities of its foreign exchange operations.

Figure 1.9 The Growth of Money Supplies



Source: The PBC.

Box 2 Steadily Push Ahead the Market-based Reform of Interest Rates

To steadily promote the market-based interest-rate reform is an important component of building a socialist market economy and bringing the market role into play in allocating resources, a precondition to improve the independent operation mechanism and services of financial institutions, and also an important link and a fundamental work to shift the macro-financial management towards using more price-based tools and strengthening the market transmission mechanism of the monetary policy.

In accordance with the arrangement of the CPC Central Committee and the State Council, since 1996, the PBC has unswervingly followed the principle of that “interest rate can be liberalized, the interest rate formation mechanism can be formed, and the interest rates can be adjusted by the central bank”, steadily pushed ahead the market-based interest-rate reform and has achieved significant progresses. Currently, China’s money market interest rates, bond market interest rates, deposit and lending rates of foreign currencies have already been market-based, the floor of RMB deposit rates and the ceilings of RMB lending rates was liberalized, the floating band of RMB deposit and lending rates has been expanded gradually, and the market plays a greater role in the interest-rate formation mechanism. In the meantime, the PBC has endeavored to build and cultivate a market-based benchmark interest rate system, and the status of the Shanghai Interbank Borrowing Rate (Shibor) has been gradually established, which can provide references in pricing financial products.

On June 8 and July 6, 2012, based on the fact that the reform of financial institutions had made new progress, the strict budget constraints of financial institutions had been strengthened significantly, and the condition for the market-based interest rate reform was basically in place, the PBC adjusted the ceiling for the deposit interest rate to 1.1 times the benchmark interest rate, and the floor for the loan interest rate from 0.9 times to 0.7 times the benchmark interest rate. This is a major step in the market-based interest rate reform. In terms of the effectiveness of the reform, the deposit and loans rates of financial institutions became more differentiated and refined. Financial institutions adopted a differentiated floating strategy for setting the deposit and loan rates in accordance with their own operation strategies and the requirement of asset and liability management. In December, the shares of new loans with interest rates lower, at par with, and higher than the benchmark rate were 14.16%, 26.10%, and 59.74% respectively, and for many financial institutions, the scope for them to utilize the floating band of deposit rates did not reach the ceiling, instead they set the floating ratio of deposit rates in a differentiated manner according to a number of factors, such as maturity and amount of the deposits and types of clients. In the meantime, market-priced financial products have developed rapidly, and the coverage of market-based interest rates further expanded. In 2012, financing by non-financial institutions through offering trust, bill, bond, and stock products whose prices are market-based, accounted for about 45% of the total social financing, up around 7 percentage points from the last year, and for the remaining bank loans, the majority of their interest rates were set by financial institutions by exercising their floating discretion above the floor of lending rates. This indicates that China has gradually moved from controlling the interest rates to relying more on market supply and demand to determine the interest rates.

Judging from successful international experiences, China's market-based interest-rate reform should be based on its own circumstance and take a gradual and progressive manner, which will help prevent and resolve financial risks, maintain the stability of the financial system, and promote a healthy economic development. The PBC will follow the overall arrangement of the Eighteenth National Congress of CPC and the Twelfth Five-year Plan, take full account of all necessary conditions for the market-based interest-rate reform, comprehensively assess macroeconomic benefits and risks of advancing the interest rate reform, coordinate with other economic and financial reforms such as the deposit insurance scheme and the reform of energy and resource prices, and promote the market-based interest-rate reform in a planned and step-by-step manner.

III. Global Economic Outlook

In 2013, the global economic situation remain complicated and uncertain, the slow growth of the world economy will continue, and the following risks need to pay attention：

The sovereign debt crisis remains the most prominent risk threatening global recovery. Despite the temporary easing of the European sovereign debt crisis, heavily indebted countries in the euro area are still faced with imbalances and vulnerabilities in their macroeconomic, fiscal and financial areas. Little progress has been made for European Union and its member countries in achieving their consensus for policy measures. Fragile macroeconomic and financial environments may worsen bank profitability and credit quality. Economic recovery in heavily indebted countries is weak, structural adjustment is very difficult, and the banking sector faces great pressure for financing.

Uncertainties regarding the U.S. fiscal policy might continue to pose risks to the global economy. Though the U.S. government and Congress have come to a preliminary agreement to avoid the fiscal cliff, they still debate regarding spending cut and raising debt ceiling. If it is impossible to avoid excessive fiscal austerity and reach an agreement on the medium-term fiscal consolidation plan to reform the welfare and taxation system in the near future, the U.S. recovery may stall again and bring a negative impact on the global economic and financial developments.

The impacts on the global economy of a fresh round of accommodative monetary policies adopted by the advanced economies

are not clear. Since the second half of 2012, the major advanced economies have further reinforced their quantitative easing(QE) policies, with spillovers to the global economy. Such open-ended QEs entail huge uncertainties for the domestic and global economies, and might add to the volatilities of cross-border capital flows, shore up the commodities prices on the international markets, cultivate asset burbles across the world, and complicate macroeconomic management in other economies.

Trade and investment protectionism might come to the fore. For the time being, a number of economies still take some explicit and implicit trade protection measures in order to pass on their domestic economic pressures. This may increase international trade frictions and investment risks, affect the vitality of the global markets, and thus hinder the recovery of the world economy. The WTO revised down its prediction of the global trade growth from 5.6% to 4.5% for 2013. Furthermore, geopolitical risks might bring disturbances to bilateral economic and trade links and regional economic cooperation with the deterioration in the political situation in the Middle East and North Africa and greater geopolitical tensions in the East Asia.

IV. China's Economic and Financial Outlook in 2013

The year 2013 is the first year to implement the guidelines of the Eighteenth National Congress of the CPC, and an important year to lay a solid foundation for the building of a moderately prosperous society in all respects. China still has strategic opportunities and favorable conditions for sustainable and healthy development, the process of urbanization, informatization, industrialization, and modernization of the agricultural sector has accelerated, and there are huge potentials for economic growth. Yet we should remain aware that China's economic development is not yet on a balanced, coordinated and sustainable track, the endogenous drive for growth has to been enhanced. The issue of excess capacities in some industries is severe, the rising costs of production and operation coexist with insufficient innovation capacity in the corporate sector, the conflict between economic development and resource and environmental constraints is prominent, the sensitivity of prices to demand expansion is likely to increase, and there are potential risks in the financial sector. Overall, the environment for economic operation in 2013 will be more complicated, and the macroeconomic management face some difficulties and challenges.

In 2013, efforts should be made to maintain policy continuity and stability, make policy measures more forward-looking, targeted and flexible, properly manage the relationship among preserving stable and fairly rapid growth, structural adjustments, price control, and crisis prevention, and improve the quality and efficiency of economic growth. First, continue to implement an active fiscal policy and a prudent monetary policy. In line with economic and financial market developments, a mix of monetary policy instruments including quantity-based and price instruments will be used, and the macro-prudential policy framework will be improved to keep market liquidity at a reasonable volume and to guide credit, and total social financing to grow in a stable and appropriate manner. Second, strengthen financial support to economic structural adjustment. The credit structure will be optimized to promote direct financing. Financial institutions will be guided to enhance credit support to ongoing and follow-up national key projects, the agricultural sector, rural areas, farmers, small- and micro-sized enterprises, and strategic and emerging industries in an innovative way. Credit extension to industries with high energy-consumption, heavy emission, and excess capacities will be strictly constrained, and the differentiated housing mortgage policies will be implemented in an earnest manner. Third, the market-based interest rate reform and the RMB exchange rate regime reform will be advanced steadily. Efforts will be made to steadily advance the market-based interest-rate reform, and foster a market-based benchmark interest rate system. Measures will be taken to improve the ability of the central bank to adjust market interest rates, and guide financing institutions to strengthen their pricing capacity and appropriately use their discretion in setting rates within the floating band of benchmark interest rates. The RMB exchange rate regime will be improved to enhance the two-way flexibility of the RMB exchange rate, to enable market demand and supply to play a larger role, and to keep the exchange rate basically stable at an adaptive and equilibrium level. Fourth, measures will be taken to safeguard the bottom line of preventing systemic and regional financial risks. The reform of financial system will be deepened to improve the modern financial enterprise system. The macro-prudential management will be improved, and financial regulation and supervision will be strengthened, financial institutions will be guided to operate soundly. Measures will be taken to strengthen systemic risks prevention, to strengthen the construction of the resolution regime, and to accelerate the building of the deposit insurance regime.

Box 3 The Potential Impact of China's Aging Population on Its Economic Growth

Theoretical studies suggest that aging population will reduce labor supply, reduce the social saving rate, result in reduced output and capital formation, and ultimately affect economic growth. Meantime, the experiences of developed countries show that with aging population, expenditure for the elder and per capita health care will rise sharply, adding to the fiscal burden.

According to the fifth national census, in November 2000 China's share of population aged 65 and above posted 6.96%, nearly hitting the 7% elder society threshold prescribed by the international community. In recent years, the pace of China's population aging quickened. In the end of 2012, population aged 65 and above reached 9.4%, and the working-age population aged from 15 to 59 declined by 3.45 million from the last year to 937 million, the first absolute decline over a long period. Compared with "synchronization of getting rich and becoming an aged society" or "becoming a rich society before getting older", China's per capita income is still relatively low, and China's situation belongs to "becoming an aged society before getting rich", and its impact on economic growth is increasingly evident. First, in the future, declining labor supply and rising labor cost will have a negative impact on the corporate sector, especially labor-intensive enterprises. Second, the rising elder dependency ratio[①] will affect households' saving amount and the propensity to save, and indirectly affect corporate saving behaviors by depressing corporate profits. The decline in savings will reduce the source of investment funds, and in turn affect the price of funds. Third, aging population will add to fiscal burden. Compared with developed countries, China's social security level is relatively low, both the pension funds and medical insurance system face the problems of insufficient funding and inadequate coverage, and there are shortfalls in many localities. As China's social security system is gradually improved, the level of pensions continues to rise, and the health insurance coverage expands, in the future fiscal expenditures resulting from aging population will grew rapidly, adding to increasing fiscal pressures.

Since population aging is a long-term issue in China, measures should be taken continuously to promote urbanization and balanced regional economic development, and to facilitate the transfer and reemployment of surplus labor in the rural area. Furthermore the following measures should be taken: increase human capital input, and improve labor quality; vigorously promote technological innovation and upgrade industrial structure to offset the gradual loss of labor advantage via technological progress; accelerate the building of the social security system, and continue to expand the coverage of pension funds and medical insurances to gradually upgrade the social security level.

① The elderly dependency ratio is defined as the proportion of those aged at or above 65 to those aged between 15 and 64, reflecting the number of the elder per 100 working-age population have to support.

Chapter II

Banking Sector

In 2012, China's banking sector actively implemented the national macroeconomic policies, continuously improved financial services to foster real economy, endeavored to strengthen management, and adhered to the risk bottom line. Although in some industries and regions, credit risks were emerging due to slowdown of economic growth or ailing enterprises, the overall risks in China's banking sector were under control, and the whole industry has maintained sound development momentum.

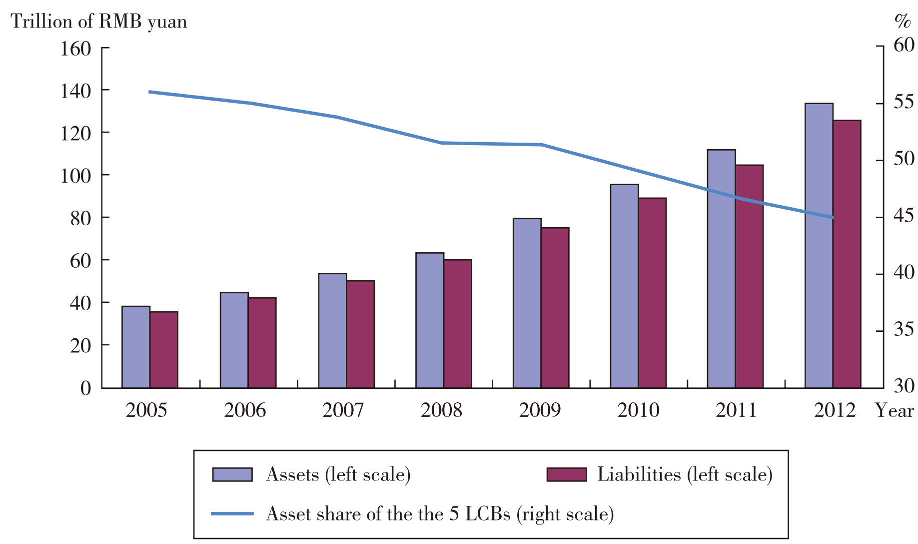
I. Recent Developments

1. The banking sector balance sheets expanded, and institutional structure was improved

Total Assets and liabilities continued to increase. At end-2012, total assets of banking institutions increased by RMB 20.33 trillion yuan or 17.9 percent on a y-o-y basis to RMB 133.62 trillion yuan. Total liabilities amounted to RMB 124.95 trillion yuan, a y-o-y growth of 17.79 percent or an increase of RMB 18.87 trillion yuan from the beginning of 2012 (Figure 2.1). Collectively, the five large commercial banks (LCBs) accounted for 44.93 percent of total commercial bank assets, 2.41 percentage points down from 2011. The asset shares of joint-stock commercial banks (JSCBs), city commercial banks and rural financial institutions (including rural commercial banks, rural cooperative banks and rural credit cooperatives) increased by 1.4, 0.46 and 0.3 percentage point respectively.

Total deposits and loans sustained a steady growth. At end-2012, the outstanding bank deposits denominated in both domestic and foreign currencies increased by RMB 11.63 trillion yuan or 14.06 percent y-o-y to RMB

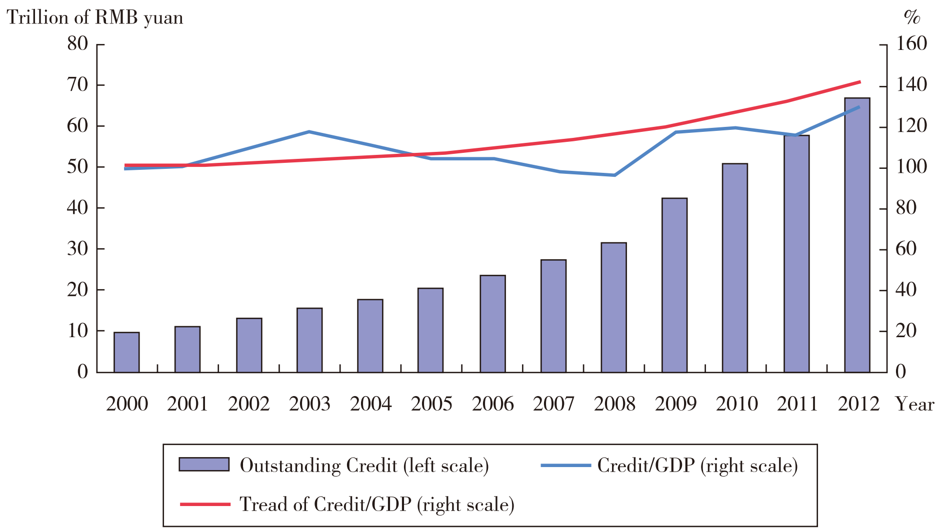
Figure 2.1 Total Assets and Liabilities of Banking Institutions



Source: The CBRC.

94.29 trillion yuan. The outstanding loans were up by RMB 9.11 trillion yuan or 15.66 percent y-o-y to RMB 67.28 trillion yuan (Figure 2.2). In terms of maturity, the increment of short-term loans and bill financing climbed up by RMB 1.69 trillion yuan, while the increment of medium and long-term loans shrunk by RMB 0.68 trillion yuan. The increase of term deposits climbed up by RMB 0.94 trillion yuan, and the increase of demand deposits was up by RMB 0.27 trillion yuan. In terms of credit orientation, fixed asset loans that are extended to project investments were squeezed by RMB 52.2 billion yuan, while operating loans experienced an upswing by RMB 2.89 trillion yuan.

Figure 2.2 Changes of Credit Structure in Banking Sector



Source: The PBC and the NBS.

Banking structure was optimized. With the soar of small and medium banking institutions, both the number and market share of new-type institutions showed continuous expansion, leading to a lower level of market concentration and a higher degree of competition. At end-2012, there were 144 city commercial banks, 337 rural commercial banks, 147 rural cooperative banks, 1927 rural credit cooperatives and 876 village banks (800 in operation and 76 in preparation) operating in China.

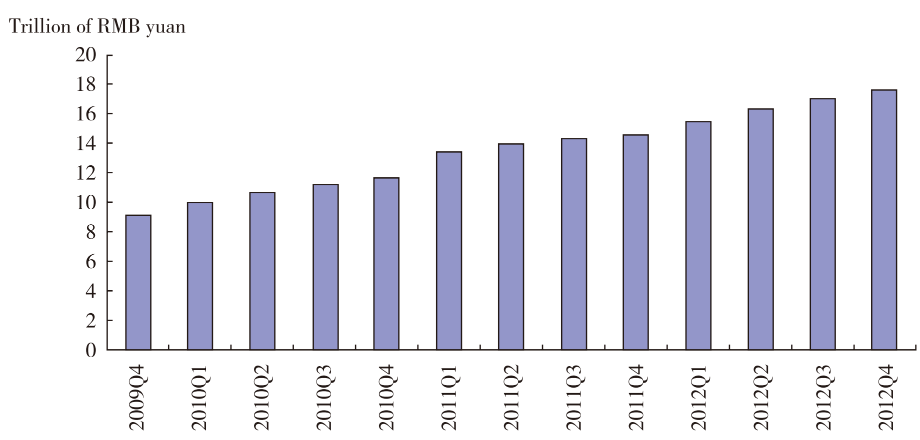
2. Credit support to fragile industries was intensified, accelerating the transformation of economic development mode

Business strategies were better aligned to economic restructuring. Oriented by national credit policies and industrial policies, China's banking institutions played an active role to facilitate economic restructuring and the transformation of economic development.

Banking institutions developed strategies conducive to National Innovation System, and a tendency to support strategic emerging industries, such as new energy industry, new materials industry, etc. Incentives were also cultivated to promote an appropriate green financial system. With commitments to impel energy conservation and emission control, banking institutions allocated more credit to strategic emerging industries, green economy and energy conservative industries. Credit extension to high polluting, energy-intensive and over-capacity industries was highly controlled and gradually squeezed. Strenuous efforts were made to effectively implement macroeconomic policies dedicated to improve people's livelihood, boost imports and exports, and expand domestic demand.

Capacity to foster agriculture, rural areas and farmers was built up. At end-2012, the outstanding agriculture-related loans (excluding bill financing) reached RMB 17.62 trillion yuan, with a y-o-y growth of 20.7 percent, 5.6 percentage points higher than the average loan growth rate during 2012 (Figure 2.3). Rural credit cooperatives achieved a significantly stronger capital position, better financial performance and a 8-year consecutive substantial growth in profit. The approaching prosperity of three new rural financial institutions-village banks, loan companies and rural mutual credit cooperatives, introduced new competitors to the rural financial market. Banking services marked footprints in all villages and towns nationwide, and 24 provinces achieved full coverage of both banking services and branch outlets.

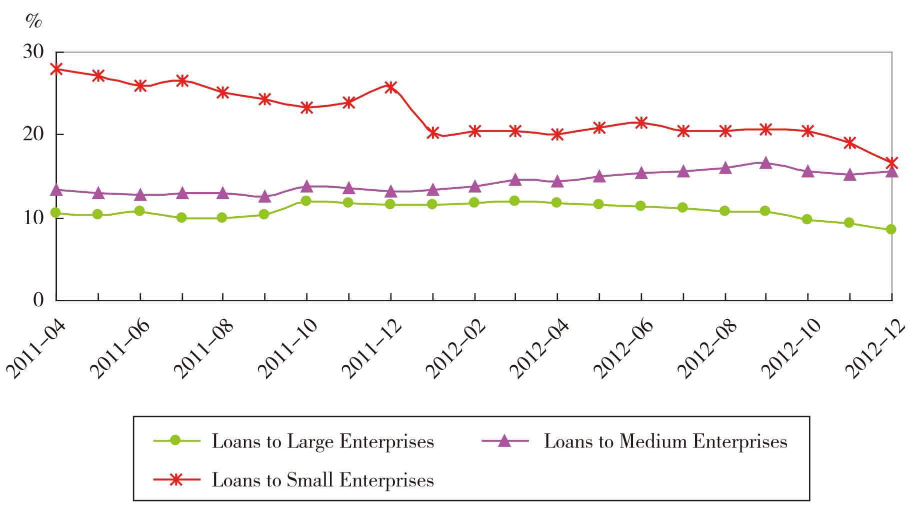
Figure 2.3 Outstanding Agriculture-related Loans



Source: The PBC.

Financial services to Small & Micro Enterprises (SMEs) were further improved. Guided by national policies, China's banking institutions generally scaled up financial services to SMEs, streamlined lending approval process and lift the ceiling of tolerance for NPLs. Loans to SMEs maintained a comparatively high growth. At end-2012, the outstanding SMEs loans reached RMB 11.87 trillion yuan, with a y-o-y growth of 16.6 percent. The growth rate was 8 percentage points higher than the loan growth of larger enterprises, and 1 percentage point higher than the loan growth of medium enterprises (Figure 2.4). In 2012, newly extended loans to SMEs registered RMB 1.71 trillion yuan, accounting for 36 percent of new corporate loans and 18.8 percent of total new loans. At end-2012, there were 6 080 micro-lending companies in total, with an increase of 1 789. Total lending balance reached RMB 592.1 billion yuan, with new lending of RMB 200.5 billion yuan. The prosperity of micro-lending companies played a positive role to alleviate the funding stress of SMEs.

Figure 2.4 Loan Growth Rates of Large Enterprises, Medium Enterprises and Small Enterprises



Source: The PBC.

3. Reforms were initiated steadily and soundness of banking sector was improved

The process of LCBs reforms was advanced. The reforms of ICBC, ABC, BOC, CCB and BOCOM were progressing well. Improvements were shown in the corporate governance. An effective mechanism that covered decision making, policy implementation and power balance was beginning to solidify. Management structures were adjusted, innovation capabilities were improved and businesses maintained steady momentum. At end-2012, CAR of the 5 LCBs stood at 13.57 percent, 12.55 percent, 13.13 percent, 14.07 percent and 13.97 percent respectively. NPL ratio recorded 0.84 percent, 1.31 percent, 1.04 percent, 0.87 percent and 0.91 percent respectively. The whole year net profit registered RMB 233.39 billion yuan, RMB145.1 billion yuan, RMB 129.6 billion yuan, RMB 192.7 billion yuan and RMB 53.8 billion yuan, with a y-o-y growth of 14.8 percent, 17.5 percent, 10.5 percent, 13.2 percent and 6.8 percent respectively.

Performances of LCBs were highlighted by overseas footprints. From 2012 to the beginning of 2013, ICBC, ABC and BOC respectively received the official banking license for a subsidiary in Brazil, a branch in New York and a branch in Chicago. ICBC was given seal of approval to take over Bank of East Asia's US unit in May and Standard Bank Argentina in November, another landmark step for overseas expansion. During the oversea push, the successful completion of FSAP, leaded by the PBOC and other relevant authorities, has played a pivotal role. It can be proved by Fed's approving orders to the 3 Chinese banks, in which FSAP report was quoted as important reference to evaluate China's financial system.

Pilot reform of ABC's Country Area Banking Division (CABD) extended coverage. More favorable policies loomed for the pilot reform in China. Differentiated deposit reserve requirement was launched for CABD business, positive incentives were strengthened through preferential policies, and reform plans were closely monitored and assessed. All these measures were dedicated to improve financial services to agriculture, rural areas and farmers. At end-2012, the pilot reform was expanded to 942 county-level sub-branches in 12 provinces. Total loans registered RMB 844 billion yuan, an increase of RMB 136.6 billion yuan. The y-o-y growth rate was 19.31 percent, 5.5 percentage points higher than the average loan growth of these sub-branches. New loan to new deposit ratio reached 53.75 percent, loan loss provision and net profit recorded RMB 18.514 billion yuan. NPL ratio dropped down from 2.34 percent to 1.93 percent. Provision coverage ratio stood at a high level of 322.1 percent.

Reforms of other financial institutions were sequenced at an appropriate pace. In January, the reform of PSBC was completed by overhauling the bank to become a corporation, and building effective corporate governance. In March, Cinda Asset Management Company roped in four strategic investors, including NSSF, to optimize equity ownership and get recapitalization. In October, Huarong Asset Management Co., Ltd. was inaugurated. While continuing disposal of non-performing assets, the company would shift attention to commercial banking, trust, leasing and other banking related businesses.

4. Fully participation in international banking supervisory reform was committed, and the effectiveness of supervision was intensified

Relevant authorities continued to actively participate in international banking supervisory reforms to promote effective implementation. In 2012, the Basel Committee on Banking Supervision (the BCBS) updated *the Core Principle for Effective Banking Supervision,* issued full text of *Basel III: the Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools,* and made significant progress in framing standards of D-SIBs framework, securitization, trading book, etc. The BCBS also conducted Basel III Regulatory Consistency Assessment among member jurisdictions. The Financial Stability Board (the FSB) was addressing impediments to the effective implementation of *Key Attributes of Effective Resolution Regimes for Financial Institutions.* The PBOC, MOF and CBRC were actively involved in the above-mentioned reforms, and took great efforts to bring national regulatory framework in line with international standards.

Effectiveness of supervision was intensified. The PBC, in conjunction with other relevant authorities, developed guidelines and supervisory standards with regard to counter-cyclical capital requirement and systemically important banks, led the design of effective resolution regimes, conducted stress tests on 17 major commercial banks, and carried out an on-site soundness assessment of financial institutions. CBRC has made strides in mitigating material risks, improving regulatory framework, and strengthening management capacities of commercial banks. In June, CBRC issued *the Rules Governing Capital Management of Commercial Banks* (*Provisional*) and *the Guidance on Innovation of Capital Instruments by Commercial Banks,* which came in force in 2013. These regulations were applied so as to inject capital constraints in market, stimulate intrinsic impetus of commercial banks, and develop a sound banking sector.

Box 4 Positive and sound implementation of new international regulatory standards

In light of the recent global financial crisis, the international society has made much headway in shaping a new international regulatory framework for banking sector. The BCBS officially issued Basel III by end of 2010, to address the weaknesses embedded in banks' capital and liquidity risk management. With national practices in mind, China was proceeding with the Basel Accords implementation in a positive and sound manner. A series of brand-new regulatory rules were put forward, including *the Rules for the Leverage Ratio Management of Commercial Banks, the Rules Governing Capital Management of Commercial Banks* (*Provisional*)*, the Guidance on Innovation of Capital Instruments by Commercial Banks,* etc.

In June 2011, China's banking regulator issued *the Rules for the Leverage Ratio Management of Commercial Banks*. While defining the leverage ratio and its disclosure requirement in accordance with Basel III, the new legislation placed a 4% minimum requirement on the underleveraged banking sector in China, higher than the 3% leverage limit in Basel III. Systemically important banks were required to comply with the rule by the end of 2013 and others would have a grace period until the end of 2016. The time table appeared aggressive compared to Basel III, in which the leverage ratio requirement would intend to migrate into Pillar 1 treatment from 2018. It is believed that the brand-new rules will reduce the risk of excessive leverage building up in individual banks and in the banking system as a whole.

The Rules Governing Capital Management of Commercial Banks (*Provisional*) (hereinafter referred to as "the Rules") was issued in June 2012, and came into force from 2013. The Rules narrowed the definition of capital, ensured the dominant form of capital to be common equity and retained earnings, standardized the classification criteria of capital, and specified the capital deduction items. To strengthen risk coverage of the capital framework, the Rules imposed a capital charge on operational risk, besides credit risk and market risk. Minimum regulatory capital requirements were lifted up. Core Tier 1 Capital Ratio, Tier 1 Capital Ratio and Total Capital Ratio were 5%, 6% and 8% respectively, and a capital conservation buffer of 2.5% was applicable above. In November 2012, the CBRC released official guidelines on the transition period to complement the Rules. The release outlined a set of transitional provisions for the implementation, including 6-year phase-in arrangements for capital conservation buffer, compulsory CAR compliance plans during the transitional period, differentiated supervision based on banks' CAR, etc. It is believed that the *Rules* is fundamental to restore capital constraints, resist an inclination to imprudent risk management and irrational expansion, impel capital-saving innovations, and consequently achieve a sustainable development and the balance between scale and profit.

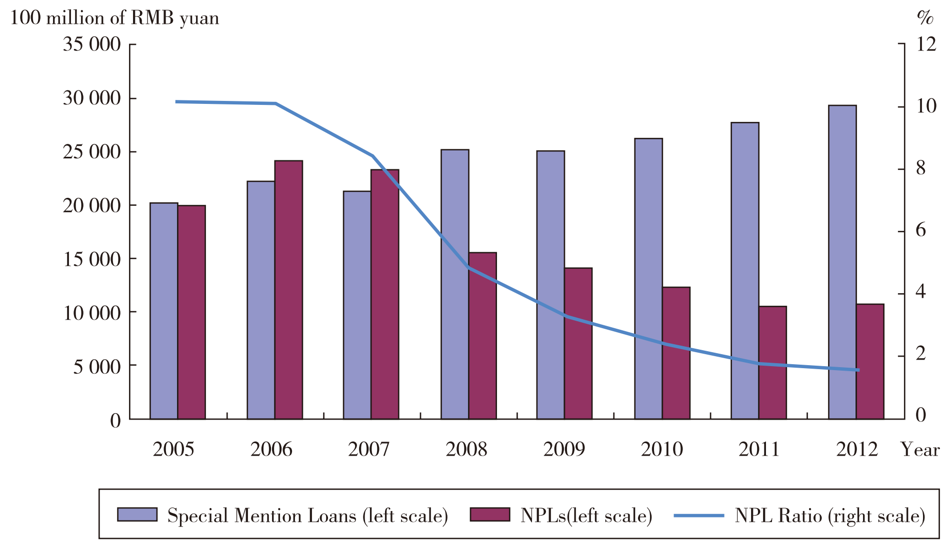
In November 2012, the CBRC released *the Guidance on Innovation of Capital Instruments by Commercial Banks*. The *Guidance* further developed criteria of eligible capital instruments, prescribed for write-downs/conversion mechanism for non-common equities, and acknowledged working streamlines in the engineering of innovative capital instruments. The new *Guidance* is believed to be conducive to improving banks' capital-replenishing channels and enhancing banks' strength to bolster real economy.

In general, the above-mentioned regulations, by invoking both international standards and national discretion, would contribute to the soundness of China's banking sector.

II. Soundness Assessment

The banking sector showed stable asset quality and sufficient provisions. The NPLs of banking institutions rebounded for the first time in the past 8 years. The total outstanding NPLs recorded RMB 1.07 trillion yuan, an increase of 23.4 billion yuan from 2011. NPL ratio reflected a downward trend of 0.22 percent to 1.56 percent (Figure 2.5). Commercial banks' NPLs climbed up by RMB 64.7 billion yuan to RMB 492.9 billion yuan, while NPL ratio maintained a stable position of 0.95 percent. Special-mention loans increased by 8 percent to RMB 1.51 trillion yuan, and past due loans increased by 46 percent to RMB 528.1 billion yuan. The upward trend indicated higher default possibilities and a potential increase in NPLs. Loan loss provision continued to stand at a high level. At end-2012, the provision coverage ratio of commercial banks increased by 17.32 percentage points to 295.51 percent, while the loan loss provision adequacy ratio increased by 36.75 percentage points to 331.54 percent. The newly introduced regulatory indicator-provision to loan ratio recorded 2.82 percent, up by 0.14 percentage point than one year earlier.

Figure 2.5 Changes of Special Mention Loans and NPLs

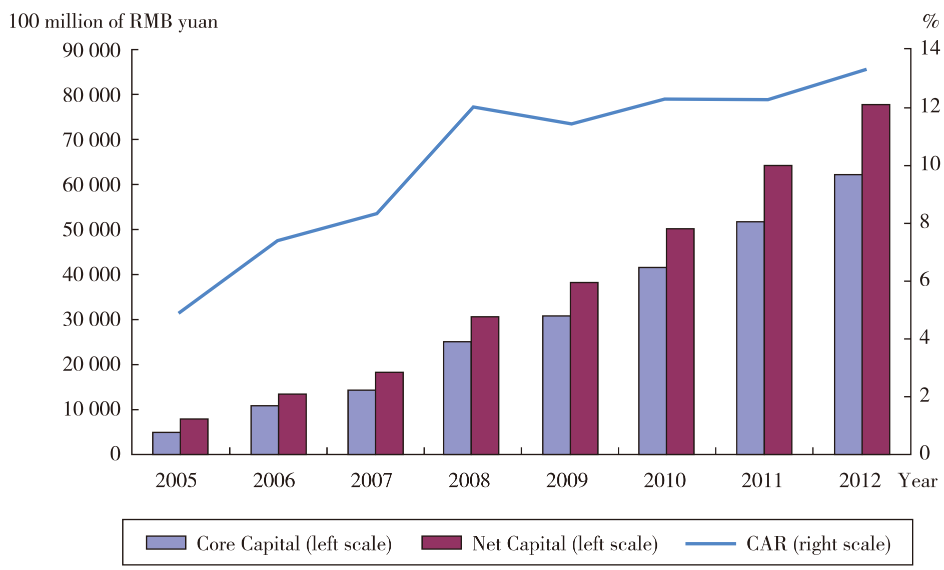


Source: The CBRC.

Higher credit risks loomed in the banking sector, and default risks spotlighted some key areas. In term of geography, the active and export-oriented market - Yangtze River Delta region, where small and medium-sized enterprises gathered, contributed most to the rising NPLs. From the industry perspective, the rebound of NPLs mainly flagged in industries saddled with excessive capacity, like PV, steel, shipping, coal chemical, as well as cement manufactures. The credit alarms mainly sounded over small and medium-sized enterprises in China. Small and medium-sized enterprises in some regions showed signs of strain due to deterioration in guarantee claims, funding resources or industry value-chain.

Banks' capital position was improved, and the quality remained relatively high. In 2012, the banking institutions achieved additional capital replenishment of RMB 1.41 trillion yuan, composed of retained earnings of RMB 984.2 trillion yuan, equity financing of RMB 226.7 billion yuan, and hybrid bonds and subordinated bonds of RMB 203.2 billion yuan. As end-2012, the CAR of commercial banks registered at 13.25 percent, with a y-o-y increase of 0.54 percentage point (Figure 2.6). In particular, the CAR of LCBs recorded 13.42 percent, up by 0.8 percentage point y-o-y. The CAR of JSCBs recorded 11.74 percent, up by 0.2 percentage point y-o-y. The CAR of city commercial banks recorded 13.68 percent, up by 0.11 percentage point y-o-y. At end-2012, paid-in capital of commercial banks accounted for 34.99 percent of the total core capital, which stood out among international peers.

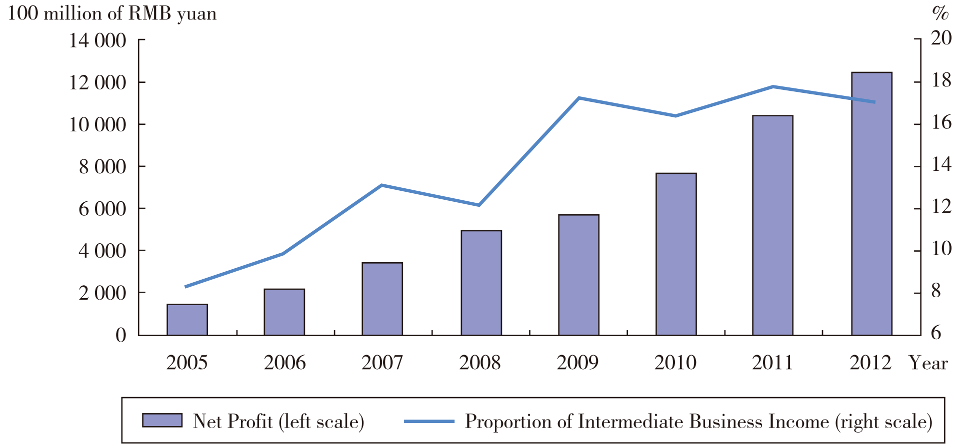
Figure 2.6 CAR and Capital Structure of Banking Institutions in Recent Years



Source: The CBRC.

Profitability continued sound growth momentum, while the pace slowed down. Following the prosperity in 2011, the profitability of banking institutions began to shift back to normal in 2012. The whole year net profit registered RMB 1.51 trillion yuan. The y-o-y growth was 20.7 percent, a decrease of 18.5 percentage points over the previous year. The ROA went up by 0.02 percentage point y-o-y to 1.22 percent, while ROE dropped 0.16 percentage point to 19.04 percent. In 2012, the financial institutions continued the process of market-oriented reforms. Meanwhile, in consideration of both national condition and the interests of low-income groups, the financial institutions squeezed fee charges. Consequently, intermediate businesses income declined 0.67 percentage point to 14.59 percent (Figure 2.7).

Figure 2.7　Profitability and Proportion of Intermediate Business Income



Source: The CBRC.

Box 5　More prudent accounting in the banking sector

The concept of prudence is the fundamental principle of modern accounting systems. The International Accounting Standards Boards (the IASB) is of the opinion that prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. In the banking sector, which generates revenue from high leverage, the concept of prudence is definitely of great importance.

In the accounting system, the principle of prudence concerning banking sector primarily applies in the following areas. Firstly, simplify the classification and measurement of financial instruments. Currently, the IASB has embarked on reducing complexity in the current classification of financial instruments, placing less weight on subjective factors, ensuring timeliness of financial reporting, and laying a solid micro-foundation for the prudent management. Secondly, refine the fair value measurement. Fair value, a timely estimate of the potential market price fluctuation of a financial instrument, could improve quality of accounting information in the banking sector. In the newly issued IFRS 13, IASB introduced a 3-level fair value hierarchy on basis of the availability of quoted prices. It was stressed that for Level 3 inputs, where relevant observable inputs are not available, information about risk assumptions and risks inherent in valuation techniques should be fully considered during the measurement. Thirdly, promote the expected loss model for recording impairments of financial assets. The current incurred loss model, under which impairments can only be recognized after a loss is identified, is believed to have a pro-cyclical effect. The IASB is deliberating the expected loss approach. When defining financial positions, this new approach would recognize loss estimates throughout the life of financial assets, and thus asset impairments can be recorded in a more prudent manner. Fourthly, micro-supervision and tax policies also contribute to the implementation of prudency concept in bank accounting. The regulatory authorities in China requested commercial banks to maintain adequate capital and loss reserves. To relieve tax burden, the State Administration of Taxation expanded the list of banks' asset losses that are entitled to pre-tax deduction.

In recent years, China has been continuously fostering a profitable and sound banking sector, but there are also some emerging issues, such as potential rebound of NPLs, rapid expansion of off-balance sheets, etc. In virtue of prudence, commercial banks should enhance loss absorbency so as to ensure solid development. Firstly, attach great importance on innovation risks, and launch innovative businesses with caution. Secondly, timely recognize asset impairments on basis of expected loss approach, and raise loss provisions. Thirdly, strengthen capital replenishment and deploy general provisions in accordance with regulatory requirements. Fourthly, extend more favorable tax policies to the banking sector, lift the proportion of tax-exempted provisions, and broaden the scope of asset losses that are entitled of pre-tax deduction.

Interbank businesses exploded, and great attention should be attached to risks embedded in the balance sheet structure. In 2012, both the interbank assets and interbank liabilities surged within the banking sector. By the end of the year, the outstanding claims on other banking institutions totaled RMB 10.06 trillion yuan, a y-o-y growth of 26.35 percent. The size of interbank asset repurchase expanded by 55.2 percent to RMB 7.5 trillion yuan. Out of the total banking assets, interbank assets accounted for 15.13 percent, 1.8 percentage points higher from the beginning of the year. From the liability perspective, interbank deposits increased by 30.29 percent to RMB 12.2 trillion yuan, while total balance of interbank reverse repurchase recorded RMB 2.69 trillion yuan, a y-o-y increase of 26.29 percent. Interbank liabilities accounted for 13.87 percent of total liabilities of the banking sector, up by 1.23 percentage points from one year earlier. To a certain extent, banking institutions were trying to bypass loan quota and arbitrage interest rate control through the surging interbank channels. The improper development of interbank market would undermine regulatory scrutiny, constrain funding circulation within banking system, and weaken banks' capabilities to serve real economy.

Box 6 Responses of the commercial banks to interest rate liberalization

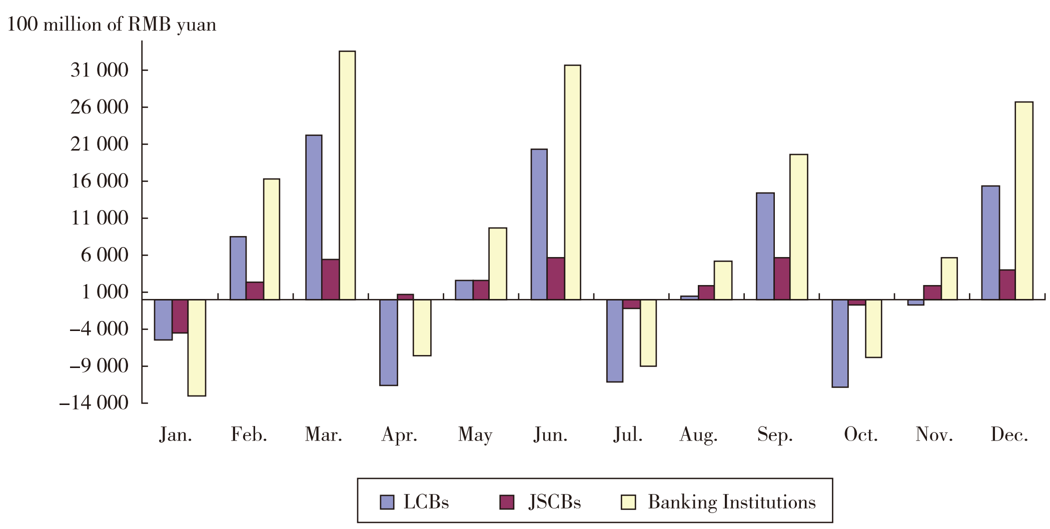
In June and July 2012, the PBC further expanded the interest rate floating range for deposits and loans of domestic financial institutions. The accelerated liberalization of interest rate has presented opportunities to commercial banks. Firstly, banks are granted more autonomy in pricing and more room to adjust the deposit and lending rates on basis of their own risk portfolios, so as to achieve risk-benefit balance. Secondly, banks will have more initiatives to optimize assets and liabilities configuration, making adjustments based upon price sensitivity to interest rates. Thirdly, the liberalization reform of interest rates will promote financial innovations in interest rate derivative markets, and stimulate banks to expand intermediate businesses.

However, interest rate liberalization also brings about challenges to commercial banks. Firstly, the net interest margin may shrink due to the increasing market competition and interest rate volatility. To a certain extent, banks may no longer be able to secure the favorable interest rate spreads merely by asset expansion, and their profitability may decline consequently. Secondly, as the interest rate risk and liquidity risk increase, banks' risk management capabilities will be put under pressure. The challenge may be even more rigorous for small and medium banks, which are in a disadvantageous position in risk management and pricing. Thirdly, the upcoming deposit rate differences may intensify market competition, redraw the boundaries of deposits among banks, and exert an influence on the funding stability of certain financial institutions.

Currently, in response to the interest rate liberalization, the commercial banks have flexibly utilized the pricing rights and timely adjusted their pricing strategies. Both deposit and lending rates are reflecting characteristics of differentiation. In the future, the commercial banks will actively adapt to the continuous reform of interest rate liberalization, and stick at the strategy of profession, differentiation and diversification. Firstly, accelerate the transition of business model, improve business structure and profit structure, and devote great efforts to retail businesses and intermediary businesses. Secondly, maintain financial discipline, persist the principle of independent operation at own risks, refine cost control techniques, make independent judgments of risk premium, and abandon the extensive development model, which places undue emphasis on customer size and market share. Thirdly, adjust risk appetite, and rectify the inclination to extend long-term loans, large-scale loans and highly-concentrated loans, so as to better foster real economy.

The increasing volatility of deposits put liquidity management under pressure. The stress of staggered growth and wide fluctuation in banks' deposits remained unchanged. In 2012, the monthly growth rate of deposits recorded 12.6 percent, 8.5 percentage points and 3.5 percentage points lower compared to 2010 and 2011 respectively. There were still great end-of-calculation-period arbitrage opportunities for banking institutions. It was a common practice for banks to boom deposits at the end of quarter while squeeze deposits base after regulatory reporting. Sometimes, the cross-quarter fluctuation spread could be over RMB 3 trillion yuan (Figure 2.8). At end-2010, the average liquidity ratio of banking institutions increased by 3.07 percentage points y-o-y to 47.77 percent. In recent years, off-balance sheet financing such as wealth management and trust business was expanding rapidly. Part of the business was subject to severe maturity mismatch by rolling over short-term borrowings to finance long term investments.

Figure 2.8 Monthly Deposits of Banking Institutions in 2012



Source: The PBC and the CBRC.

The off-balance sheet business experienced rapid growth, and risks began to emerge. In recent year, commercial banks showed increasing incentives to push credit off balance sheet, taking off-balance sheet businesses as an incubator for financial innovation and growth engine. At end-2012, outstanding balance on the off-balance sheet of banking institutions (including entrust loans and entrust investments) registered RMB 48.65 trillion yuan, an increase of RMB 8 trillion yuan or a y-o-y growth of 19.68 percent. The outstanding balance accounted for 36.41 percent of the total size of on-balance sheet, up by 0.54 percentage point from the beginning of the year. Risks lurking on the off-balance sheet might be spread to on-balance sheet by contagion, and regulatory measures should be taken to curb risky behaviors of internal earning transfers, cross subsidizations, etc.

Risks were latent in the booming wealth management business. Impelled by appetency for investment and financing, cross-sector financial services, represented by wealth management products, expanded rapidly. At end-2012, there were 3.1 trillion wealth management products in the market, with a balance of RMB 6.7 trillion yuan. Some trust companies and securities companies, as investment vehicles, channeled the wealth management funds to securities markets and real industries. Sales of wealth management products have helped mitigate the economy's over-reliance on bank funding, and satisfy partial financing needs of the real economy. However, the correlated risks should be attached importance. Some wealth management products were simply designed as alternatives of bank loans; part of the wealth management funds was directed to activities or industries explicitly banned by governments, aiming to bypass macro-control and financial supervision.

Some non-financial institutions with financial functions involved in illegal practices, and private lending risks were emerging. At end-2012, there were 6 080 micro-credit companies, 9 071 credit guarantee institutions, and 6 084 pawn houses. Due to weakness in internal management and external supervision, some institutions were driven by intermediate interest, violated the regulatory rules, and even got involved in illegal lending and fundraising. These misbehaviors seriously disrupted market discipline, and triggered risk events in some areas. Excessive interconnectedness existed between private lending markets and regulated financial system. Consequently, once the funding supply chains get disrupted in private lending markets, contagious risks would be spread to regulated financial system, and invoke unexpected events or regional events.

III. Outlook

Looking forward in 2013, banking institutions will be responsive to the new trends in financial markets, adhere to policies of reform, opening-up and development, actively address risks and challenges, constantly enhance the capacity to serve real economy, and dedicatedly build up a modern financial system that is reasonably structured, efficient and resilient.

Ensure implementation of prudent monetary

policies, and promote economic restructuring and transformation. It was stressed in the 18th CPC National Congress that fostering real economy should be an important mission of the banking sector. In 2013, banking institutions will keep credit volume at a reasonable level, optimize credit structure, improve the quality and efficiency of lending, and pursue favorable credit policies to key areas and vulnerable segments in the economy. Great efforts should be taken to speed up urbanization, improve financial services to agriculture, rural areas and farmers, and develop a diversified and moderately competitive rural financial system. Financial innovations dedicated to SMEs should be encouraged to address the funding stress of SMEs.

Deepen reform of banking sector, to cultivate a diversified banking structure. Measures should be taken to push forward ABC's reform of CABD, ensure the market orientation of CDB's reform, and promote the reforms of Exim Bank and ADBC. It is desired that policy banks and commercial banks complement each other, developing on the track of benign progress. Continue the commercialization of asset management companies. Remain committed to the current orientation of the reform of rural credit cooperatives, and encourage participation of private capitals. Devote major efforts to develop small and medium-sized financial institutions that have comparative advantages to serve SMEs, and nourish the development of community financial institutions. More support will be given to private capitals to enter the banking sector, getting involved in establishment and restructuring of new-type banking institutions. Initiate guidance to optimize hierarchy and regional distributions of various banking institutions. Accelerate the establishment of deposit insurance mechanism, and shore up the market-oriented safeguard to mitigate financial risks.

Take strict precautions against risks in key areas, and mitigate existing risks in a proper way. Banking institutions should adhere to the differentiated credit policies. While in support of reasonable social financing needs, banking institutions should enhance risk prevention in key areas, industries and regions, and mitigate the overcapacity risks in certain industries. With regard to LGFPs, gradual responses should be taken to control the overall size and manage risks through differentiated approaches. Continue to implement national real estate control policies and differentiated mortgage requirements; intensify the supervision over real estate lending and other funding risks. To address funding stress, proper measures should be taken to reduce risks related to reciprocal arrears or guarantees. More efforts are required to squeeze NPLs and improve the asset quality.

Deploy resources effectively against off-balance sheet risks, and stay cautious of risk contagion. Improve the reporting and supervision mechanism of cross-sector financial instruments, standardize the recognition, measurement, reporting and disclosure requirements of off-balance sheets, and ensure the completeness and accuracy of related information. Refine management policies and procedures regarding off-balance sheet businesses, impose strict internal risk control, take stringent reviews over funding cycles and risk control measures, establish risk firewall and risk compensation mechanism, develop emergency plans and prevent risk contagion to on-balance sheets. Strengthen credit management regarding inter-group customers and affiliates, so as to mitigate connected transaction risks. Intensify coordination among different regulatory policies and measures, clarify supervisory responsibilities and strengthen information sharing.

Improve regulatory framework drawing on international banking regulatory reforms. Refresh supervisory philosophy and mechanism, build up a prudent supervisory system, and improve the effectiveness of supervision. A banking regulatory framework should be built up on the basis of current situation in the banking sector, also in line with international standards. Within the framework, commercial banks will be incentivized to steadily implement new capital regulatory standards, counter-cyclical capital buffer requirement will come in force, and a more efficient capital constraint mechanism will be in place. Liquidity management framework will be gradually improved on basis of quantitative impact studies. Assessment methodologies, supervisory rules and effective resolution regimes that specifically target to D-SIFIs are expected to be finalized, and SIFIs will be guided to develop RRPs and carry out resolvability assessments accordingly.

Promote financial innovations steadily, and accelerate the transformation of financial sector. Push forward trails of cross-sector operation actively and prudently, The banking sector should be motivated to upgrade current business model that over relies on capital consumption and interest spreads, foster capital-saving businesses, and optimize capital structure, liabilities structure, customer structure and income structure. Financial instruments and innovations that are of benefit to real economy should be encouraged, including securitizations, risk mitigation instruments and new capital innovations. Explore the applicability of forestland rights, contractual management rights of rural land and rural homeland as mortgages collaterals. Bring forth new ways to attract private capitals into banking sector and encourage private capitals to involve in the establishment of new-type banking institutions or restructuring of existing banking institutions.

Box 7 Capital instrument innovations

As the recent global financial crisis unfolded, capital base in the global banking sector was insufficient to bear losses efficiently. In response to this shortcoming, the BCBS redefined capital, requiring that all eligible non-common equities must have contractual terms that allow them to be converted to common equities or written off at the point of non-viability. The proposal is an important element of finalizing the BCBS's package of measures to guarantee loss absorbency of regulatory capital instruments, and such capital instruments are qualified as contingent capital or bail-in debts.

The complete proposal of contingent capital is based on the contractual terms of capital instruments (preferential shares, long-term subordinated debts, etc.) that allow the capital instruments to be converted to common equities or written off on the occurrence of trigger event. The trigger could be event that the bank's capital ratio reaches a minimum threshold or the bank becomes non-viable. Contingent capital, as an on-line repair instrument, could replenish banks with high quality common equities, and sustain banks to continue as going concern.

Bail-in refers to a recapitalization mechanism whereby the claims of creditors are written-down or converted to common equities on the occurrence of gone concern in accordance with contractual terms of the instrument or statutory rules. The recapitalization may be achieved in one of the two ways: (i) Contractual bail-in: conversion or write-down of capital instruments under terms that are stipulated in contracts; or (ii) Statutory bail-in: statutory debt-equity conversion or write-off powers exercised by authorities at discretion. Essentially, bail-in regime is extension to the concept of contingent capital. While contingent capitals mainly include non-common equity capital instruments, bail-in regime applies a broader range from capital instruments to liabilities, such as senior short-term debts, derivatives, etc. Some even hold the opinion to cover uninsured deposits in the scope of bail-in.

So far, some internationally active banks have issued new Tier 1 and Tier 2 capital instruments compliant with Basel III criteria and the insurances have been structured to include certain contingent/bail-in requirements. Some highlights from the issuances are: (i) The trigger events are diversified, including CET 1 ratio falling below a pre-specified threshold, a point of non-viability, or mandatory conversion at a pre-specified future date. (ii) Loss absorbency mechanisms are different. Some instruments convert to common equities on the occurrence of trigger event, while others employ a permanent write-down or a temporary write-down. (iii) Most issuances have a higher premium compared with traditional capital instruments, usually by 50-200 basis points. The higher returns have attracted risk-seeking investors such as hedge funds, private investors, specialized fund companies, etc. In some jurisdictions, recognition has been given to contingent capital under supervisory requirements of capital.

Over the years, capital structure in China's banking sector appears relatively simple due to the underdeveloped financial market. To enrich capital toolkit and replenish capital basis, new capital instruments should be explored by drawing on a holistic perspective of both international experiences and national situation. In consideration of challenges like legal constraints, limited investor base, and incomplete financial infrastructures, the banking sector should take a gradual approach, starting with less complicated capital features within the current legal framework. During the process, the banking sector should make full use of existing distribution channels and market infrastructures, and prioritize innovations with fewer legal impediments.

Chapter III

Securities and Futures Sector

In 2012, reforms in the key areas of securities and futures sector were pushed forward steadily. Market institutions operated soundly in general. The sector had witnessed a rapid progress in innovation, with its capability of serving real economy further promoted.

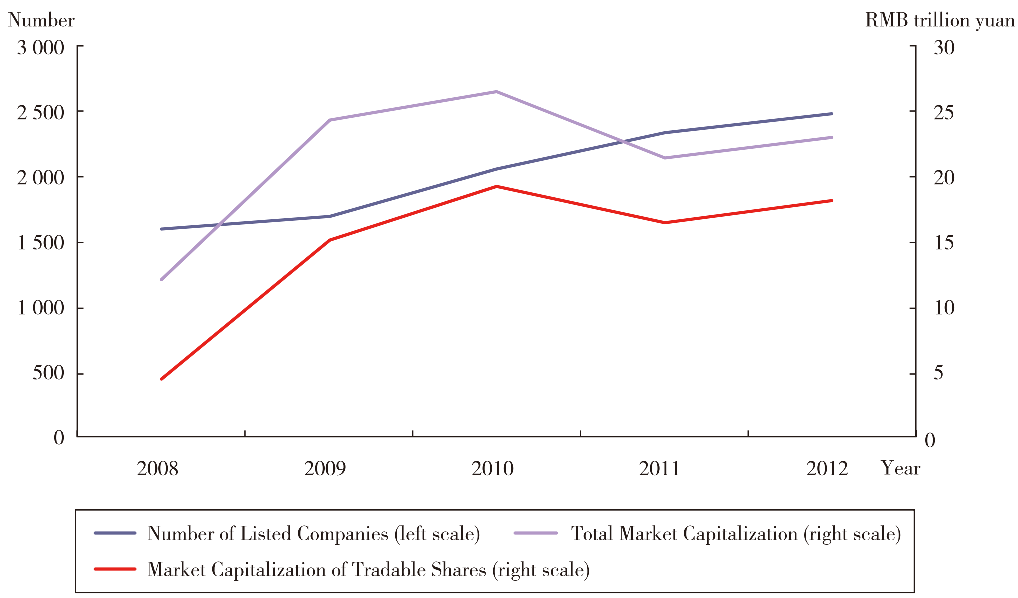
I. Recent Developments

1. Market entities developed steadily

Listed companies and stock market further grew. By the end of 2012, there were 2 494 listed companies on Shanghai Stock Exchange and Shenzhen Stock Exchange altogether, increased by 152 y-o-y, of which 154 were newly listed and 2 were delisted during the year. The total market capitalization reached about RMB 23.04 trillion yuan, an increase of 7.26% y-o-y; the market capitalization of tradable shares totaled RMB 18.17 trillion yuan, an increase of 10.15% y-o-y. Compared with -19.09% and -14.60% growth rates of the total and the tradable in 2011, the market capitalization regained a growth path (Figure 3.1).

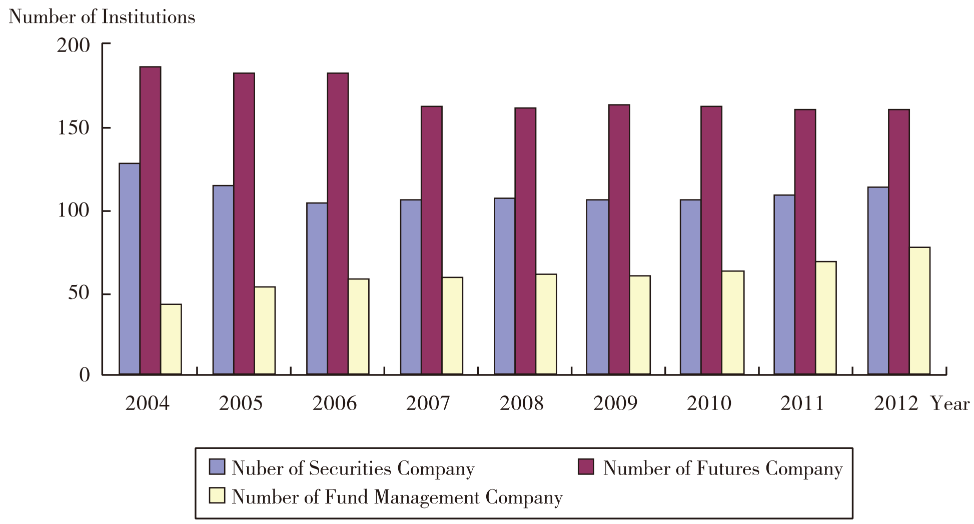
The number of securities and futures institutions increased further. By the end of 2012, there were 114 securities companies in total, up by 5 y-o-y. Of which 19 securities companies had been listed, up by 1 y-o-y. There were 161 futures companies, same as the previous year. The number of fund management companies was 77, up by 8 y-o-y (Figure 3.2).

Figure 3.1 Number and Market Capitalization of Listed Companies, 2008—2012



Source: The CSRC.

Figure 3.2 Number of Institutions Operating in Securities and Futures Sector, 2004—2012



Source: The CSRC.

The asset of securities and futures sector grew significantly. By end 2012, the total assets of securities companies[①] (excluding customers' assets) amounted to RMB 1.1 trillion yuan, up by RMB 209.2 billion yuan and 23.22% y-o-y. The futures companies' assets (excluding customers' assets) totaled RMB 50.55 billion yuan, up by RMB 10.35 billion yuan and 25.75% y-o-y. There were 1 173 funds managed by fund management companies, with 3.17 trillion units and a total net asset value of RMB 2.87 trillion yuan, up by 19.62% and 31.05% respectively y-o-y.

The innovation strengthened increasingly in the sector. Securities companies were allowed to issue Commercial Papers in inter-bank bond market, and engage in underwriting Non-financial Corporate Debt Financing Vehicles, making their financing channels and business scope further expanded. Besides, business lines, including the bond pledged repurchase through quotation, the mutual repurchase agreement and the cash management products, were gradually extended from pilot institutions. Under a newly released asset management policy, the operation limits of securities companies were lowered, and the investment scope was widened, making the asset management business boost notably. By end-2012, the asset managed by securities companies reached RMB 1.9 trillion yuan, jumped by 570% y-o-y. A new pilot program for futures companies to engage in asset management business was launched, and 20 futures companies had acquired such qualifications by the end of 2012. Progress was also made in the access policy for fund management sector, and to encourage institutions to innovate new fund products. During 2012, new products, like the cross-market ETF, cross-border ETF and wealth management products, were introduced to market.

① Data on securities companies had not been audited, the same below.

Box 8 Speed up the Business Innovation of Securities and Futures Institutions

In recent years, continuous progress was witnessed in developing multi-layered capital market, and expanding the breadth and depth of the market. However, the market intermediaries in securities and futures sector provided highly homogeneous services and products, and their earnings relied heavily on "channel business" and can easily be affected by the real economic environment. The lack of innovation capability disabled securities and futures companies to fulfill the needs from the real economy, and also make it difficult for enterprises and residents to invest and finance. In 2012, the authorities pushed the innovation and lifted the sector's serving capability.

For securities sector, firstly, certain rules were revised to support innovation, including the *Rules of the Calculation Standard for Securities Companies' Venture Capital Reserves, Rules on Securities Companies' Governance* and *Administrative Measures on Client Asset Management by Securities Companies*, as along with relevant supplementary documents. Secondly, the regulator reformed administrative approval procedures to encourage the innovation, abolished ones for asset management plans, and simplified those for qualification of margin selling and short selling. Thirdly, the business scope of securities companies also enlarged. A series of standards were released, such as *Guideline for Securities Companies' OTC business*, modified and extended basic functions of securities companies in custody, payment and OTC trading, and the legal right of securities companies to operate their subsidiaries and run direct investment funds also got clarified. Fourthly, the authority enriched the financial sources by allowing securities companies to issue commercial papers in inter-bank bond market.

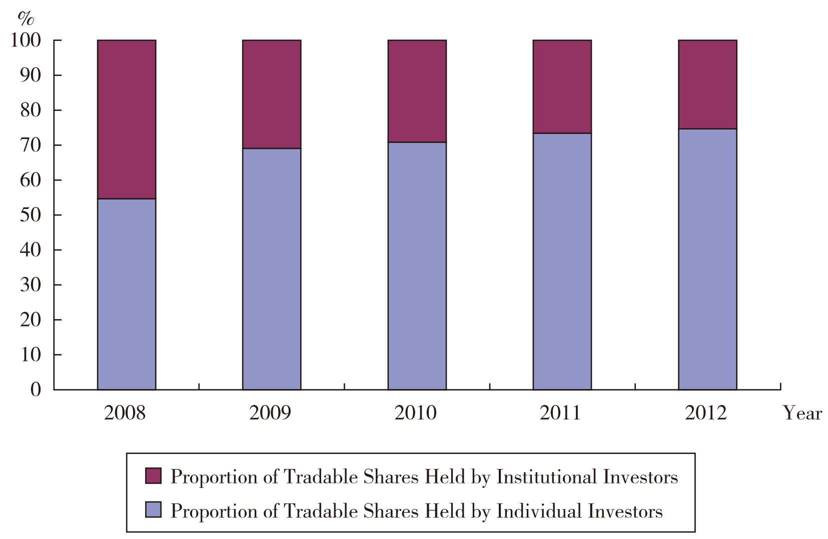
With regard to futures companies, the authority started an asset management business pilot program, which encouraged futures companies to found subsidiaries to run their risk management business.

Also, the regulator revised a series of laws and regulations regarding fund management companies, such as the *Securities Investment Fund Law of PRC* and *Administrative Measures on Securities-Investment-Fund Management Companies, etc*., which further enlarged the business line and investment scope for fund management companies, properly loosened the investment limits, emphasized corporate governance of the institutions, and simplified the administrative approval procedures for new products. Innovative products like cross-market ETF and cross-border ETF were gradually introduced.

Considering the complexity of business innovation design, which involved various kinds of market entities, close attention should be paid to the potential cross-market or cross-sector risks. In the next phase, in accordance with the requirements proposed by the National Financial Meeting 2012, securities and futures institutions should further deepen their innovations and strengthened their risk management, so as to better serve the capital market and the real economy.

The institutional investors were further expanded. Authorized by the State Council, in 2012, PBC, CBRC and CSRC jointly granted city commercial banks to join the pilot program, which allows commercial banks to set up fund management companies. The pilot program started in 2005, two batches of 8 commercial banks set up their own fund management companies ever since, with fund value totaled approximately RMB 500 billion yuan. The expansion of the pilot program contributed to build a channel of capital transferring from savings to the capital market, encouraged more professional institutions to participate in the capital market. With more supplementary rules on Social Security Fund (SSF) investment released, long-term capital investment, like SSF and Housing Accumulation Fund (HAF), had made further progress, which improved the investor structure of the capital market. At the end of 2012, the value of the tradable shares held by institutional investors accounted for 74.67% in Shanghai Stock Exchange and Shenzhen Stock Exchange, an increase of 1.22% y-o-y. The dominant role of institutional investors has played in China's capital market (Figure 3.3).

Figure 3.3 Comparison of Proportion of Tradable Shares Held by Institution and Individual in Tradable A-Share Market, 2008—2012



Source:The CSRC.

2. Institutional infrastructure construction progressed orderly

Progress had been made in building multi-layered capital market. Authorized by the State Council, the National GEM Equities Exchange System(usually referred as "new third board") was established, which officially started the pilot program of enlarging equities exchange of unlisted public companies, and there were 98 companies listed on the board by end-2012. The supervision and regulation measures for delisting public companies got released, clarifying rules on share exchange and issuance behaviors of these companies. To further consolidate multi-layered capital market, the authority guided the development of the district equity exchange markets, and encouraged securities companies to explore to establish OTC markets.

The construction of futures market was promoted steadily. Four new futures products were introduced into the market in 2012, including Silver Futures, Glass Futures, Rapeseed Futures and Rapeseed Oil Futures. The ongoing work in 2012 also included the preparation of Petroleum Futures market, simulation trading of Treasury Futures and exploring new trading vehicles like Carbon Emission Futures, Indexes and Options. The revised *Regulations on the Administration of Futures Trading* was issued. The regulation and supervision reforms in the futures sector were pushed forward, lowered trading costs, and enhanced market efficiency.

Reforms on market access and exit mechanism were notable. The focus changed from company's profitability to information disclosure for the IPO. Supervision on IPO pricing was intensified and a more reasonable pricing mechanism was formed. Compared with 2011, the average IPO price and the P/E ratio in 2012 decreased by 28% and 26% respectively; average excessive fund raised by companies listed on GEM lowered from 144% to 94%. The structure of capital market was optimized, and the institutional arrangement of delisting had been improved. By the end of 2012, two companies on Shenzhen Stock Exchange had completed the delisting process. The market-oriented reforms on M&A was also made progress, and about 70% of M&A business had no need to get approval.

The corporate governance of listed companies was further improved. Information disclosure mechanism of main board and GEM board were improved in 2012, in particular, *Guidelines on Industrial Information Disclosure for GEM* was issued. The companies applied for IPO were required to improve the disclosure quality regarding financial information , the conducts of issuer or market intermediate to whitewash the performance were inhibited, and the manipulation driven by interests was prohibited. Also, intensified supervision was also adapted to regulate the conducts of both issuer and accounting firm, which were required to execute the Accounting Standards strictly. The internal governance improving was emphasized as well.

Investors' protection mechanism was improved. Listed companies were encouraged to build up a consistent, clear and transparent cash dividend mechanism, and the listed companies which did not implement cash dividend or implemented in a long run were punished. Also, incentive measures were introduced, such as different individual tax collected based on the stock holding period. In 2012, the total cash dividend from domestic listed companies totally RMB 477.2 billion yuan, increased by 22% y-o-y. Investors' education was launched widely to make investors' behavior accord with their risk preference and make investment more rational.

Box 9 IPO Reform Carried out Steadily

IPO scheme includes a series of institutional arrangements, related to pricing, underwriting and selling, among which, stock pricing plays the core role. In 2005, the IPO pricing methodology changed, from setting administrative pricing limits, such as a limit of P/E ratio, to a relatively market-oriented way by bidding inquiry from qualified institutional investors. But buyers were still short of effective measures to supervise sellers' behavior, and the information disclosed by intermediaries and companies was lack of accurateness, stock price with high P/E ratio and over funding always accompanied the new listing. As a result, the stock price experienced fast climbing on the initial listing day and a quick drop later, causing individual investors huge financial losses, and preventing them from forming healthy and long-term investment behaviors due to the idea of "speculating new stock". So starting from 2009, obeying the principles set by the State Council "phasing-in reform, and gradually completion", the relative authorities launched IPO reform, aiming to establish market-oriented pricing mechanism.

Progress had been achieved in IPO reform in 2012. In April, the authority issued *Guidelines on Deepening IPO Reform*, which further clarified the responsibilities of issuers and market intermediaries, adjusted pricing consultation objects and subscription ratio, strengthened supervisions on IPO pricing and "speculating new stock", increased the amount of tradable shares, and aggravate the punished on illegal and irregular activities. Later, the support rules were also issued, including *the Decision of Revising "Administrative Measures on Issuing and Underwriting of Securities", Notice on IPO Pricing Related Issues,* and *Notice on Further Enhancing the Quality of IPO Companies' Financial Information Disclosure*. Meanwhile, the regulator intensified the supervisions and inspections of issuers, listed companies as well as the accounting firms, launched a special inspection on companies' financial conditions, and urged market intermediates to fulfill their duties.

After the introduction of these policies, 77 companies had been listed based on new IPO rules during the year. By the end of 2012, IPO reform reached the phase goal. Firstly, the IPO pricing mechanism functioned well: with the positive response from institutional investors, the number of institutional investors involved in IPO price consulting and stock subscription rose to 56 and 105, increased by 43% and 62% respectively y-o-y. The IPO P/E ratio decreased impressively to an average value of 29.4. Secondly, pricing mechanism on the initial trading day improved: the ratio of stocks with a closing price on its initial trading day lower than its issuing price drop from 27% in 2011 to 26%; the turnover ratio of initial trading day fell from 68% in 2011 to 63%. Thirdly, the phenomenon of stock price rushing down after issuance was improved; the average growth rate of stock price issued during May to August 2012 was −9.03%, better than −12.59% in 2011. Fourthly, market participants were more responsible, the issuers disclosed all the required information, market intermediaries behaved with more obligations; and some companies initiatively withdrew their IPO applications due to market question.

In the next phase, the route and detailed measures of IPO reform should be taken into consideration. Supervisions on market intermediaries and market-oriented pricing mechanism should be consolidated, so as to optimize the environment and structure of capital market.

3. Sector regulation and supervision made positive progress

Legal framework was further improved. The revised *Securities Investment Fund Law of PRC* was issued, which covered private investment funds under supervision. *Regulations on the Administration of Futures Trading* was also revised, in which the definition and rules of futures trading had been modified, and the responsibility of local government for banning out the illegal futures trading was clarified. The *Temporary Measures on Credibility Administration for Securities and Futures Sector* was released to consolidate credibility database of capital market.

Regulation and Supervision were strengthened. Punishments to illegal activities, including insider trading, fraud information disclosure, market manipulation etc., were much more severe. The case hearing efficiency for the sector was increased as well, with 380 case clues were accepted during 2012, a rise of 31% y-o-y; 316 new investigations were carried out, a rise of 21% y-o-y; 90 administrative penalties were executed, of which 33 had been delivered to the public security system, increased by 32% y-o-y. During 2012, an investigation and trial separation system was established, and a quick, joint and timely judicial reaction mechanism was formed. Besides, the supervision function of Stock Exchange, administrative agencies under CSRC and self-regulation organizations was strengthened as well.

Rectifying various exchanges were pushed forward. Following the State Council's order, authorities enhanced the standardization for setting up new exchanges, and achieved breakthrough in rectifying key areas and key exchanges. By the end of 2012, exchanges in 16 provinces including Zhejiang, Hubei had passed the inspection.

Supervisory cooperation was promoted. At the end of 2012, PBC and CSRC signed *MOUs on Strengthening Supervisory Cooperation of Securities and Futures Sector and Jointly Maintaining Financial Stability*. Such cooperation was aimed to take full advantage of PBC's widespread branches, to fill up the supervision gap at the city (county)-level due to shortage of CSRC branches. By means of enlarging information sharing and strengthening coordination etc., the financial supervision and risk monitoring were effective, and the prevention and resolution of market risks in securities and futures sector were jointly proceeded based on the *MOUs*, and branches of PBC and CSRC were encouraged to explore various, effective and innovative ways of cooperation based on the local conditions.

4. Steadily accelerated the opening-up of securities and futures sector

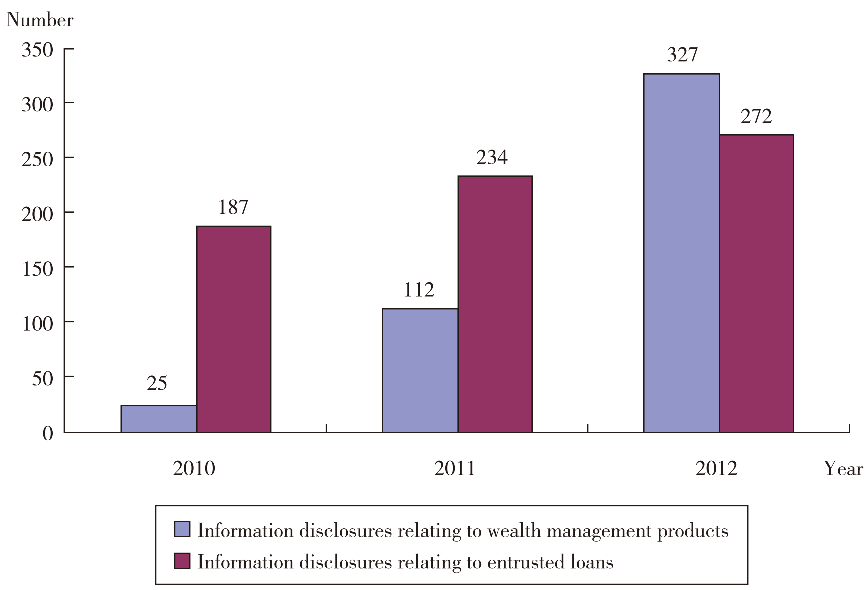
In 2012, the ceiling of shareholding ratio for foreign companies in one joint venture securities firm was lifted to 49%; foreign capital was also permit to invest in futures companies, with same upper limit of 49%. Requirements were lowered for mainland enterprises' IPO in Hong Kong stock market, and issue of RMB bonds in Hong Kong market was also encouraged. Shanghai Stock Exchange, Shenzhen Stock Exchange and Hong Kong Stock Exchange were supported to establish a joint company. The entry barrier was lowered for QFII, and 72 new foreign institutions had acquired QFII qualifications during the year. Besides, the total quota for QFII and RQFII was increased, which reached USD 80 billion and RMB 270 billion yuan respectively. The authority also raised the ceiling of QFII investment and the amount approved in 2012 totaled USD 15.8 billion, and the total QFII and RQFII quota amounted to USD 37.44 billion and RMB 70 billion yuan respectively by end-2012.

II. Soundness Assessment

1. The profitability of listed companies differed, and some companies blindly developed their non-core business

The aggregate profits earned by 2 494 listed companies in Shanghai Stock Exchange and Shenzhen Stock Exchange reported to RMB 2.09 trillion yuan, a y-o-y increase of 2.76%; of which, 238 listed companies were at loss (excluding the one planed to delist in 2012), up by 66 y-o-y. Under the circumstance of economic slowdown, some listed companies blindly developed non-core business in order to gain excessive returns. They took advantage of low-cost financing channels like bank loans or bonds, and invested in entrusted loans and/or wealth management products (Figure 3.4), which not only affected their core business and harmed the development of real economy, but also brought potential danger to the banking system. Once the risks of entrusted loans or wealth management products burst, the banking sector would certainly suffer.

Figure 3.4 Number of Information Disclosures Relating to Wealth Management Products and Entrusted Loans: Listed Companies, 2010—2012

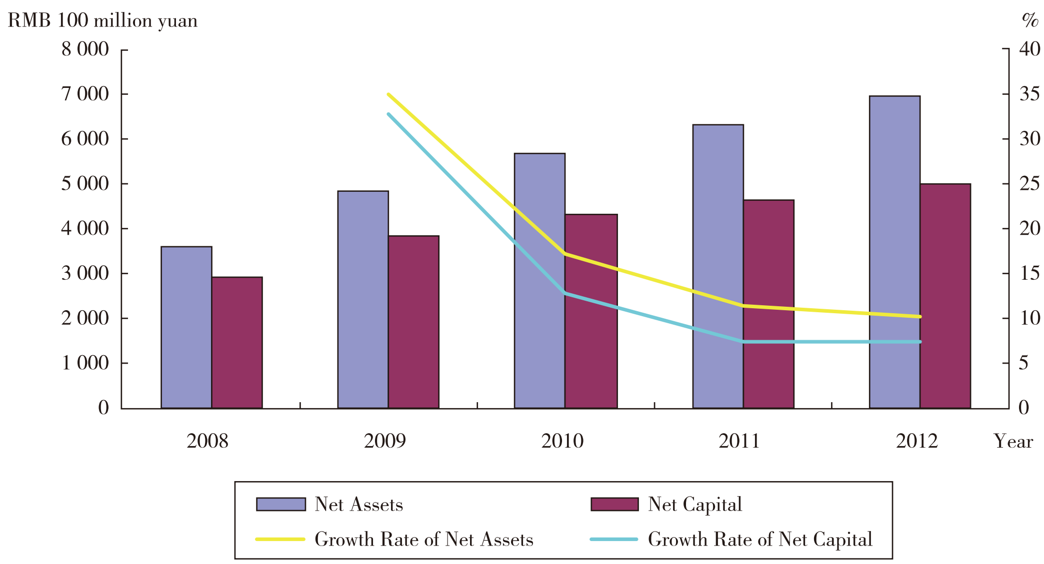


Source: Wind.

2. Securities companies' capability to withstand risks was relatively strong, and the overall liquidity was adequate

By the end of 2012, the net assets of securities companies amounted to RMB 694.3 billion yuan, and the net capital reached RMB 497.1 billion yuan, up by 10.15% and 7.27% respectively y-o-y (Figure3.5). On average, the ratio of net capital to risk-based capital provision reached 838%, ratio of net capital to net assets reached 72%, ratio of net capital to liabilities reached 49%, ratio of net assets to liabilities reached 68%, all risk control indicators met regulatory requirements. Besides, as a whole, the liquidity was adequate in the sector, with relatively low leverage and strong resilience to market risks in 2012.

Figure 3.5 Changes of Net Assets and Net Capital of Securities Companies, 2008—2012

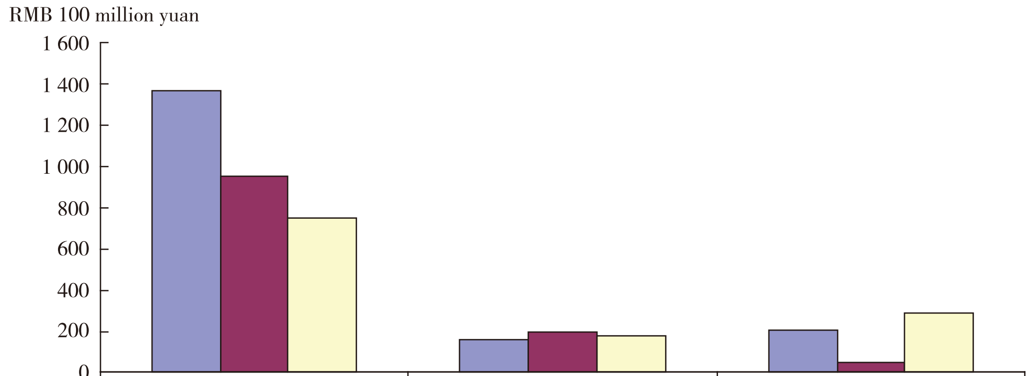


Source: The CSRC.

3. The profit structure of securities companies was modified, yet the potential risks of cross-sector financial products were worth attention

In 2012, the operating income of securities sector amounted to RMB 129.5 billion yuan in total, decreasing by 4.8% y-o-y, among which, RMB 75.4 billion yuan from fee and commission income with a y-o-y drop of 21%; RMB 29 billion yuan from the securities investment gains (including investment income and fair market value adjustments) with an y-o-y increase of 480%; RMB 17.5 billion yuan from net interest income with a y-o-y decrease of 10% (Figure 3.6). The net profits of 2012 accumulated RMB 32.9 billion yuan, dropped by 15% y-o-y. Breakdown analysis of the income structure showed that, fee and commission income was still the main income source of securities companies, the proportion of which, however, lowered from 70.2% in 2011 to 58.2% in 2012. The innovative business, especially the expansion of specified asset management business, contributed to the improvement of securities companies' income structure. By the end of 2012, the entrusted assets managed by securities companies reached RMB 1.89 trillion yuan, almost increased by 600%, compared with RMB 281.9 million yuan at the beginning of 2012. The innovative business of securities companies was launched in a relatively short period of time, and its design mechanism was relatively complex, which involved various kinds of institutions including banks, trust companies etc., so the potential cross-market or cross-sector risks were worth close attention.

Figure 3.6 Comparison of Securities Companies' Income Structure, 2010—2012



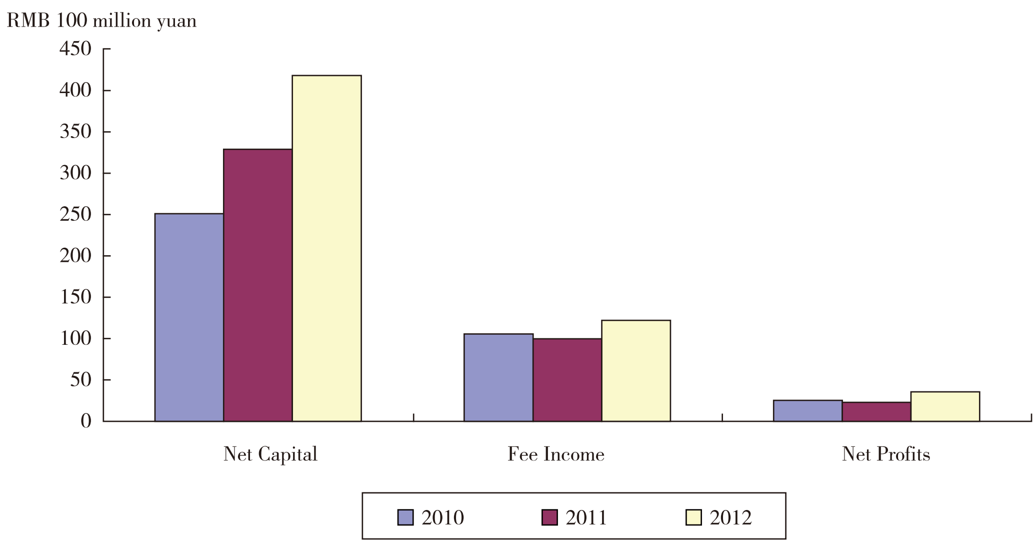
	Fee and Commission Income	Net Interest Income	Investment Gain (Gain from Fair Value Change is included)
2010	1372.23	156.45	207.00
2011	954.40	194.04	50.00
2012	753.54	174.83	290.00

Source:The CSRC.

4. The profitability and strength of futures companies continuously enhanced

By the end of 2012, the total assets of futures companies (excluding entrusted assets from customers) amounted to RMB 50.553 billion yuan, the net assets reached RMB 45.684 billion yuan and net capital reached RMB 41.81 billion yuan, up by 25.75%, 27.32% and 27.16% respectively y-o-y. The total client margin reported to RMB 176.706 billion yuan, a y-o-y increase of 18.91%; the operating income reached RMB 16.96 billion yuan in 2012, an increase of 46.33% y-o-y; and the net profits totaled RMB 3.573 billion yuan, a y-o-y increase of 59.72% (Figure 3.7). Yet, compared with other financial institutions, the strength of futures companies was relatively weak. By the end of 2012, the average net capital of futures companies was less than RMB 0.3 billion yuan. The income of futures companies were mainly relied on fee and commission from client and interest income of client margin, in which RMB 12.22 billion yuan from the former source and RMB 4.246 billion yuan from the latter one in 2012.

Figure 3.7 Changes of Major Indicator for Futures Companies, 2010—2012



Source:The CSRC.

5. The fund management sector developed soundly, yet the redemption risks of fixed income funds needed attention

By the end of 2012, the value of securities investment funds reached RMB 2.87 trillion yuan, among which, stock market funds and mixed funds accounted for 40.04% and 19.70%, with y-o-y decrease of 6.7% and 6.3% respectively, while bond market funds and money market funds accounted for 13.18% and 19.95%, up by 7.7% and 6.5% respectively y-o-y. The growth speed of fixed income funds was apparently faster than that of stock market funds, which was mainly attributed to investors' risk avoidance and the launch of short-term financial products. With the change of macroeconomic environment and rebound of stock market, fixed income funds were likely to face certain redemption pressure, so liquidity management of such funds needed to be strengthened.

III. Outlook

In 2013, for enhancing the capability to serve the capital market and real economy, the securities and futures sector should further develop in a stable way, push forward the reforms and innovations steadily, perfect market system, strengthen supervision, foster orderly development of listed companies and market institutions, protect investors' legal right, and hold the bottom line of preventing systemic and regional risks from happening.

1. Further develop multi-layered capital market and improve the capability of serving real economy

The authorities should continue to modify the Main Board, SME Board and GEM Board, and clarify refinancing rules for GEM. The pilot "New Third Board" coverage should be enlarged, by loosening the location limits, and allowing more qualified medium-small sized enterprises to be listed on "New Third Board". Also, the innovation of financing and trading mechanism of "New Third Board" should be strengthened to attract more medium-small sized enterprises to finance on "New Third Board". The role and function of regional equity exchange market should be further defined, to promote a harmonious development with "New Third Board", and to provide differentiated services based on the size, type and the growth phase of enterprises.

2. Continue to strengthen legal enforcement and supervision system

The authorities should provide additional measures for enforcing the laws in securities and futures sector, and strictly investigate and punish any illegal activities including insider trading, market manipulation, fraud listing and false information disclosure, etc.. An effective case-clue finding system should be established, and information sharing mechanism should be reinforced. More efforts need to be made to improve supervision system for capital market accounting, through strengthening on-site inspections to auditing and assessment institutions, and strengthening punishments to illegal practice of accounting and assessment institutions. The authorities should also further perfect investigation-trial-separation mechanism, and accelerate enlarging the administrative punishment pilot. Furthermore, the authorities should assess capital market's law and regulation enforcement in an all-around manner, and intensify supervision and administrative punishment on market irregularities.

3. Steadily push forward business innovation and promote diversified development of securities and futures institutions

A diversified, differentiated and professional business model should be encouraged. Holding risk under control, securities and futures institutions should foster innovations in business lines, products and management. Securities companies should be supported to conduct innovative businesses like asset management, OTC products, and asset-backed securities (ABS). For futures companies, authorities should continue to promote the pilot business like asset management and investment consulting, and deepen futures products' innovation, including Petroleum Futures, Treasury Futures, Commodity Index Futures and Options. Public wealth management firms like fund management companies should be encouraged to create new management model, expand business scope and develop more products to meet the market's needs.

4. Improve corporate governance and transparency, and intensify investor protection mechanism

The authorities should consolidate supervisions on information disclosure, and enhance the authenticity, accuracy and punctuality of the information disclosed by listed companies. Also, the authorities should improve the approval mechanism for listed companies' M&A, enrich ways of M&A, and innovate ways on firms' issuance of merger bonds, merger funds and bridge loans, in order to promote listed companies' overall capability and the sector's upgrading. IPO mechanism should be reformed in a market-oriented way; the administrative approval procedure should be simplified; capital constraint, market discipline and credit constraint should be reinforced. Besides, the authority need to further improve dividend mechanism of listed companies, encouraging listed companies to increase cash dividend. Market exit mechanism reform should be accelerated, to enhance listed companies' comprehensive strength.

5. Push forward the opening-up actively, and foster the international competitiveness

Further perfect the institutional arrangement for QDII, increase QFII and RQFII's investment quota, and enhance investment convenience. The authorities should support the development of cross-border ETF and cross-border bond market, and explore new ways of cooperation like mutual recognition of investment products in Hong Kong market and the mainland market. The authorities should actively promote foreign investors to participate in the construction of domestic metal, petroleum and financial futures market, and push forward the pilot program of overseas brokerage business of futures companies. The authorities should study the feasibility of lowering the market entry, increasing the shareholding ratio for foreign capital, and gradually widening the business scope. And all these policies should be tried first for financial institutions from Hong Kong and Macao. The authorities should also keep on supporting domestic enterprises to go listed overseas, and encourage qualified securities and futures institutions to participate in the international market.

Box 10 Push forward steadily the delisting mechanism reform

Delisting mechanism provides incentive and constraint for listed companies, and increases the quality of listed companies. China established the delisting mechanism in 2001, but due to the simple standard and complex procedure, poor-performed listed companies always managed to avoid delisting. Such situation that failed listed companies' share-trading was suspended but not to delist caused speculation on "Shell Resource", and along with this, insider trading and market manipulation came forth.

In March 2012, the State Council clearly required the regulatory authorities to carry out the delisting reform, and set up an "orderly and smooth" market exit mechanism. In April, Shenzhen Stock Exchange revised and issued *Rules on GEM stock listing of Shenzhen Stock Exchange*, which established new delisting rules, and clarified that listed companies on GEM board should be transferred to Equities Exchange and Quotations system after delisting, and the relisting through "company shell" will not be supported. In June, both Shanghai Stock Exchange and Shenzhen Stock Exchange announced the reform schemes for Main Board and SME Board's delisting rules, revised the measures of delisting which was released in 2008, and added market-oriented delisting standards. According to the new rules, companies will be delisted if any of the following happens: net assets was negative for three consecutive years, operating income was lower than RMB 10 million yuan for three consecutive years, the closing price was lower than face value of the share for 20 consecutive trading days. In July, Shanghai Stock Exchange and Shenzhen Stock Exchange respectively issued the revised stock listing rules, which modified the contents about delisting, trade suspension and resumption, and later issued the supplementary rules, including the setup of "Risk Warning Board", "Delisting Finishing Period" and "Relisting Rules", etc..

By the end of 2012, Shenzhen Stock Exchange terminated two companies' listing. In January 2013, Shanghai Stock Exchange officially ran the "Risk Warning Board" system, which meant shares of 23 ST companies and 20 *ST companies would be traded under this special arrangement. The delisting operation involved a large number of investors' interests, so handling the impact to all involving parties should be cautious, and make sure the market would still run stably. In the next phase, the delisting reforms should be carried out actively and steadily, and further perfect the delisting mechanism, and make the delisting normalization.

Chapter IV

Insurance Sector

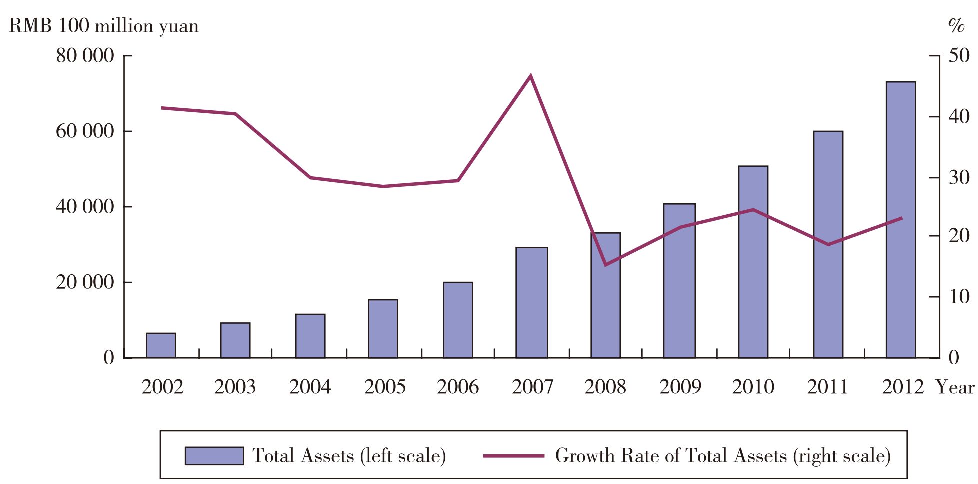
In 2012, China's insurance sector registered steady growth and made progress. The overall market was stable, the institution reform was further promoted, the reform of insurance funds utilization achieved breakthrough, and solvency adequacy level of the sector was enhanced. However, the sector's development has encountered increased pressure during the year.

I. Recent Developments

1. Asset size increased relatively fast and the number of institutions rose steadily

By the end of 2012, total assets of the insurance sector registered RMB 7.35 trillion yuan, increasing 22.9 percent year on year (Figure 4.1). The number of insurance institutions was 164, including 10 insurance groups and shareholding companies, 61 property insurance companies, 68 personal insurance companies, 8 reinsurance companies, 15 insurance asset management companies, 1 export credit insurance company and 1 rural insurance cooperative. Compared with 2011, the number of insurance institutions rose by 12, among which 6 were personal insurance companies, 4 were insurance asset management companies, and 2 were property insurance companies.

Figure 4.1 Total Assets and Growth Rate of the Insurance Sector



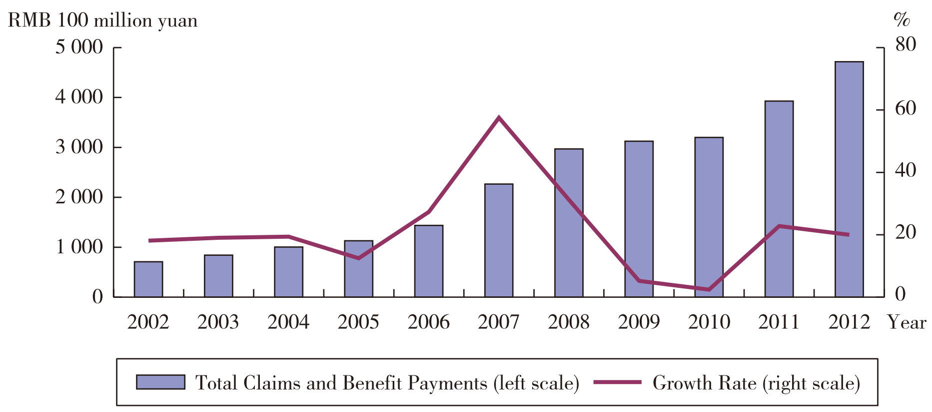
Source: The CIRC.

2. Premium income kept growing, and the sector's capacity to serve the economy and society was enhanced

In 2012, premium income nationwide amounted to RMB 1.55 trillion yuan, increasing 8 percent year on year, 2.4 percentage points lower than last year. Premium income from property insurance, life insurance, health insurance and accident insurance were RMB 533.1 billion yuan, RMB 890.8 billion yuan, RMB 86.28 billion yuan and RMB 38.62 billion yuan, up 15.4

percent, 2.4 percent, 24.7 percent and 15.6 percent y-o-y, respectively. Claims and benefit payments amounted to RMB471.63 billion yuan, increasing 20 percent y-o-y (Figure 4.2). The capacity of insurance sector to serve the economy and society was further enhanced. Agriculture insurance developed fast, with premium income standing at RMB 24.06 billion yuan, an increase of 38.3 percent year on year. It provided risk coverage of RMB 900.6 billion yuan for 183 million household times, and RMB14.82 billion yuan of payment has been claimed to 28.18 million rural households. The pilot program of micro insurance was expanded to the whole country, and the number of participants amounted to 32 million, up 33.3 percent y-o-y. The insurance sector actively participated in the new rural cooperative medical insurance program, and was entrusted with the management of RMB 5.05 billion yuan of funds. Export credit insurance premium income registered RMB14.26 billion yuan, offering risk coverage of USD 293.65 billion to 35 thousand enterprises.

Figure 4.2 Total Claims and Benefit Payments and Its Growth Rate



Source: The CIRC.

Box 11 Micro-Credit Insurance

Micro-credit insurance is an insurance business that insures the banking financial institutions, micro-credit companies or other institutions (referred to as "banks" hereinafter) when their micro-loan borrowers cannot repay the loans in time. By enhancing security of credit assets, micro-credit insurance can help transform potential social financing demand to effective demand, therefore playing an important role in supporting real economy, especially agriculture, farmers, rural areas and small & micro enterprises. From the aspect of insurance responsibilities, micro-credit insurance can be divided into personal accident insurance for micro-credit borrowers and micro-credit guarantee insurance. Taking government participation into consideration, it can also be categorized as "bank + insurance company" model or "government+ bank + insurance company" model. For the first one, the government will not provide such supportive policies as premium subsidy or preferential tax, while for the latter, local governments will provide subsidy to insurance companies when insurance claims exceed premium income by a certain percentage, which mainly applies to micro-credit guarantee insurance.

In 2003, China Pacific Life Insurance Company and rural credit cooperatives took the lead in micro-credit insurance business. In 2008, China Insurance Regulatory Commission (CIRC) issued *Pilot Program of Small-sum Personal Insurance in Rural Areas*, and launched pilot programs in some villages below county level in nine provinces, including Guangxi, Henan and Sichuan. In 2009, the pilot program was further expanded. Until now, micro-credit insurance has achieved relatively fast development, but challenges still exist. First of all, there were not enough insurance options. Most of the micro-credit insurance policies were personal accident insurance, while products insuring repayment risks caused by natural disasters were few. Secondly, risk sharing mechanism needed improving. Credit loss was covered fully by insurance companies, increasing burdens of insurance companies and banks' moral hazard. Thirdly, it was difficult to control related risks. Insurance companies usually didn't possess effective means or capabilities to collect credit conditions of loan borrowers, which led to difficulties in monitoring use of micro-credit funds and obtaining re-insurance. The fourth problem is lack of policy support. Micro-credit insurance is a quasi-public good used to support agriculture, rural areas, farmers and small & micro enterprises. However, except for a few provinces (municipalities) such as Zhejiang, Jiangsu and Shanghai, most provinces (municipalities) don't have government supportive policies such as premium subsidy or tax deduction and exemption. Last but not the least, some farmers, rural credit cooperatives, small & micro enterprises don't have enough insurance knowledge to understand the merits of micro-credit insurance products, and sometimes even resist these products.

In order to promote the development of micro-credit insurance, insurance companies will further improve product design in line with the development stage of regional economy and differentiated needs of clients, launch products that better meet the real demand of loan borrowers, and establish better risk sharing mechanism with banks. The governments will strengthen premium subsidy and tax deduction and exemption, and enhance education and guidance by means of media publication, such as television programs, newspapers, broadcasting and the internet. These will help educate the public and small & micro enterprises on the role and typical cases of micro-credit insurance, deepen their understanding of the role played by micro-credit insurance in risk management, and help them gradually develop the habit and awareness of insurance consumption, therefore creating a favorable development environment for micro-credit insurance.

3. Cross-sector share holding between banks and insurance companies increased, integrated operation has made new progress

In July 2012, the former Ping An Bank and Shenzhen Development Bank merged into Ping An Bank, enabling China Ping An Insurance Group Co., Ltd.(Ping An Insurance) to become a company that possesses diversified financial business lines and deeply integrated operation. Banking assets accounted for 57 percent of total group assets, and banking business's contribution to group profits reached 34.3 percent, while the contribution of securities, trust and asset management business was about 10 percent. In the same month, Industrial and Commercial Bank of China (ICBC) became a shareholder of AXA-Minmetals Life Insurance Co., Ltd. which was renamed as ICBC-AXA Life Insurance Co., Ltd. In January 2013, Agricultural Bank of China (ABC) acquired 51 percent of shares of Jiahe Life Insurance Co., Ltd., which became ABC Life Insurance Co., Ltd. Until now, there have been nine insurance companies controlled by banks, among which eight were personal insurance companies and one was property insurance company in China. Relying on the broad network of bank outlets, the above mentioned personal insurance companies developed fast, achieving RMB 39.4 billion yuan of premium income in 2012, up 71 percent year on year, which accounted for 3.96 percent of the total premium income of China's personal insurance companies, up 1.55 percentage points y-o-y.

4. Insurance sector reform was steadily promoted, and the sector's operation was on a firmer footing

In February, China Insurance Security Fund Co., Ltd. injected RMB 6 billion yuan into China United Insurance Company Limited (China Insurance); in November, China Insurance was approved to introduce China Orient Asset Management Corporation as its major shareholder, which takes up 7.81 billion shares. By then, the restructuring of China Insurance was basically completed, and the long-endured insolvency problem was addressed. On 7 December, the People's Insurance Company (Group) of China Limited launched its IPO in H-share market of Hong Kong and raised USD 3.56 billion, which was the largest IPO in the last two years in

Hong Kong. On 18 December, China Export & Credit Insurance Corporation (Sinosure) held its reform and capital injection ceremony, and convened the first meeting of board of directors. Through capital injection and reform, Sinosure's capital adequacy was significantly reinforced, its corporate governance further improved, and its role as a policy insurance company was strengthened, which greatly enhanced its ability to support China's export enterprises.

5. Foreign insurance companies' operation was expanded, and opening-up was further enhanced

In 2012, having met all of the commitments made when joining the World Trade Organization[①], China further opened its insurance market to foreign capital by amending *Regulations on Compulsory Traffic Accident Liability Insurance for Motor Vehicles* and allowing foreign-funded insurance companies to run business of compulsory liability insurance for vehicles. As of year-end, there were a total of 52 foreign-funded insurance companies in China, including 27 joint venture insurance companies and 25 insurance companies solely funded by foreign investors. Foreign-funded insurance companies gained premium income of RMB 54.25 billion yuan, accounting for 3.5 percent of total premium income in China, up 0.4 percentage point than last year. The premium income of foreign-funded personal insurance companies and foreign-funded property insurance companies registered RMB 47.54 billion yuan and RMB6.71 billion yuan, occupying 4.77 percent and 1.21 percent of total premium income of life insurance companies and property insurance companies in China, increasing 0.73 and 0.12 percentage point year-on-year, respectively.

6. The Regulation on Agricultural Insurance was formally issued, strengthening the construction of insurance system

In November, the State Council issued *The Regulation on Agricultural Insurance*, setting rules on principles, operations, policy support, regulation and supervision of agricultural insurance. *The Regulation* took effect on March 1, 2013. The issuance and implementation of *the Regulation* will help promote the healthy development of agricultural insurance, improve the system of agriculture support and protection, and enhance risk resilience of the agriculture sector. In August, six departments, including National Development and Reform Commission, Ministry of Health, Ministry of Finance, Ministry of Human Resources and Social Security, Ministry of Civil Affairs and CIRC, jointly announced *The Guidance for the development of Critical Illness for*

① Except that foreign-funded insurance companies cannot run statutory business and that foreign-funded life insurance companies must be founded in a joint basis with Chinese shareholders and foreign investors cannot hold more than 50 percent of the shares, China's insurance sector has basically achieved all-fledged opening-up.

Urban and Rural Residents, signaling the full launch of critical illness insurance system led by the government and operated by commercial insurance institutions. In order to strengthen insurance regulatory system, the insurance regulator issued the plan for establishment of China's second-generation solvency supervision system, putting forward the idea of establishing a new risk-oriented solvency supervision systemin line with China's specific conditions and characteristics of emerging insurance market. The market-oriented reform of insurance fund management was pushed forward, and more than 10 new regulations were issued successively on asset allocation, bond investment, equity and real estate investment, and etc. Private capital was encouraged to enter the insurance sector, and the shareholding proportion of single and eligible private investor was enlarged to above 20 percent. Principles, methods and procedures related to the formulation and approval of commercial vehicle insurance clauses and premium rates were clarified, and management of insurance clauses and premium rates of life insurance companies were strengthened. Management mechanism of insurance sales personnel was improved by the issuance of opinions on promoting the reform of administrative system of insurance sales personnel. Comprehensive measures were taken to deal with misleading sales in life insurance sector and difficulties in claims of auto insurance, as identification and criteria of law enforcement concerning life insurance misleading sales misguidance were standardized, accountability mechanism was brought in to strengthen the responsibility of insurance institutions, and the guideline for the management of auto insurance claims was formulated to standardize claim services and procedures for auto insurance.

Box 12 Promoting Market-Oriented Reform of Insurance Funds Utilization

Fund utilization is an important pillar for insurance sector development. In 2012, in order to further enhance efficiency of insurance fund utilization, CIRC successively issued over 10 new regulations concerning asset allocation, entrusted investment management, bond investment, equity and real estate investment, investment in infrastructure debt plans, overseas investment, financial derivatives investment, stock index futures trading, investment in financial products and insurance asset management companies, making a great breakthrough in scope of investment and entrusted institutions (Table 4.1). Firstly, the scope of investment was expanded. Insurance funds were allowed to invest in financial products, stock index futures, and etc., and the investable categories of bonds were enlarged to include almost all public issued bonds. Secondly, investment limit was raised, with the proportion of investment in unlisted equity and real estate increased to 10 percent and 20 percent from 5 percent and 10 percent, respectively. Thirdly, investment thresholds were lowered. Insurance companies that met the lower limit of solvency adequacy ratio of 120 percent, instead of 150 percent in the previous rule, could invest in unsecured non-financial corporate bonds, unlisted equity and real estate. Fourthly, overseas investment was expanded. Insurance funds could be invested in stocks, equities and real estate in 25 developed economies and 20 emerging market countries. Fifthly, business scope of insurance asset management companies was expanded, which were allowed to manage funds entrusted by pensions, enterprise annuities, housing funds, and etc. Sixthly, investment management market was opened to encourage more market competition. Securities companies and fund management companies were brought in as trade counterparties.

The market-oriented reform of insurance fund utilization enabled the scope of investment of China's insurance sector to approach that of mature insurance market, which strengthened the initiative and flexibility of insurance companies in asset allocation, and was favorable for better matching of assets and liabilities, diversification of market risks and increasing investment return of insurance companies.

Table 4.1 Scope of Investment for Insurance Funds

Scope of investment	Current rules	Previous rules
Deposits, government bonds, central bank bills, financial bonds issued by policy banks, money market mutual funds	The same as the previous rules.	Total investment should not be lower than 5 percent of the total assets at the end of last quarter.
Bonds	**Bonds are divided into government bonds, quasi-government bonds, and enterprise (corporate) bonds.**	**Bonds are divided into government bonds, financial bonds, and enterprise (corporate) bonds.**
Government bonds	Investment volume can be self-determined; investment in central bank bills follows the same rules.	Investment volume can be self-determined.
Quasi-government bonds	Investment volume can be self-determined; investment in financial bonds and subordinated bonds issued by policy banks follows the same rule.	This classification does not exist.

concluded

Scope of investment	Current rules	Previous rules
Financial bonds	This classification does not exist.	Funds can be invested in central bank bills and financial bonds and subordinated bonds issued by policy banks; investment volume can be self-determined.
Enterprise (Corporate) bonds	Convertible bonds and hybrid capital bonds issued by commercial banks and insurance companies are included in the investment scope. For financial enterprise (corporate) bonds and secured non-financial enterprise (corporate) bonds, investment volume can be self-determined; for unsecured non-financial enterprise (corporate) bonds, balance of investment cannot exceed 50 percent of total assets as of the end of last quarter.	For covered enterprise (corporate) bonds, investment volume can be self-determined; for unsecured enterprise (corporate) bonds and non-financial enterprise debt financing instruments, total book balance of investment cannot exceed 20 percent of the total assets as of the end of last quarter.
Stocks and securities investment fund	The same as the previous rules.	Total investment should not exceed 25 percent of total assets.
Stocks and equity funds		Total investment should not exceed 20 percent of total assets.
Securities investment fund		Investment should not exceed 15 percent of total assets.
Overseas investment	Overseas investment scope is clarified as including 25 developed countries and 20 emerging market countries. Investment cannot exceed 15 percent of total assets at the end of last year; and investment balance in emerging markets cannot exceed 10 percent of total assets at the end of last year.	Investment should not exceed 15 percent of total assets at the end of last year. Funds can be invested in Hong Kong main board market.
Unlisted enterprise equities	Total investment in unlisted enterprise equities and private equity fund cannot exceed 10 percent of total assets at the end of last quarter.	Investment should not exceed 5 percent of total assets as of the end of last quarter.

concluded

Scope of investment	Current rules	Previous rules
Real estate	Total investment in real estate that is not for self use, infrastructure debt investment schemes and real estate-related financial products cannot exceed 20 percent of total assets at the end of last quarter.	No higher than 10 percent of total assets at the end of last quarter.
Real estate not for self use	No higher than 15 percent of total assets.	
Infrastructure debt investment plans and real estate-related financial products	Total investment cannot exceed 20 percent of total assets at the end of last quarter.	
Infrastructure debt investment plans	No level limits on bond issuers and payers; limits on investment proportion are the same with the previous rules.	Bond issuers and payers should be at central level. Investment cannot exceed 10 percent of total assets at the end of last quarter.
Financial products	The balance of wealth management products, credit asset-backed securities, assembled fund trust plans, specific asset management plans and project asset-backed plans cannot exceed 30 percent of total assets at the end of last quarter; the total balance of infrastructure investment plans and real estate investment plans cannot be higher than 20 percent of total assets at the end of last quarter.	n.a.
Financial derivatives	Domestic derivative trading can only be made with the intention of hedging or avoiding risk, not speculation.	n.a.
Stock index future trading	At the end of any trading day, the contract value of call stock index futures and the book balance of stocks and equity funds held by insurance institutions altogether cannot exceed 20 percent of total assets.	n.a.

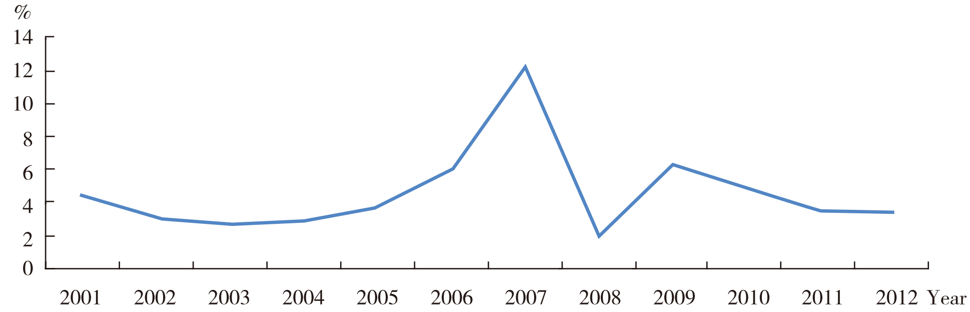
Source: Summarized on the basis of CIRC files.

II. Soundness Assessment

1. ROI of insurance funds decreased, and the risk of mismatch between asset and liability maturities increased

By the end of 2012, the balance of insurance investment funds was RMB 6.85 trillion yuan, increasing 24 percent year on year, among which bank deposits were 2.34 RMB trillion yuan, accounting for 34.2 percent of total funds; bond investment was RMB 3.05 trillion yuan, accounting for 44.6 percent; stock (equities) investment was RMB 660.6 billion yuan, accounting for 9.6 percent; and investment in securities investment fund was RMB 362.6 billion yuan, accounting for 5.3 percent. Return on investment was RMB 208.5 billion yuan, and the average Return on Investment (ROI) was 3.39 percent, 0.18 percentage point lower than last year (Figure 4.3). Affected by fluctuation in bond market and a weak stock market, insurance companies adjusted investment structure, with the share of deposits going up by 2.2 percentage points and those of bonds and stocks down 2.5 and 0.7 percentage points. Currently, the life insurance industry usually uses a ROI of around 5.5 percent as actuarial assumption, but the ROI of insurance funds has been lower than this level for 3 successive years, forming a ROI gap. In addition, the insurance sector has also the problem of short-term use of long-term funds, which led to mismatch between maturities of assets and liabilities. As of the end of 2012, maturity gap between assets and liabilities that exceeds 15 years was more than RMB 2 trillion yuan in the industry, among which traditional insurance took up about RMB 881.4 billion yuan, and participating insurance and universal insurance accounted for about RMB 816.1 billion yuan and RMB 325.0 billion yuan, respectively. Due to inadequate mid-to-long term investment tools in the financial market, mismatch risk in insurance fund maturities could worsen in the future.

Figure 4.3 Average ROI of Insurance Funds

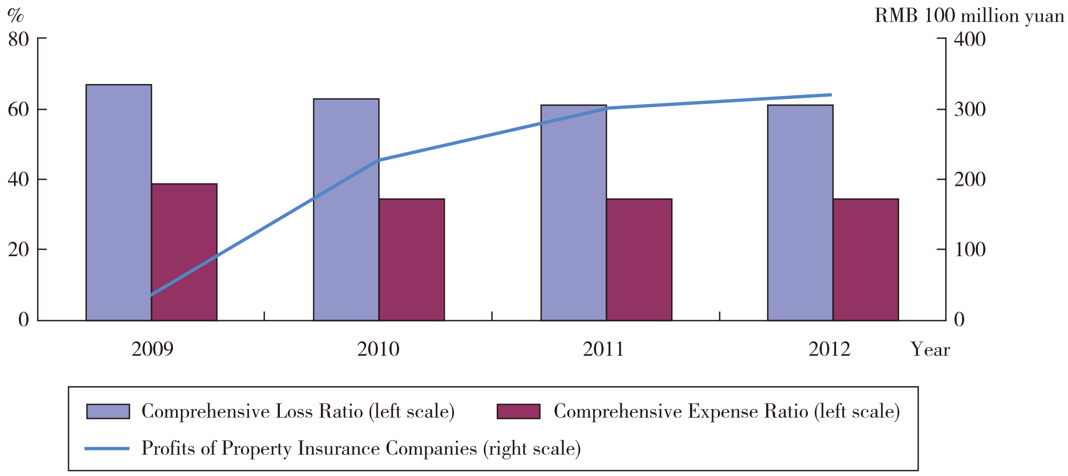


Source: The CIRC.

2. Premium income growth of property insurance was stable, while the demand for property insurance was insufficient

In 2012, affected by slower economic growth, the demand for property insurance was overall insufficient, with auto insurance premium growth rate down 2.4 percentage points y-o-y, and construction insurance and hull insurance experiencing negative growth, though some other insurance categories, such as agricultural insurance, achieved relatively fast premium income growth. During the year, property insurance companies gained premium income of RMB 553 billion yuan, up 15.7 percent y-o-y, 2.8 percentage points lower than last year. Total profits of property insurance industry in the year were RMB 32.14 billion yuan, an increase of 7.4 percent year on year, and the combined ratio was 94.12 percent (Comprehensive Loss Ratio plus Comprehensive Expense Ratio); both reached best levels of recent years (Figure 4.4).

Figure 4.4 Trend of Combined Ratios of Property Insurance Sector

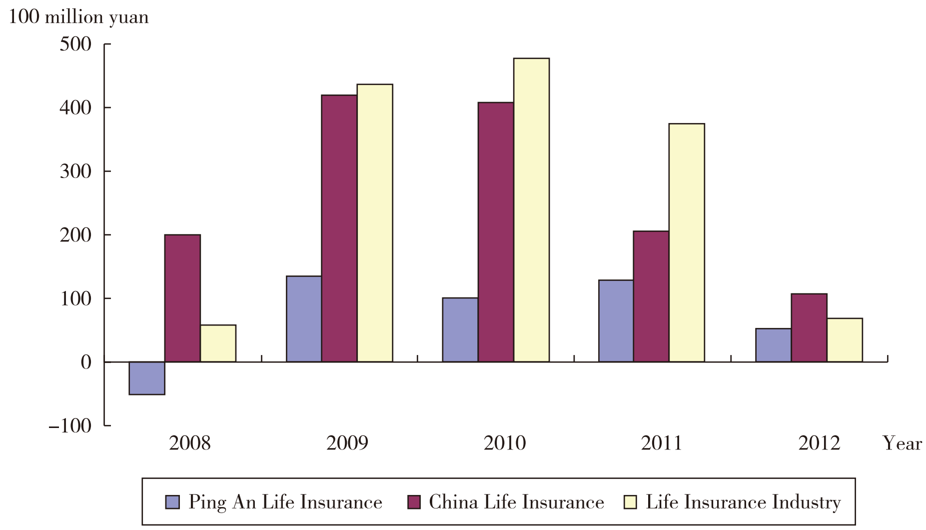


Source: The CIRC.

3. Growth of life insurance premium was sluggish, and profits went down dramatically

Sales representatives and banks are the most important distribution channels for life insurance. As costs of salesperson increased, the number of life insurance sales staff declined, and the old strategy of relying on a huge crowd of people to sell insurance policies did not work anymore. In respect of bancassurance, regulators have issued new rules that require one bank branch to sell only products from three insurance companies to the most in principle, and insurance company staff cannot sell insurance in banks. In addition, the yields of main bancassurance products were not high and their attractiveness kept decreasing, leading to relatively large fall in bancassurance business. In 2012, personal insurance companies gained premium income of RMB 995.8 billion yuan, up 4.1 percent y-o-y, in which the life insurance premium income only increased 2.4 percent. Life insurance industry realized profits of RMB 6.89 billion yuan, dropping 81.6 percent year on year (Figure 4.5).

Figure 4.5 Pre-tax Profits of China Life Insurance, Ping An Life Insurance and the Life Insurance Industry

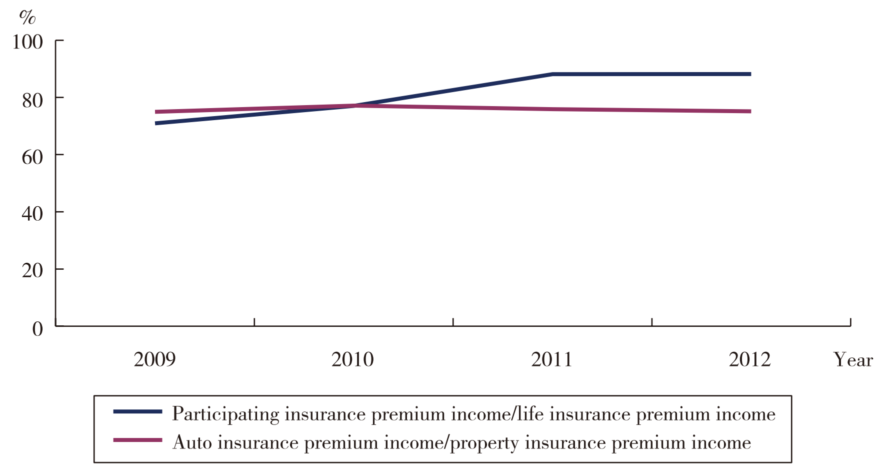


Source: Annual reports of listed companies, the CIRC.

4. Product structure needs further adjustment and development pressure increased

Among property insurance products, liability insurance, family property insurance and cargo insurance developed slowly, and auto insurance premium income have accounted for more than 70 percent of total premiums in recent years. As external economic environment changed and car purchase quota in some areas was implemented, the growth rate of auto insurance premium went down, requiring property insurance industry to find new sources of business growth. In life insurance industry, many companies focused on short-term wealth management market in order to realize fast growth of premium income, and neglected the importance of protection insurance products and installment insurance products. Premiums from participating insurance took up more than 80 percent of the shares of life insurance on a continuous basis (Figure 4.6), and traditional pure protection insurance only accounted for about 10 percent. In addition, to satisfy clients' requirement of high liquidity and yields, maturities of life insurance products were becoming shorter, and the products were more and more similar to each other and to wealth management products, therefore leading to a situation where life insurance industry was competing with other financial industries in the wealth management market. Since yields of wealth management products of banks and trust institutions were relatively higher than those of participating insurance products, whose yields usually lower than bank savings account rates, products of banks and trust institutions were more attractive to consumers, causing great pressure on participating insurance. In 2012, participating insurance premium income reached RMB 785.4 billion yuan, an increase of only 2.5 percent.

Figure 4.6 Participating Insurance as A Share of Life Insurance and Auto Insurance as A Share of Property Insurance in Recent Years



Source: The CIRC.

5. Risk of surrender rose in life insurance industry, making liquidity management more difficult

Due to various factors, including low insurance fund ROI, lower than expected yields of products such as participating insurance, relatively weak product competitiveness and misleading sales, life insurance surrender pressure in 2012 went up, and large-scale collective surrender broke out in some areas, affecting financial and social stability. During the year, surrender payments increased 25 percent year on year for life insurance companies, in which surrender payments of China Life Insurance, Ping An Life Insurance, China Pacific Life Insurance and New China Life Insurance rose by 11.5 percent, 21.2 percent, 28.5 percent and 20.2 percent. 2013 is a peak year for life insurance mature payment, and 5-year bancassurance alone needs to pay RMB 230 billion yuan to mature. Against the background that premium income of life insurance grows slowly and cash inflow to life insurance companies slows down accordingly, more expiration payments and risk of surrender together will make liquidity management of insurance companies more difficult.

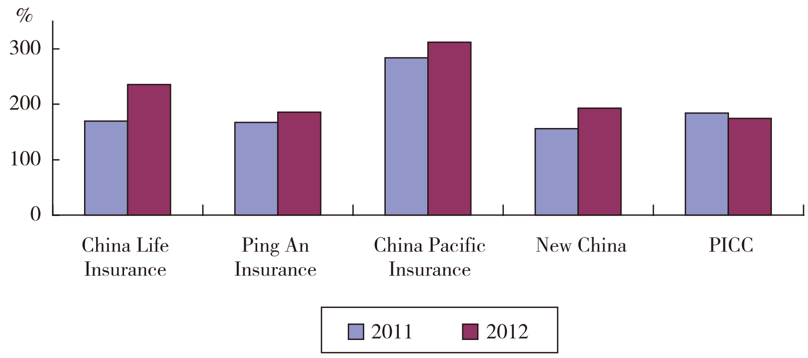
6. Market structure was improved, but competitiveness of small insurance companies urgently needed improvement

In 2012, concentration of insurance market declined to some extent. In property insurance companies, the biggest company and the five biggest companies accounted for 34.9 percent and 74 percent of the total premium market share, decreasing 1.4 and 0.4 percentage point y-o-y, respectively. Among personal insurance companies, the biggest company and the five biggest companies took up 32.4 percent and 71 percent of the total share, down 0.9 and 1.8 percentage points y-o-y, respectively. However, among 61 property insurance companies, 47 companies had market share of lower than 1 percent, and 57 out of 68 personal insurance companies hold less than 1 percent of the market share. Compared with large insurance companies, smaller ones were disadvantaged because of weaker capital strength, inadequate basic data accumulation, lack of professionals and poor ability to develop products. Some small insurance companies tried to develop in a comprehensive way by spreading out branches and following product designs of others. Some companies used irrational competition methods such as reducing insurance rates and raising charges, causing significant rise in operational costs and higher financial risk, and leading to market disorder in the meantime.

7. Capital was replenished in various ways and solvency was improved

In 2012, insurance companies employed various ways to enhance capital strength. Thanks to the capital injections of China Insurance Security Fund Co., Ltd. and China Orient Asset Management Corporation, China Insurance had its long-term insolvency problem solved. The People's Insurance Company (Group) of China Limited successfully went public in Hong Kong as a whole, and raised HKD 26.7 billion, greatly improving its capital strength. During the whole year, the insurance company increased capital and issued new shares for 46 circumstances, with accumulative capital raised reaching RMB 63.6 billion yuan and RMB 73.1 billion yuan of subordinated bonds were issued by 10 insurance companies. Solvency adequacy ratios of public insurance companies were maintained at a relatively good level (Figure 4.7). Insolvent companies decreased to two from five in 2011. In particular, property insurance companies all met the solvency requirement for the first time.

Figure 4.7 Solvency Adequacy Ratio of Listed Insurance Companies



Source: Annual reports of listed companies.

8. Insurance complaints increased, and protection of financial consumers still needed improvement

In 2012, the insurance regulator received 16 087 effective complaints from insurance consumers, up 206 percent year on year, in which more than 98 percent was related to insurance companies. Among cases related to insurance companies, property insurance companies and personal life insurance companies accounted for 43 percent and 57 percent, respectively, with number of complaints increasing 233 percent and 183 percent. The ranking of top companies in premiums was basically consistent with the ranking of number of complaints. Claims disputes were the major cause of property insurance complaints, accounting for 74 percent of total complaints on property insurance companies and up 356 percent. Sales misleading, surrender disputes, claims/payments disputes were the main causes of personal insurance complaints, accounting for 30 percent, 26 percent and 17 percent of total complaints of personal insurance companies respectively.

Box 13 Development and Supervision of County-Level Insurance Market

In recent years, China's insurance sector eventually became strong, and county-level insurance market which focuses on county town, countryside and villages has developed vigorously, and has played an important role in supporting county economy and new countryside construction. According to surveys conducted by the PBC, premium income of county-level insurance market has already taken up around 30 percent of total premium income in the insurance sector. In most provinces, county-level premium income contributed to 25-50 percent of total local premium income. The more developed the counties were, the higher proportion of total premiums did county-level premium take. For instance, county premium income in such provinces as Zhejiang has exceeded 50 percent of total premium income.

In the process of fast development, some problems also emerged in county-level insurance market: first of all, some insurance companies set up institutions illegally. Currently, most insurance companies set up branches in county towns and marketing divisions in villages. These institutions are not allowed to develop products, and their main task is sales. However, in practice, some of these institutions did not operate in line with their predetermined functions. Some institutions set up outlets in the name of internal sections of superior companies; some used copies of business licenses from superior companies as certificates to run business; and some operated business without the approval of supervisors. Some insurance companies rent temporary places to run business before setting up formal institutions, and withdrew business once volume of business could not meet certain levels. Some applicants complained that insurance offices closed after their purchase of insurance policies, and they could not get follow-up services. Secondly, unfair competition existed. In order to attract clients, some insurance companies paid high charges to agencies, and offered rate discounts and high kickbacks to clients illegally. Some increased insurance coverage discretionarily, and raised payment level and scope without authorization. Some exaggerated negative information about other companies to suppress peers. Thirdly, some insurance companies violated the interests of insurance applicants. Some salesperson exaggerated product features subjectively, and misled clients by not honestly informing clients of the restrictive and exception clauses. Relying on information advantages, some insurance companies delayed payment, paid less than they should or refused to pay claims without justifications, resulting in increasing number of lawsuits related to insurance contracts.

Currently, China's insurance regulation cannot fit the development of county-level insurance market very well. The insurance regulator only has 2691 full-time employees, and there are no local offices in most of the prefecture-level cities and all counties. In prefecture-level cities, though insurance associations were established, which are self-regulatory institutions consisting of insurance company representatives and financed by insurance companies, they only have limited constraints on insurance companies. In fact, county-level insurance market is in a state of non-regulation. No on-site inspections have ever been made on many insurance outlets since their establishment; regulations haven't been fully implemented as punishments are extremely low; costs to protect consumer rights in county-level insurance disputes are so high that some policyholders chose radical measures to protect their rights, causing increased social risks. Therefore, more regulatory resources should be put in the county-level insurance markets to strengthen on-site inspections and punishments, as well as better regulate operations of practitioners and to protect consumer rights effectively.

III. Outlook

The 18th CPC National Congress set the goal of completing the building of a moderately prosperous society in all respects and deepening reform and opening-up, providing enormous development opportunities for the insurance sector. Currently, China's insurance penetration and density is still far away from world average levels. At the same time, with the complicated domestic and foreign economic and financial situations, the development of insurance sector also faces many challenges. In the next step, the insurance sector will seek progress amidst stability, promote reform and innovation, seize the coming opportunities, accelerate transformation of development mode, adjust business structure and enhance sector competitiveness.

1. Promote transformation of development mode and structural adjustment, enlarging service coverage of insurance sector

Following the goals proposed in the 18th CPC National Congress, the insurance sector, as a booster and stabilizer of economic and social development, will strengthen awareness of long-term sustainable operation, attach equal importance to scales and efficiency, strengthen initiative and creativity, actively pursue transformation of development mode and structural adjustment, combine self-advantages with diversified development routes, go back to the concept of risk protection, continuously enrich insurance products, raise innovation ability and expand coverage of insurance. Efforts will also be made to develop personal life insurance, health insurance and enterprise annuity business, liability insurances related with environment pollution and public security, which are closely connected to public interests, and also insurance businesses with regard to residential housing and car consumption. Policy support in respect of legislation, finance and taxation would be considered to promote development of agricultural insurance critical illness insurance, pilot program of individual tax-deferred pension insurance would be pushed forward, and catastrophe insurance system would be established, improving catastrophe risk diversification and transfer and compensation mechanism.

2. Deepen insurance sector reform and strengthen innovation to raise industry competitiveness

Efforts will be made to deepen institution reform, improve corporate governance and internal control, and formulate scientific and rational incentive and restraint mechanism. Eligible insurance companies will be encouraged to raise capital to strengthen capital adequacy and solvency by means of public offering, issuing new shares and subordinated bonds. Reforms in important business fields will be pushed forward. Commercial auto insurance clause and rate reform will be pursued in a stable way, and pricing mechanism reform of life insurance products will be advanced orderly to realize more reasonable rates. Cooperation between banks and insurance companies will be deepened. The reform of administrative system of insurance sales personnel will be advanced, practitioners classification management system will be established, and diversified distribution channels and methods will be developed. The insurance sector should fully make use of its advantages in risk management and long-term asset and liability management, gain competitive advantages, and raise its position in national economy.

3. Take the opportunity to improve the utilization of insurance funds

In 2012, the insurance regulator issued a series of new regulations concerning the use of insurance funds, greatly expanding the investment scope and instruments of insurance companies. Seizing this opportunity, and taking into account the adjustment of macroeconomic policies and changes in the market, insurance companies should invest more flexibly, improve fund utilization methods and skills, strengthen liability management, establish coordinating mechanism of product development and investment operation, develop financial products so as to reduce mismatch between assets and liabilities, smooth assets and liabilities fluctuations due to changed economy, and improve fund utilization efficiency. Efforts should also made to strengthen identification, analysis and quantification of risks, improve operation risk prevention, reserve more professional technologies and specialists, comprehensively enhance risk awareness and risk management , and prevent investment risks.

4. Regulate market order and better protect consumer rights

Efforts will be made to strengthen regulation on irrational competition and illegal conducts by insurance companies, investigate and punish the behaviors of charging non-existent charges and false claims. On-site inspections on important fields and important companies shall be strengthened, and regulations on auto insurance and agricultural insurance need to be improved. The investigation and punishment standards would be further clarified; the punishment and management of commercial bribery would be enhanced, as well as the accountability of senior managers and institutions would be strengthened. Measures should be taken to promote insurance companies to improve service quality, push forward standardization and popularization of insurance products, and regulate the minimum service standards, comprehensively manage misleading sales and difficulties in claims, establish management mechanism to ensure the authenticity of insurance application information, and improve insurance dispute settlement mechanism. Education and publication of insurance knowledge would be promoted, raising understanding of consumers about insurance products, and better protecting the rights of insurance consumers.

5. Actively participate in international insurance sector regulatory reform and improve China's insurance regulation

Since the financial crisis, international insurance sector achieved progress in regulatory reform on solvency, Internationally Active Insurance Group, global systemically important insurance institutions. While actively participated in international insurance regulatory reform, China will advance the establishment of the second-generation solvency supervision regime based on the current situation of insurance sector improve regulation on insurance groups, corporate governance, strengthen insurance company information disclosure mechanism, and improve market entry and exist mechanisms. Efforts will be made to strengthen the risk monitoring and early warning, improve stress testing techniques and methods of insurance companies, and review the impact on insurance sector of changes in macroeconomic factors such as economic growth and inflation, effectively prevent life insurance mature payment and surrender risks, fund utilization risk and insolvency risk, improve emergency plan system and risk resolution and rescue mechanism of the insurance sector, further strengthen regulatory coordination and cooperation, and hold the bottom line to avoid systemic and regional risks.

Box 14 The Construction of China's Second-generation Solvency Supervision System

After the global financial crisis, major economies and international organizations accelerated insurance regulatory reforms centering on solvency supervision. Currently, China's solvency supervision system plays a very important role in preventing risks and promoting scientific development of the insurance sector. However, this system requires improvement in risk identification and efficiency of risk management. In order to adapt to the new situation, further strengthen solvency supervision and raise risk prevention ability of the sector, the insurance regulator formulated and issued *Plans for the Construction of China's Second-generation Solvency Supervision System* in March 2012. The Plan sets up the general goal of China's second-generation solvency supervision System, i.e., forming a set of solvency supervision system in 3-5 years which is in line with international standards and suitable for the developing insurance market in China as well, promotes insurance companies to establish a comprehensive risk management system to strengthen risk management and capital management in the industry, actively explores solvency supervision system suitable for emerging market economies, and provides China's experiences to international community in constructing solvency supervision system.

In April 2013, the insurance regulator completed *The Overall Framework of China's Second-generation Solvency supervision System*, further clarifying the goals, frameworks and technical principles of the system, which not only is in accordance with international standards, but also reflects China's specific situations. The overall framework is composed of three parts including system characteristics, supervision elements and supervision fundamentals. In respect of system characteristics, the framework emphasizes the importance of unified supervision and takes into account the emerging markets characteristics, giving the same emphasis on both risk prevention and avoiding too much capital burden on insurance companies, focusing on increasing corporate value and enhancing competitiveness. With regard to supervision elements, there are three pillars, namely quantitative capital requirement, qualitative supervision requirement and market discipline mechanism. The first pillar is mainly used to prevent quantifiable risks such as insurance risk, credit risk and market risk, requiring insurance companies to hold enough capital that matches their risk level and scale of business. The second pillar is mainly used to prevent unquantifiable risks by measures such as regulatory analysis and inspection, internal risk management requirement of insurance companies, comprehensive solvency assessment and regulatory measures, second pillar follow-up capital requirement. The third pillar uses measures such as information disclosure and market restraints to strengthen solvency of insurance companies. In terms of regulatory basis, insurance companies should establish a comprehensive internal solvency management system, and integrate them into organizational structure, decision making, operation and management and other activities.

Chapter V

Financial Market

In 2012, China's financial markets developed more soundly. The market as a whole ran smoothly, with steadily expanding size, rapidly growing financing, and further deepening innovation. It played a positive role in optimizing the allocation of resources and supporting the development of the real economy.

I. Market Overview

1. Borrowing and repo markets remained active

In 2012, the transaction of borrowing and repos remained active and the volume of transaction kept a fast growth. The turnover of inter-bank borrowing market totaled RMB 467 trillion yuan, accumulatively with an increase of 39.7%t y-o-y; the turnover of bond repos reached RMB 141.7 trillion yuan, with a y-o-y increase of 42.4%. Among which, short-term transactions still accounted for a large share of the total, with turnover of overnight inter-bank borrowing reaching RMB 40.3 trillion yuan, about 86.2% of the total inter-bank borrowing, and 1-day bond pledged repo totaling RMB 110.9 trillion yuan, accounting for 81.2% of the total bond repos. The repo markets played an important role in adjusting the institution liquidity and the market liquidity was generally abundant. Interest rates on the money market lowered in a fluctuating way (Figure 5.1). The weighted average interest rates of bond pledged repo registered 2.62%, down 206 basis points from January and down 75 basis points compared with the previous year.

Figure 5.1 Interest Rate Movements on the Money Market in 2012

Source: National Interbank Funding Center.

Box 15 The Comparison of Shibor and Libor

Libor is the inter-bank rate which BBA calculated Libor benchmark rate according to selected bank quotation. At present, Libor has been the main reference for interest rates in the international financial markets. In 2007, China, in view of the experience from Libor and other main benchmark rates, launched Shibor as the money market benchmark.

Shibor and Libor are similar at technical arrangement. By quotation types, both adopt the independently quoted inter-bank rate from the high quality banks' quotation group with higher credit rating, belonging to a single interest, no guarantee and wholesale interest rate. By selected standard of quotation banks, both require quotation banks to meet a series of standards, mainly including higher credit rating, active transaction in money market, stronger pricing ability, and etc. By the way of quotation generation and publishing, both quote timely through quotation banks in each transaction day. After eliminating several highest and lowest quotations, the quotation interest results from the arithmetic mean of the remaining quotation, and published by the designated third party.

Shibor and Libor are different in quotation banks' regulation management mechanism. BBA is the management body of Libor, as self-discipline organization, BBA has no regulation authority to quotation banks, and Libor's credibility mainly depends upon the self-discipline of the quotation banks. In the initial design of Shibor, it has emphasized the quotation establishment of market constraints and regulation management in institutional arrangements. PBC timely published Shibor's implementation standards, and take the lead to establish money market basic interest workshop that responsible for supervising quoted interest operation, quotation banks and designated publisher's quotation behaviors. In the mean time, the followings also have been done: formulated Shibor quotation banks' quotation quality evaluation index system, required that quotation should refer to money market interest rates, emphasized the quotation obligation, set up index referring to inter-bank funding market influence and quotation feasibility, etc. The quotation banks' quotation quality was appraised and the last one would be eliminated on a yearly basis. Shibor's above-mentioned features ensured the accuracy and objectivity of Shibor quotation.

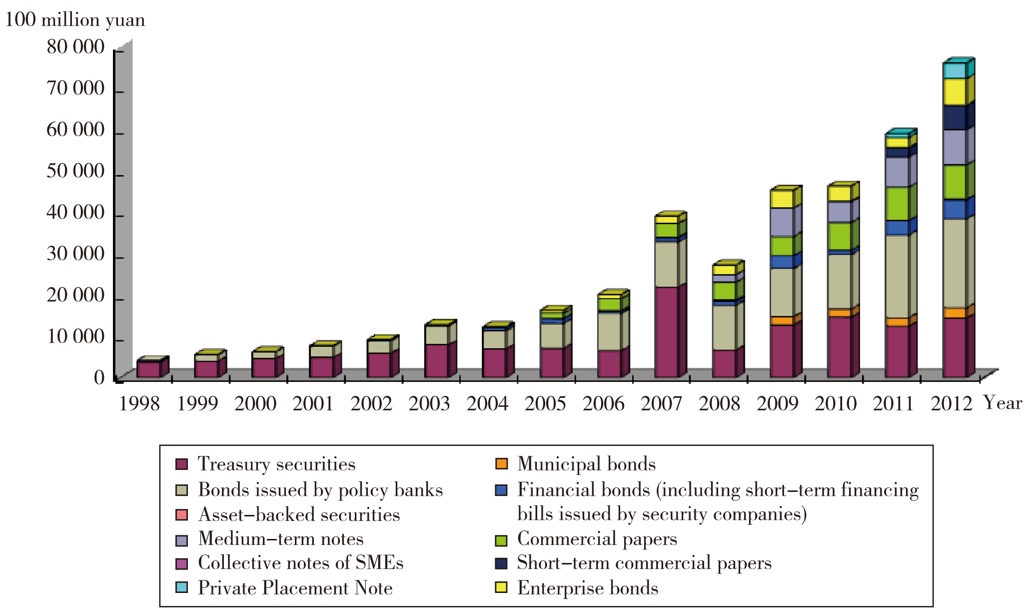
In 2012, Barclays and UBS violated the rules of Libor quotation, which has attracted wide public concern. The relevant regulators and authorities such as FSA and BBA assessed the Libor Mechanism and came to a conclusion that weak regulating was the important factor of the violation. In September, FSA proposed ten suggestions to comprehensively reform Libor, including legislation and supervision, institutional restructure, management regulation and international cooperation, etc. According to these suggestions, BBA formally issued the timetable to stop compiling and issuing some of Libor varieties and currencies with very limit market application. And meanwhile, BBA continued to carry on other reforms.

The way Shibor focuses on regulation and management over quotation banks is the same as the direction of Libor reform. China will continue to strengthen the regulation and management and emphasize the quotation obligation. Meanwhile, China will also attach importance to learn the lessons of Libor and take steps to optimize Shibor Mechanism. In December, the number of Shibor quotation banks has increased from 16 to 18, and the number of quotation banks, which must be rejected as the highest or the lowest quotation banks, has increase from 2 to 4 respectively. That improved the representation of quotation banks. In the future, PBC will continue to focus on the reform and development of the benchmark interest rate in major international money market, including Libor, and further improve the mechanism of Shibor quotation and management, promoting the credibility of Shibor as benchmark.

2. The Bond Market Grew soundly

The issuance amount increased and the market participants became more diversified. In 2012, the total issuance amount of RMB bonds is RMB 8 trillion yuan, up 2.4% y-o-y (Figure 5.2). Among these, the issuance amount on the inter-bank market reached RMB 7.5 trillion yuan, up 1.7%. The issuance amount of corporate bonds increased significantly compared with the previous year, totaled RMB 3.6 trillion yuan, an increase of 60.5%, accounting for 44.5% of the whole issuance amount of the bond market. By the end of the year, bonds outstanding reached RMB 26.0 trillion yuan, among which RMB 25.0 trillion yuan in the inter-bank market, up 16.7 % y-o-y. The participants on inter-bank market reached 11 287, an increase of 415, including various financial and non-financial institutional investors. The inter-bank market had become an important platform for various market participants to raise fund, to make investment and to conduct risk management.

Figure 5.2　Amounts of Major Bonds Issued on Inter-bank Markets in Recent Years

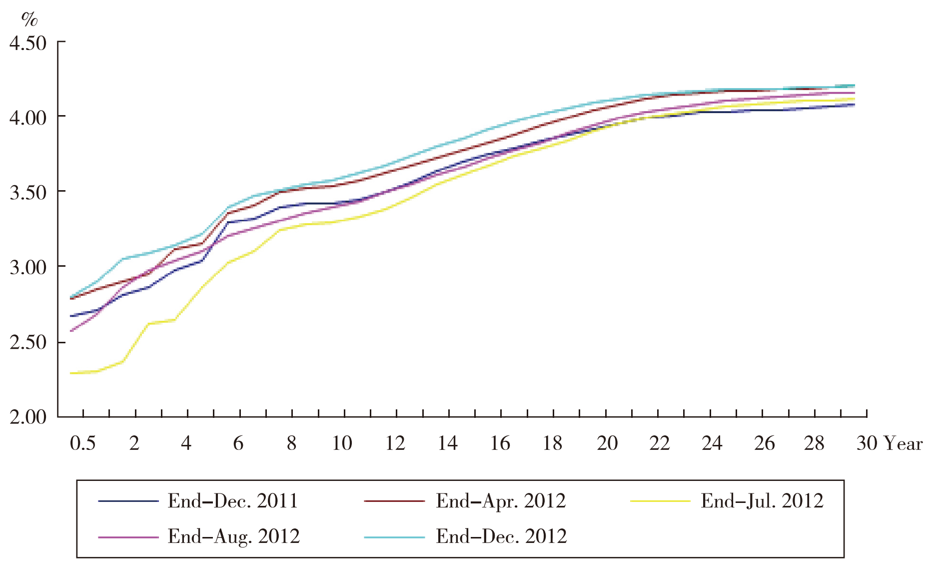


Source：China Government Securities Depository Trust and Clearing Co., Ltd., Shanghai Clearing house.

Medium-and-short-term bonds still dominated the bond market. In 2012, the issuance of bonds with the maturity within 5 years accounted for 42.3% of the total, down 10.6 percentage points from last year; the issuance of 5–10 year bonds accounted for 39.2% of the total, up 9.4 percentage points y-o-y; and the issuance of bonds with a maturity of 10 years or longer accounted for 18.5% of the total, an increase of 1.2 percentage points from last year.

Market turnover grew slightly and bond indices edged up. In 2012, the turnover of cash bond trading on the inter-bank market registered RMB 75.2 trillion yuan, up 18.2% y-o-y, and total turnover of government securities transactions on the stock exchanges reached RMB 91.42 billion yuan, down 27.06% y-o-y. In general, bond price indices climbed up, with the inter-bank bond index rising from the 139.78 in the beginning of the year to 144.68 in the year-end, up 3.5 %. And government bond index traded on the stock exchanges picked up from the 131.44 in the beginning of the year to 135.84 in the year-end, up 3.3%. Yield curves of treasuries bonds moved stably upwards (Figure 5.3).

Figure 5.3 Yield Curves of Treasury Securities Traded on the Inter-bank Market in 2012



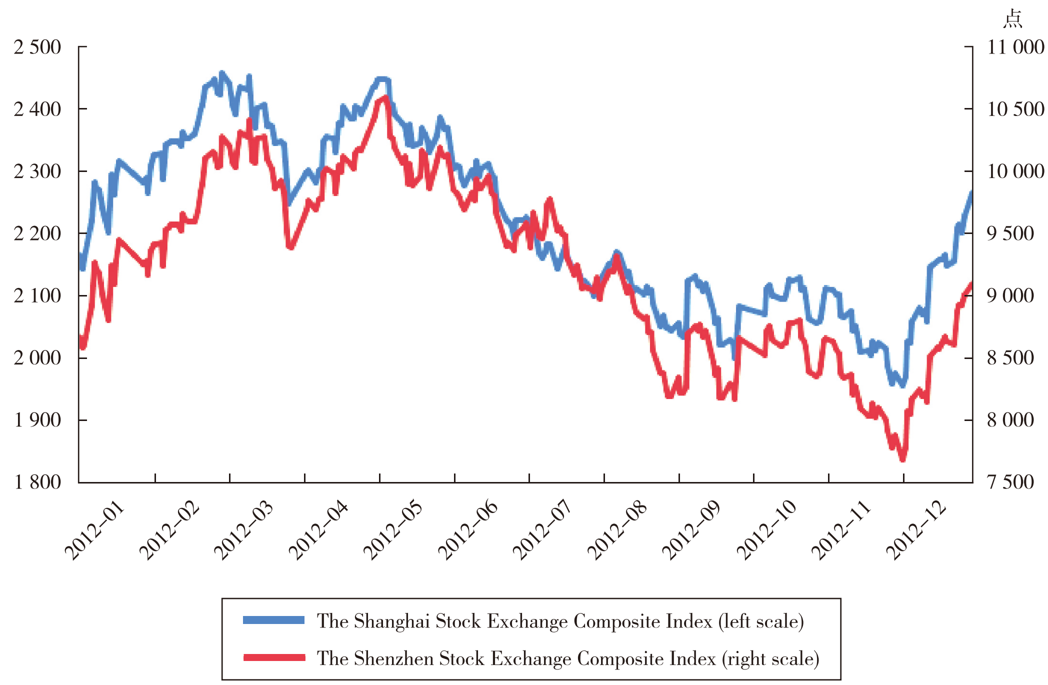
Source: China Government Securities Depository Trust and Clearing Co., Ltd.

3. The stock markets grew slightly and trading on the future markets was brisk

The stock markets jittered and finally stabilized. In 2012, Shanghai and Shenzhen stock market first rose and then declined (Figure 5.4). The Shanghai Stock Exchange Composite Index declined to 1949.46 and stabilized at the beginning of December, closing at 2269.13, up 3.17% y-o-y. The Shenzhen Stock Exchange Component Index closed at 9116.48, up 2.22 percent y-o-y. The total domestic market capitalization of Shanghai and Shenzhen Stock Exchange reached RMB 23.04 trillion yuan and the tradable market capitalization registered RMB 18.17 trillion yuan, up 7.26% and 10.15 percent y-o-y respectively. The average daily trading volume for the year was RMB 129.5 billion yuan, down RMB 433 yuan from the previous year.

Trade volume was booming on the futures market. In 2012, total trading volume on the futures market registered 1.451 billion lots, and the trade amount reached RMB171.13 trillion yuan, up 37.60% and 24.44% y-o-y respectively. Among these, trade volume and amount of the commodity futures were 1.346 billion lots and RMB 95.29 trillion yuan respectively, up 34.06% and 1.64% respectively. Trade volume of financial futures was 0.105 billion lots and total trade amount was RMB 75.84 trillion yuan, a y-o-y increase of 108% and 73.29% respectively.

Figure 5.4 The Shanghai Stock Exchange Composite Index and the Shenzhen Stock Exchange Compenent Index in 2012

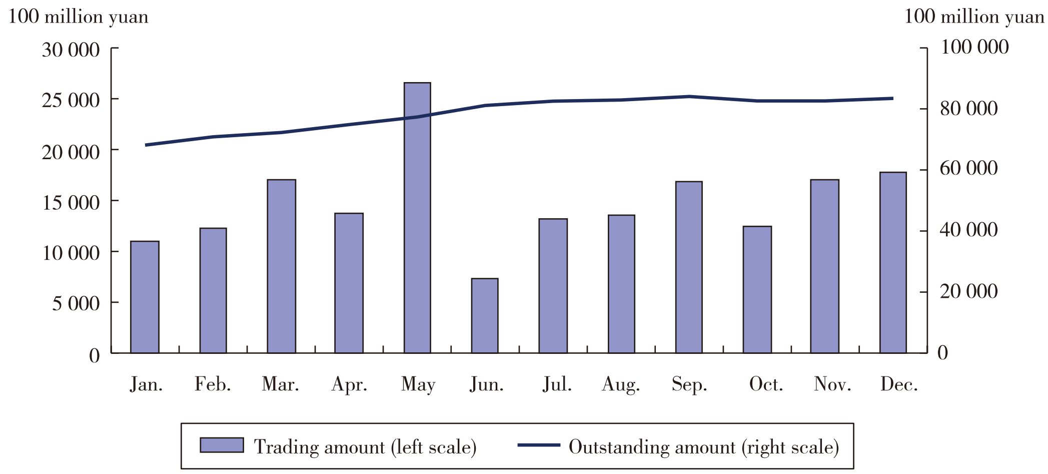


Source: Shanghai Stock Enchange, Shenchen Stock Exchange.

4. The Bill Market Grew Steadily

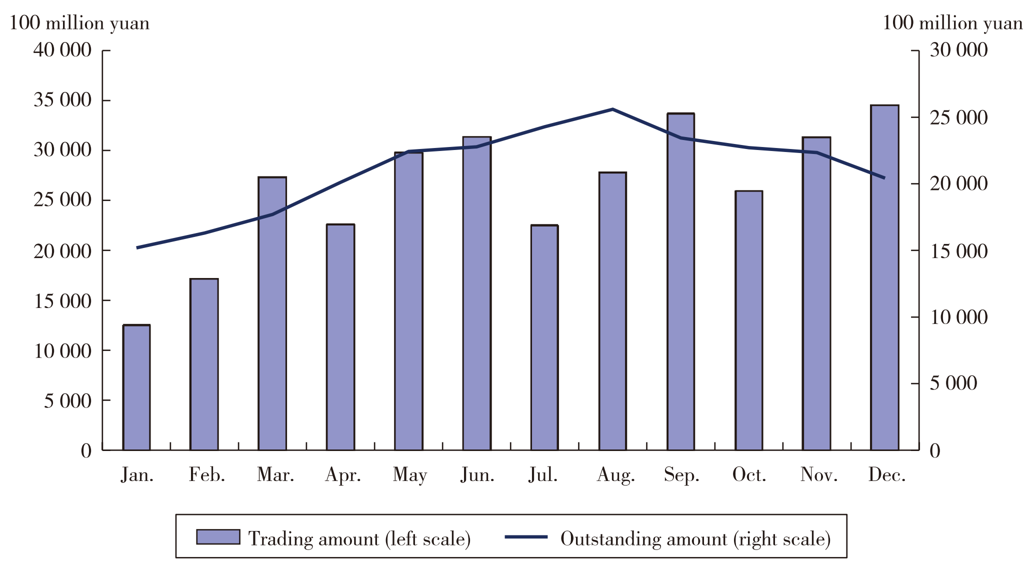
In 2012, a total of RMB 17.89 trillion yuan of commercial drafts were issued, an increase of 18.81% y-o-y (Figure 5.5). Discounted bills registered RMB 31.64 trillion yuan, up 26.40% y-o-y (Figure 5.6). Rediscounted bills amounted to RMB 232.98 billion yuan with 16.46% y-o-y increase. At the end of 2012, outstanding commercial bills stood at RMB 8.35 trillion yuan, up by 25.37% y-o-y. Outstanding discounted bills increased y-o-y by 35.09% to RMB 2.04 trillion yuan. And outstanding rediscounted bills saw a 70.51% increase to RMB 75.95 billion yuan.

Figure 5.5 Draft Issuance in 2012



Source: The PBC.

Figure 5.6 Draft Discount in 2012



Source: The PBC.

5. The gold price was volatile and the trade volume decreased

In 2012, international gold price peaked at USD 1791.75 per ounce with the lowest price of USD 1 540 per ounce and closed at USD 1 664 per ounce at the end of the year, up 5.68 percent y-o-y. The movement of domestic gold prices kept pace with that on the international market. During the year, the highest price on the Shanghai Gold Exchange (Au99.95) was RMB 362.5 yuan per gram, and the price closed at RMB 334.34 yuan per gram, up 4.55% y-o-y. The weighted average price of gold was RMB 339.81 yuan per gram, up 3.75% from the previous year. The trading volume of gold on the Shanghai Gold Exchange was 6 350.2 tons, a decrease of 14.63% y-o-y, and its turnover posted RMB 2.15 trillion yuan, a decrease of 13.18% y-o-y.

6. The Foreign Exchange Market saw reduced level of trading

At the end of 2012, the turnover of spot RMB/FX totaled USD 3.36 trillion, representing a decrease of 5.6% y-o-y. The turnover of RMB/FX swap transactions totaled USD 2.52 trillion, representing an increase of 42.2% y-o-y. Among these, the turnover of overnight RMB/USD swap transactions totaled USD 1.4 trillion, accounting for 55.6% of all swap transaction. The turnover on the RMB/FX forward market totaled USD 86.6 billion, down 59.6 percent y-o-y. And the turnover of foreign currency pair transactions amounted to USD 85.7 billion, a decrease of 9.5% year on year. Among these, the most traded product was the pair of US dollar to Hong Kong dollar, with the turnover accounting for 41.6% of the total. The number of participants on the foreign exchange market further expanded. At the end of 2012, there were 353 members on the foreign exchange spot market, 79 members on the foreign exchange forward market and the foreign exchange swap market, 31 members on the foreign exchange options market.

II. Overview of Financing in the Market

Bond financing has become the major direct financing channel in China. In 2012, a total of RMB 8 trillion yuan RMB bonds were issued, up 2.4% y-o-y. The issuance amount of corporate bonds totaled RMB 3.6 trillion yuan, up 60.5 percent y-o-y, accounting for 44.5 percent of the whole bonds issuance. Among the corporate bonds, short-term commercial papers registered RMB 582.2 billion yuan, commercial paper RMB 835.6 billion yuan, medium-term notes RMB 845.3 billion yuan, Collective note of SMEs RMB 7.1 billion yuan, private placement notes（PPNs）RMB 375.9 billion yuan, non-financial enterprise asset-backed commercial note RMB 5.7 billion yuan, enterprise bonds RMB 649.9 billion yuan, listed corporate bonds RMB 255 billion yuan, private placement bonds of SMEs RMB 9.4 billion yuan. In 2012, bond financing accounted for 90% of all direct financing, up 14.2 percentage points from last year, and direct financing accounted for 15.9% of total social financing, up 1.8% points from last year.

Table 5.1 Issuance of Major Bonds in 2012

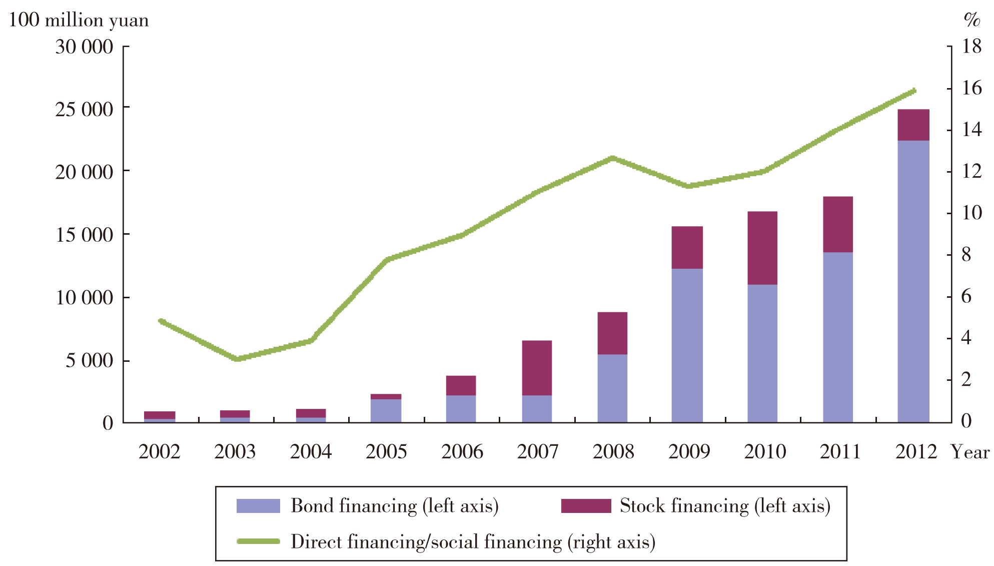
Type of bonds	Issuance(RMB 100 million yuan)	Y-o-y growth(%)
Treasury securities	16 860	-3.1
Of which: Municipal bonds	2 500	25.0
Policy bank bonds issued by the China Development Bank and other policy banks	21 399	7.1
Financial bonds	4 034	14.3
Corporate bonds	35 648	60.5
Of which: Commercial papers	8 356	4.1
Short-term commercial papers	5 822	159.9
Medium-term notes	8 453	16.3
Collective note of SMEs	100	36.5
Private Placement Note	3 759	318.2
Asset-backed commercial notes	57	—
Enterprise bonds①	6 499	162.8
Corporate bonds	2 550	102.1
Private bonds of SMEs	94	—

Note: ①Not including government-backed bonds from Ministry of Railways.

Source: The PBC and the SEC.

Stock financing declined. In 2012, the total amount of domestic stock financing registered RMB 312.754 yuan, down 38.35% y-o-y. Among these, the fund raised through IPO totaled RMB 103.432 yuan, down 63.39% y-o-y, the fund raised through SEO RMB 197.222 billion yuan, up 9.78% y-o-y, and the fund raised through allotment of shares RMB 12.1 billion yuan, down 71.32% y-o-y.

Figure 5.7 Size of Direct and Social Financing and Their Ratio in 2002—2012



Source：The PBC and the CIRC.

Box 16 The Scale of Social Financing and Its Structural Change since 2002

The scale of total social financing, which was introduced to the Chinese financial macro-management in 2001, refers to the total funds real economy receiving from the financial system. In practice, this index fully reflects the relationship between the finance and economy, and the support of the firm to the real economy. Meanwhile, the index can overcome the shortage of the traditional aggregate index which was difficult to fully reflect financial innovation, and makes comprehensive use of various tools to strengthen financial macro-steering. Therefore, all sectors of society have widely accepted it.

Over the past decade, the expansion of China's social financing has effectively promoted the stable and rapid development of the economy. In 2012, the scale of social financing was RMB 15.76 trillion yuan, an increase of RMB 2.93 trillion yuan from the previous year, which is 7.8 times of that in 2002 and is the highest level in history; the ratio of the scale of social financing to nominal GDP was 30.4%, compared with 2011 and 2002, up 3.3 and 13.7 percentage points respectively.

It can be seen from the change of social financing structure that China's finance has been diversely developed, playing a more and more important role in optimizing the allocation of social resources. Firstly, the proportion of RMB loans was substantially declined. In 2012, the new RMB loans totaled RMB 8.2 trillion yuan, accounting for 52.0% of the total social financing, which is the lowest level in history. Compared to that in 2011 and 2002, the amount declined 6.2 and 39.9 percentage points respectively. Secondly, foreign currency loans maintained the growth momentum. In 2012, the new foreign currency loans totaled RMB 916.3 billion yuan, up RMB 345.1 billion (2011) and RMB 843.2 billion (2002) respectively. Thirdly, direct financing developed rapidly, especially in corporate bond financing. In 2012, the total financing of non-financial enterprise were RMB 2.51 trillion yuan, accounting for 15.9% of the total social financing, up 1.8 (2011) and 11.0 (2002) percentage points respectively, which is the peak of history. Among them, the net financing of corporate bond was RMB 2.26 trillion yuan, the highest level in history. Fourthly, the financing of real economy through the off-balance-sheet of financial institutions grew rapidly. In 2012, the total financing of real economy through undiscounted bank acceptance bills, entrusted loans and trust loans were RMB 3.62 trillion yuan, increasing RMB 1.09 trillion from 2011. Fifthly, non-bank financial institutions steadily improved to support the real economy. In 2012, the compensation of insurance companies and new loans from small loan companies and loan companies totaled RMB 514.0 billion yuan, increasing RMB 74.9 billion yuan (2011) and RMB 470.8 billion yuan (2002) respectively.

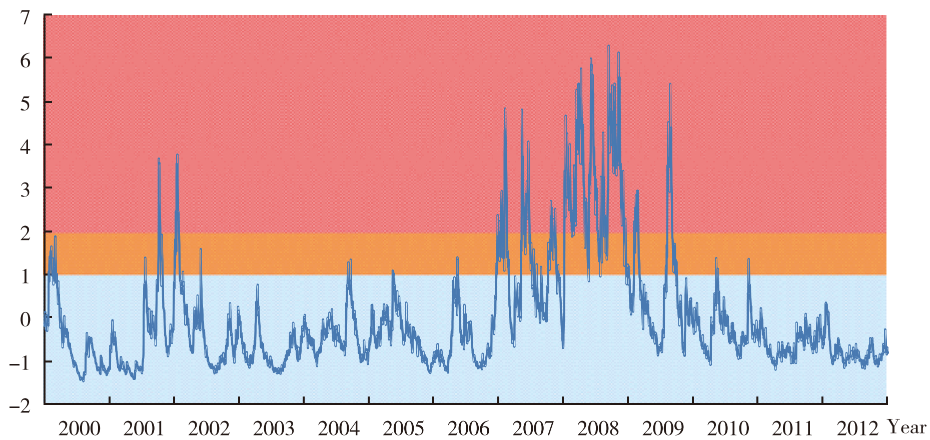
III. Stability Assessment

The credit risk of the bond markets called for more attention, and the risk sharing mechanism needed to be improved. The domestic rating agencies' credibility should be enhanced, and some issuers got exaggerated ratings. The role of credit enhancement was limited because of the limited capital base of credit enhancement institutions and weak guarantee capability. Slow development of the credit derivatives market led to a lack of effective risk hedging tools. The potential credit risk in individual bond and the implicit guarantee from underwriters and local governments, not only brings about moral hazards of investors and weaken market discipline, but also lead to risk contagion across the industries.

The stock market evaluation dropped to historic low level and stress index located in blue area. At the end of 2012, the P/E ratios of AB shares, SHSZ300 shares, Small and Medium Enterprises shares and ChiNext shares were 15.26, 11.86, 28.30 and 34.65 respectively, down 7.84%, 6.46%, 5.09% and 3.46% y-o-y. And the P/B ratio of AB shares, SHSZ300 shares, Small and Medium Enterprises shares and ChiNext shares were

2.02, 1.85, 2.94 and 3.09 respectively, down 9.82%, 9.31%, 20.33% and 25.00% y-o-y. Market evaluation stood at historic low level. In terms of the stress index of stock market, the fluctuation of the index was not only far smaller than that in financial crisis 2008-2009, but also smaller than that in 2011. Only several trading days in January saw fluctuations larger than the average level since 2000, and the deviation was no larger than one standard deviation in most trading time. Throughout the year, the stress index of the stock market remained in the blue area. Limited fluctuations reflected a stable market performance (Figure 5.8).

Figure 5.8 Stock Market Stress Index 2002—2012



Source: Calculation based on Wind data.

The stock index futures market worked well and its market function was gradually exerted. In 2012, the correlation between main contract of stock index futures and SHSZ300 index were 99%, and the return correlation between the two was 96.6%. During nearly 94.3% of trading days, the basic difference between spot and futures was between -1% and 1%. 12 contracts were delivered with cumulated 23 405 shares in 2012. The trend of futures price was stable on delivery day. The deviation rate between the settlement price and closing price was below 0.042%. So there was no “the expiration effect” in both spot and futures markets. The volatility of SHSZ300 index was 19.96% in 2012, down 1.3 percent y-o-y. The investors used stock index futures to manage the risk and achieved a good hedging effect. Owing to stock index futures, ETF and other financial innovations were further brisk.

Box 17 The Real Estate Sector and Credit Supply to the Sector in 2011

In 2012, the real estate market as a whole developed in the expected direction of macro-regulation. The number of cities that witnessed month-on-month increases in housing prices declined from the beginning of the year. The trading of commercial real estate grew slightly, with a growth rate below the previous year. The growth of investment in real estate development remained low while the growth of real estate loans increased.

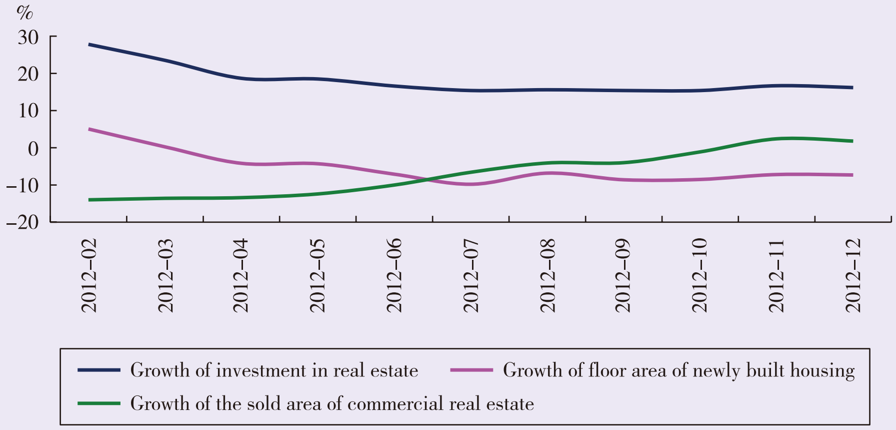
1. Real estate market condition

During the previous ten months, the number of cities with month-on-month increase in real estate price showed a declined tendency. After November, that number bounced again but still less than the level of the year beginning. In December, the prices of newly built residential housing rose in 40 out of 70 large- and medium-sized cities over the same period of last year, 28 more than that in October but 13 less than in January. The price of second-hand residential housing rose in 25 cities over the same period of last year, 10 more than in October but 5 less than that in January.

The sold areas of real estate in 10 consecutive months were below the previous year but rose after November. In 2012, the sold area of real estate posted 1.113 billion square meters, up 1.8% y-o-y, a deceleration of 2.6 percentage points from the previous year. Sales of commercial real estate were up 10 percent y-o-y to RMB 6.4 trillion yuan, representing a deceleration of 1.1 percentage points from 2011.

Investment in real estate development still remained low. In 2012, the investment totaled RMB 7.2 trillion yuan, up 16.2% y-o-y, representing a deceleration of 11.9 percentage points from the previous year, at the lower level from 2010. The growth of floor area of newly built housing slowed down gradually, maintaining the downward trend since April 2012. The floor area of newly built housing slowed down 7.3% to 1.77 billion square meters, but an acceleration of 16.2 in 2011 (Figure 5.9).

Figure 5.9 Growth of Real Estate Investment, Floor Area of Newly Built Housing and Sold Area of Real Estate



Source：National Bureau of Statistics.

The construction of low-income housing units completed the target set at the beginning of the year was reached. In 2012, 6.01 million units of low-income housing basically completed while 7.81 million units broke ground, meeting the goal set by the central government at the beginning of the year.

2. Credit to real estate sector

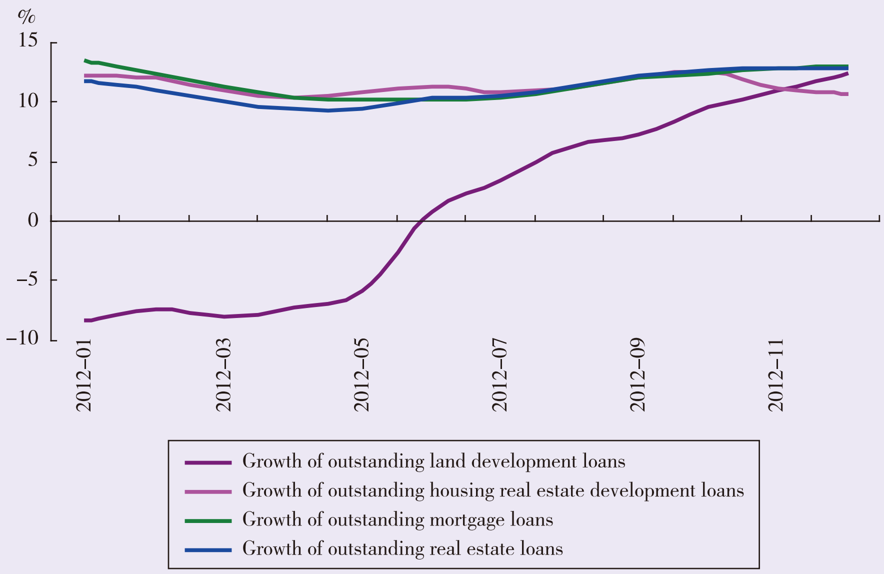
In 2012, growth of real estate loans picked up gradually, but still lower than that in 2011. As of the end of 2012, the real estate loans of the major financial institutions (including foreign financial institutions) posted RMB 12.1 trillion yuan, an increase of 12.8% y-o-y, with a month-on-month acceleration from May, but still down 1.1 percentage points from the end of 2011 and down 33.5 percentage points from the height reached in April 2010. Outstanding real estate loans accounted for 19.8% of the total outstanding loans, down 0.3 percentage point from 2011. And new real estate loans registered RMB 1.3 trillion yuan, up RMB 88.9 billion yuan y-o-y, accounting for about 17.4% of total new loans and down 0.1 percentage point from 2011.

Figure 5.10 Outstanding Real Estate Loans of Major Financial Institutions and Their Growth

Source：The PBC.

Real estate loans had the following characteristics: First, growth of land development outstanding amount showed a month-on-month rising tendency at June after month-on-month declining for consecutive eleven months. At the end of 2012, the land development loans outstanding amount totaled RMB 863 billion yuan, up 12.4 percent y-o-y, where as of the end of 2011 there had registered a y-o-y decrease of 7.9%. Second, growth of housing estates development loans as a whole showed a gradual decline trend throughout the year. Outstanding housing estates development loans grew by 10.7% y-o-y to RMB 3 trillion yuan, representing a deceleration of 6.4% from the end of the previous year. Third, growth of mortgage loans increased continually from June, but still at the lower level in history. The outstanding mortgage loans stood at RMB 7.5 trillion yuan, a y-o-y increase of 12.9% (Figure 5.11), representing a deceleration of 1.9% from the end of the previous year; fourth, the proportion of development loans for low-income housing increased significantly, with new loans in 2012 posting RMB 179.6 billion yuan, accounting for 66.5% of the total new real estate development loans, representing an increase of 1.9 percentage points from 2011.

Figure 5.11 Growth of Various Outstanding Real Estate Loans of the Major Financial Institutions



Source：The PBC.

Housing provident fund loans grew rapidly. By the end of 2012, outstanding amount of personal housing provident funds in China registered RMB 1.66 trillion yuan, up 27.47% y-o-y, about 22.21% of the commercial personal mortgage loans in the same period of time, representing an acceleration of 8.3 percentage points from the end of the previous year. New personal housing provident fund loans stood at RMB 356.7 billion yuan, up RMB 148.1 billion yuan from the same period of last year.

IV. Outlook

Looking forward, the relevant administrative departments of financial market will stick to the market orientation, promote the sound development of the financial market with complete products and functions, encourage financial innovation, operate efficiently with proper scale, so as to meet the needs of economic development.

Actively promote the healthy development of the bond market. Steadily expand the bond market size, encourage the innovation and diversification of products. Strengthen the construction of market infrastructure, continually implement market-oriented reforms, cultivate commercial credit culture, strengthen market discipline and risk sharing mechanism, improve market transparency, so as to create a good environment for the development of bond market.

Focus on the improvement of the stock market. Streamline the development of the main board and SMEs board, supporting SMEs financing through the capital market. Promote the construction of GEM and support the development of innovative economy. Make great effort to expand the pilot of transferring the non-listed company's shares, and to accelerate the building of unified supervision of the national OTC market. Explore the establishment of the international market. Improve the change mechanism between different market, continue to deepen the market-orientated reform of IPO system, explore to establish the preferred stock system, complete the delisting mechanism, and improve the refinancing mechanism and the reward mechanism of investors in listing corporations.

Continue to develop the money, exchange and gold market. Put in great efforts to improve the healthy coordinated development of money market and sub-markets. Encourage innovation of money market tools, enhance the function of liquidity management. Meanwhile, steadily push forward construction of exchange market, continue to enrich products of exchange market and improve the trading mechanism of exchange market. Promote the steady development of the gold market, improving the service system of the gold market, improving storage, transportation, delivery and account service system of the gold market.

Box 18 The Innovation and Development of the Bond Markets

Developing bond markets and promoting financial innovation will optimize the financing structure, support the urbanization and the construction of key industries, solve the financing problem of the small and medium-sized enterprises, thus play a positive role in promoting and serving real economy. In recent years, the People's Bank of China, together with other relevant departments, has been vigorously promoting the financial innovation which can meet not only the financing needs of the real economy, but also the requirements of macro-management and risk prevention. During 2002 to 2012, the bond markets, driven by innovation, had undergone tremendous changes, with the market outstanding increasing rapidly from RMB 2.8 trillion yuan to RMB 26 trillion yuan and the ratio to GDP up from 24% to 50%. Corporate bonds achieved leapfrog development with bond balance increasing from RMB 123.3 billion yuan in 2004 to RMB 7 trillion yuan in 2012. The proportion of the enterprise financing through the bond markets accounting for the total social financing rose from 1.8% in 2002 to 14.3% in 2012.

In 2012, the People's Bank of China, together with other departments, continued to vigorously promote the innovation of bond markets. First, steadily pushed forward the pilot of securitization of loans. In May, the people's Bank of China in conjunction with the CBRC, the Ministry of Finance issued "notice" on the matters related to the pilot of further expanding the securitization of loans, so as to encourage and support more eligible institutions to participate in the issuance, investment and trading of asset-backed securities. By the end of the year, the State Development Bank and other 5 financial institutions had been allowed to issue asset-backed securities in the inter-bank market, which amounted to RMB 19.3 billion yuan. Second, the short-term financing bonds issued by the securities companies were launched. By the end of the year, 4 securities companies issued RMB 53.1 billion yuan of short-term financing bonds. Third, the non-financial enterprise asset-backed commercial notes were launched. In August, the first batch of 3 asset-backed notes up to RMB 2.5 billion yuan issued successfully. By the end of the year, the registered asset-backed notes aggregated RMB 7.2 billion yuan and RMB 5.7 billion yuan was issued. Fourth, piloted and promoted the asset management companies to issue financial bonds. In October, Cinda asset management companies issued RMB 10 billion yuan of financial bonds.

The practice mentioned above shows that promoting innovation of the bond markets should always be based on giving impetus to sound and fast economic development and satisfy the diverse demands for investment and financing. The initiative and innovative spirits of market entities should be respected, and the discipline mechanism of market should be brought into play. We should correctly handle the relationship between innovation promotion and risk prevention, improve the market management system, and strengthen the market infrastructure, so as to ensure market transparent and keep risks under control.

Chapter VI

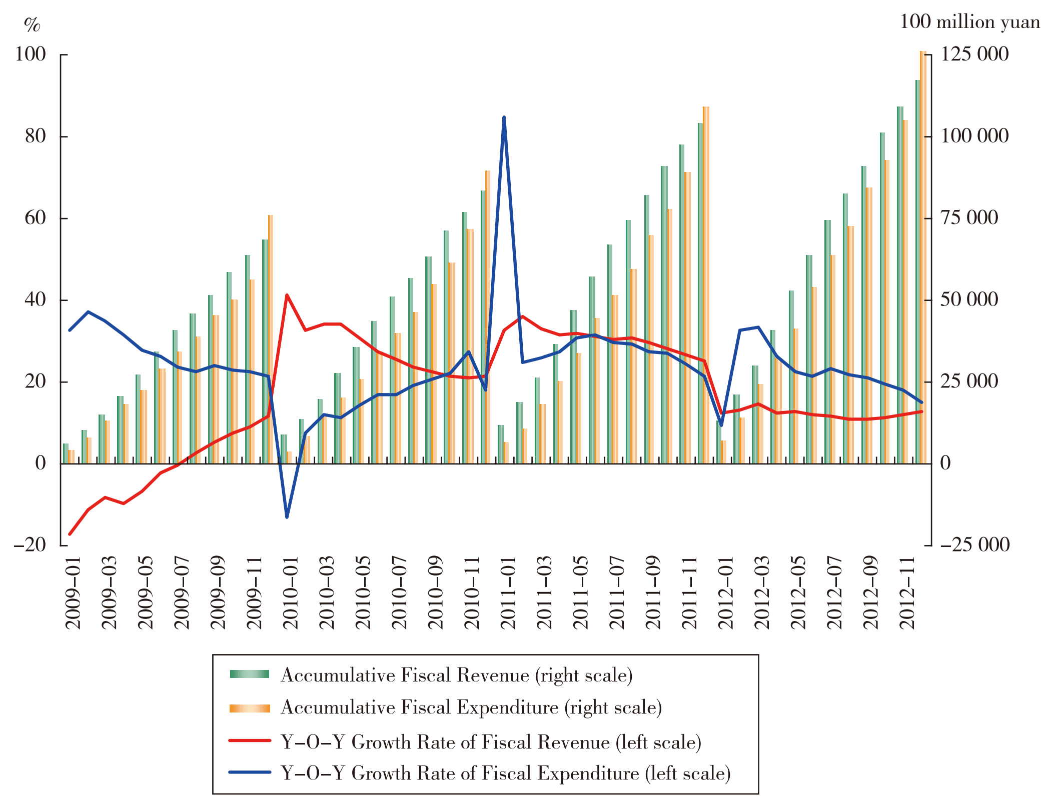
Financial Analysis of the Government, Corporate and Household Sectors

In 2012, the growth rate of fiscal revenue and expenditure of government sector slowed down, the growth rate of revenue from main business of enterprises declined notably, and the growth rate of total profits continued to fall, and the household indebtness was low.

I. Government Sector

Fiscal revenue grew at a slower pace. Due to economic slowdown h, decrease of corporate profit growth, fall of inflation rate and intensified efforts in structural tax cuts, fiscal revenues in 2012 amounted to RMB 11.72 trillion yuan, up 12.8 percent, 12.2 percentage points lower than that of last year (Figure 6.1). In terms of revenue structure, tax revenue in 2012 amounted to RMB 10.06 trillion yuan, accounting for 85.8 percent of total fiscal revenues. Among the tax revenue, VAT, corporate income tax and business tax were the main sources of revenue, posting RMB 2.64 trillion yuan, RMB 1.97 trillion yuan and RMB 1.57 trillion yuan respectively, or with a y-o-y growth rate of 8.9 percent, 17.2 percent and 15.1 percent respectively. Non-tax revenue amounted to RMB 1.66 trillion yuan, with a y-o-y growth rate of 17.5 percent, 25.4 percentage points lower than that in the same period of last year.

Figure 6.1 Accumulative Fiscal Revenue and Expenditure and Their Y-O-Y Growth



Source: The NBS.

Fiscal expenditure continued to grow at a slower pace. Fiscal expenditure in 2012 amounted to RMB 12.57 trillion yuan, with a y-o-y growth rate of 15.1%, 6.5 percentage points lower than that of last year. Among which, expenditure on education was 2.12 trillion yuan, 16.8% of total expenditures, up 28.3%; expenditure on social security and employment was RMB 1.25 trillion yuan, 10% of total expenditures, up 12.9%; expenditures on the agricultural sector, forestry and water utilities was RMB 1.19 trillion yuan, 9.5% of total expenditures, up 19.8%; expenditures on urban and rural communities affairs was RMB 902 billion yuan, 7.2% of total expenditures, up 18.4%; expenditures on housing security was RMB 444.6 billion yuan, 3.5% of total expenditures, up 16.4%.

Government debt was low. The disposable fiscal revenue of the year was RMB 11.99 trillion yuan, and the fiscal expenditure of the year was RMB 12.79 billion yuan. The fiscal expenditure exceeded the fiscal revenue by RMB 800 billion yuan, an equivalent to 1.5% of GDP in 2012. The outstanding balance on government bonds in the central budget was RMB 7.76 trillion yuan, which was under the budgeted limit of RMB 8.27 trillion yuan approved by the NPC. And RMB 200 billion yuan was used to repay the principal on local government bonds and 1.3 RMB billion yuan was carried forward to 2013. The government debt was low, but the social security issues such as medical care, pension plan deserve our attention.

Box 19 *Fiscal Cliff* in USA

Fiscal cliff was a simultaneous increase in tax rates and decrease of government spending that would have occurred in the beginning of 2013, which shapes fiscal deficit curve like a cliff. *Fiscal cliff* mainly includes four policy changes, first, Bush tax cuts expire; second, the social security payroll tax holiday by Obama government expires; third, the Emergency Unemployment Compensation by Obama government terminates; fourth, *Automatic Spending Cuts* based on *2011 Budget Control Act* will be launched.

The origination of *fiscal cliff* is that the US government and congress realized that the debt was unsustainable and the deficit must be cut down by a large margin. But the two parities could not reach a proper program on deficit reduction due to political polarization, this gave rise to a radical program of deficit reduction. According to the prediction of CBO, the reduction in U.S. *fiscal deficit* in 2013 amounts to 5.1% of GDP due to *fiscal cliff*, and GDP growth in US was lowered by 0.5% in 2013 (the y-o-y growth rate in the fourth quarter, similarly hereinafter). And the unemployment rate at the end of 2013 rose to 9.1%.

The two parties in US had consultations on *fiscal cliff* after the presidential election in 2012, but they disputed over the traditional concept of revenue increase and budget decrease. The democrats expected to cut deficit by canceling tax reduction and exemption for the rich and increasing tax revenue. But the republicans insisted that the tax reduction and exemption should benefit the rich and required government to cut down expenditure by a large margin, especially the welfare expenditure. After several rounds of difficult discussions and debates, the two parties reached a solution program of *step by step* by December 31st, such as levying more tax on families with annual income of over USD 450 000, extending tax cuts and unemployment relief for low-income people, delaying the effective date of across-the-board spending cuts in *automatic spending cuts* by two months, and etc. Based on the prediction of CBO, the program will increase the US fiscal deficit by USD 4 trillion yuan in the next ten years comparing with that in *fiscal cliff* (excluding the interest payment on extra debts amounting to USD 600 billion).

Although *fiscal cliff* was avoided at the last moment, but the US fiscal sustainability was still an issue, and cannot be solved thoroughly. Judging from current political polarization in US, the two parties will continue to debate over expenditure cutting, lifting debt ceiling, and soon the related policy uncertainty will continue to affect the stability in the US and global financial market.

II. Corporate Sector

1.Growth in Corporate Sales and Profit decelerated and Operating Cycle was protracted

Growth Rate of Corporate Sales fell dramatically. In 2012 corporate sales of enterprises above designated size[①] increased by 10.8% y-o-y, down 16.4 percentage points y-o-y[②]. Corporate sales of 5 000 industrial enterprises which the PBC monitors (hereinafter referred to as 5 000 industrial enterprises) increased by 2.9% y-o-y, down 9.6 percentage points from the previous year; and gross industrial products (at current prices) increased by 3.4% y-o-y, down 8.2 percentage points.

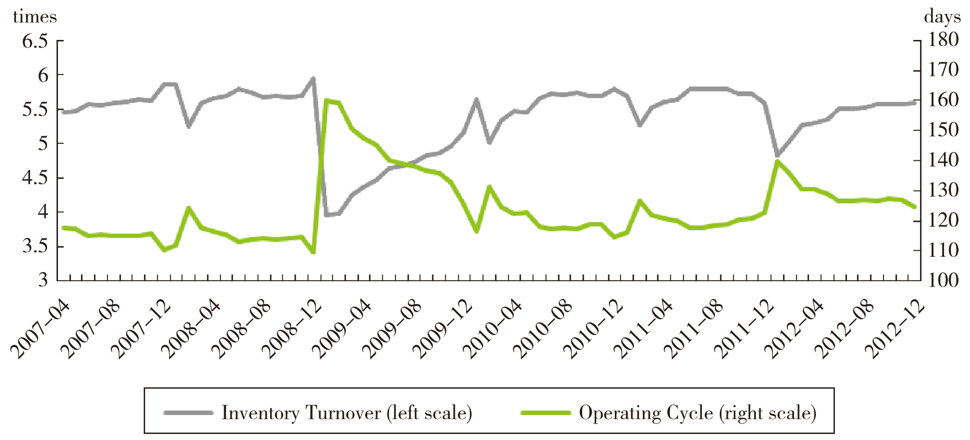
① Starting from January 2011, the National Bureau of Statistics (NBS) raised the minimum statistics standard for enterprises above designated size from those with annual business income of 5 million yuan to those with annual business income of 20 million yuan, and the minimum standard for fixed assets investment projects from those with planned investment volume of 500 000 yuan to those with planned investment volume of 5 million yuan. After raising the standards, the enterprises above the minimum standard will be checked one by one, and the enterprises below the minimum standard will go through sampling survey or scientific accounting.

② As to the total profitability data for enterprises above designated size, the National Bureau of Statistics (NBS) just count data from January to February, from January to May, from January to August, from January to November. As to data of other months and the year, there are only data of 22 provinces and municipalities, therefore, the business performance for enterprises above designated size in 2012 can be explained only with data from January to November in 2012, it is also true with other parts of the paper.

The Growth Rate of Total Corporate Profit continued to fall. In 2012, profits of enterprises above designated size increased by 3% y-o-y, down 22.4 percentage point's y-o-y. Total profits of 5 000 industrial enterprises fell by 6.2%, down 12.1 percentage point's① y-o-y. Judging from the questionnaire survey of 5 000 industrial enterprises, in the fourth quarter, corporate profitability index was 53.1%, down 4 percentage point's y-o-y, but up 1.7 percentage points from the last quarter.

Corporate Asset Turnover remained unchanged and Operating Cycle② was protracted. In 2012, the inventory turnover of 5 000 industrial enterprises was 5.6 times, same as that of last year. In which, finished products turnover was 21.6 times, up 0.1 times y-o-y; raw material turnover was 15.4 times, up 0.7 time y-o-y, total assets turnover was 0.91 time, same as that of last year. The operating cycle of 5 000 industrial enterprises was 124.7 days, up 1.9 days y-o-y (Figure 6.2).

Figure 6.2 Inventory Turnovers and Operating Cycle



Source: The PBC.

① The time of adjusting sample enterprises is not coincident to the time of reporting data by enterprises. The y-o-y growth rate of total profits at the end of 2012 is the data before the adjustment, while the adjusted data at the end of 2011 was 5.9 percent.

② Operating cycle = Days sales of inventory + Days sales in receivable.

Box 20 Business Tax Changed to VAT

The main framework of current tax system in China was determined in 1994 when *tax sharing system* was being reformed; the system is mainly constituted by turnover taxes, such as VAT, business tax and consumption tax. Business tax was levied based on business volume without deduction items. Therefore, the more turnover the heavier the tax, which is unfavorable to labor division, and impedes the efficiency of resource allocation. VAT was levied on *added value*. The VAT levied in the upstream can be deducted in the downstream. Business tax changed to VAT (hereinafter referred to as business tax to VAT) can avoid double taxation, reduce taxation burden for enterprises, which is favorable to the development of the tertiary industry, especially, the development of modern service industry, facilitating the adjustment of economic structure.

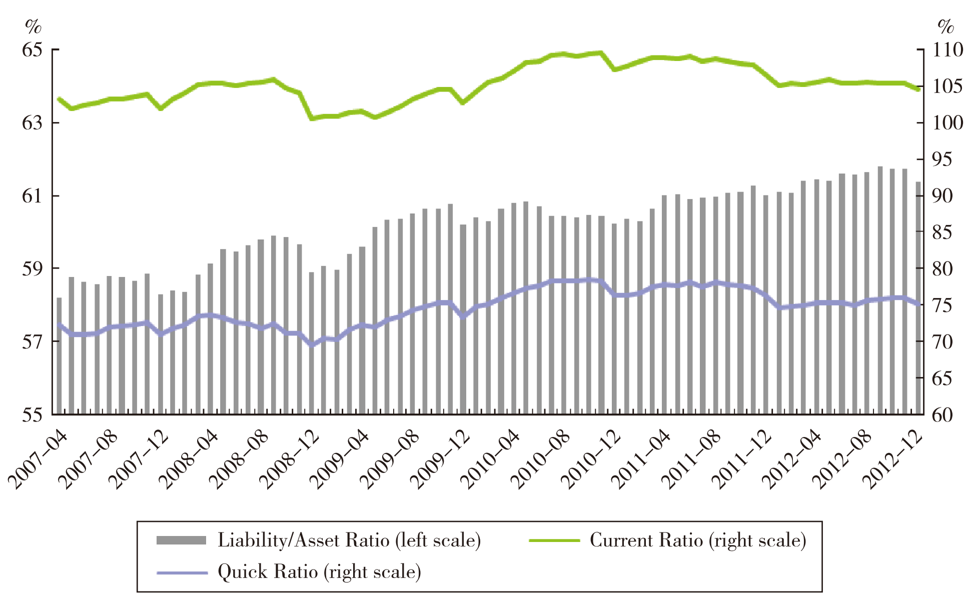
On January 1, 2012, Shanghai, as the first city in China to start the pilot program of *business tax changed to VAT* in transportation industry, and some modern service industry (R&D and technical service, information technology service, culture and creative service, logistics and ancillary service, certification and consulting service and leasing service of tangible property). From September to the end of December, the pilot program was extended to eight provinces (municipalities), those are Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, Guangdong. Within these regions, taxpayers engaged in transportation industry and some modern service industries pay VAT instead of business tax starting from the date of tax change. According to the estimation of the State Administration of Taxation, after the implementation of business *tax changed to VAT*, tax revenue will be reduced by over RMB 100 billion yuan, but consumption and investment will increase, bring the GDP up 0.5 percentage point, and the proportion of tertiary industry will increase 0.3% with about 700 000 new jobs.

Currently, financial business is not incorporated into the pilot program of *business tax to VAT,* and *business tax to VAT* was implemented only in finance leasing business, as one form of the leasing service of tangible assets. In the future, *business tax to VAT* implemented in the financial sector will greatly relieve tax burden for the sector. If financial institutions issue VAT invoice to the real economy, enterprises can have tax deduction, it will give tax relief to the real economy and avoid double taxation. In addition to this, *business tax changed to VAT* is conducive to changing *small and comprehensive, large and comprehensive* business model, established for the avoidance of double taxation under the current tax system. *Business tax to VAT* can promote specialization, diversify financial services and products, and improve business operation and management.

2.The Debt-Servicing Capacity declined from a high level with a quick increase in sale on credit

The Short-term Debt-servicing Capacity declined and Asset Liability Ratio rose slightly. At the end of 2012, the current ratio of 5 000 industrial enterprises was 104.6%, down 2.1 percentage point y-o-y. The quick ratio of 5 000 industrial enterprises was 75.2%, down 1.2 percentage point y-o-y. The interest coverage multiplier of 5 000 industrial enterprises was 5.2 times, down 1.3 times over that of last year. The long-term corporate debt-servicing capacity weakened slightly. The asset liability ratio of 5 000 industrial enterprises rose to 61.4%, up 0.4 percentage point y-o-y (Figure 6.3).

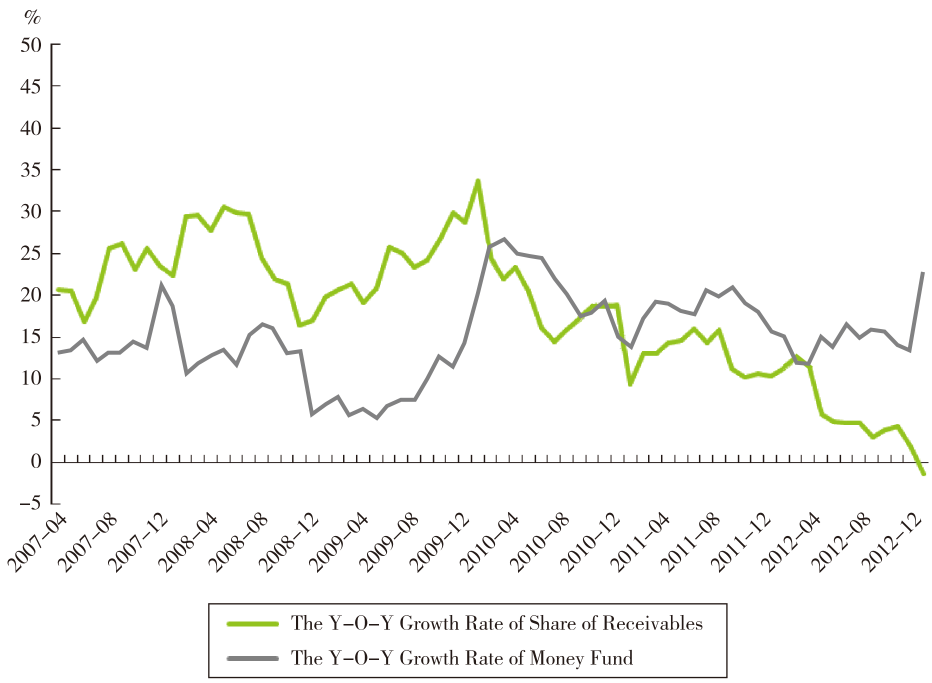
Figure 6.3 Liability/ Asset Ratio, Current Ratio and Quick Ratio of 5,000 Industrial Enterprises



Source: The PBC.

Net Receivables increased rapidly, the collection of sales fund was slow. As of the end of 2012, outstanding money fund of 5 000 industrial enterprises decreased slightly by 1.4% y-o-y, down 11.7 percentage points from the end of last year. The net receivables increased by 22.5% y-o-y, up 0.2 percentage points over that at the end of last year, 23.9 percentage points more than that of outstanding money funds (Figure 6.4). It indicates that the collection of corporate sales fund was slow. At the end of the year, the receivables of industrial enterprises above designated size increased by 15.9% y-o-y, down 2.7 percentage points from the end of last year. Finished products fund increased by 7.9% y-o-y, 12.9 percentage points higher than that at the end of last year.

Figure 6.4 The Y-O-Y Growth Rate of Money Fund and Share of Receivables

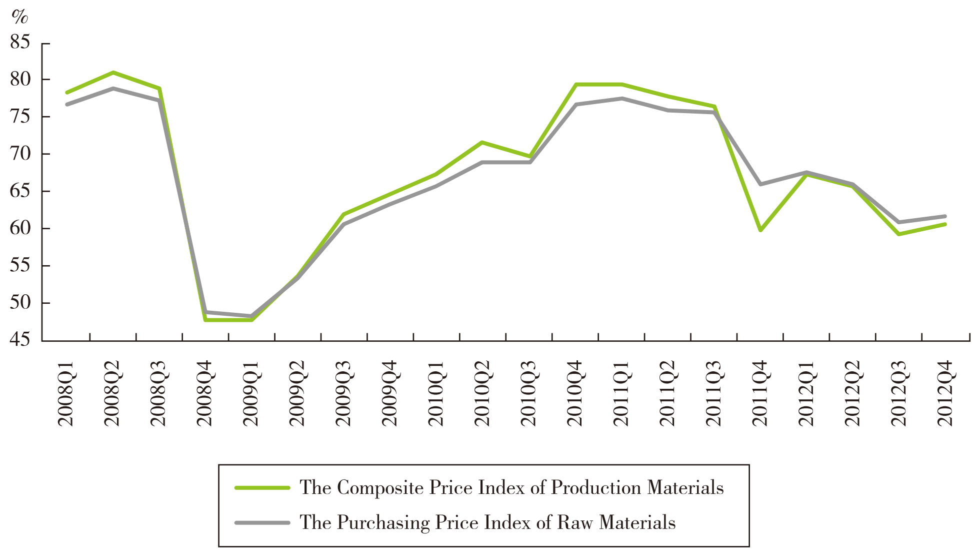


Source: The Survey of 5 000 Enterprises by PBC.

3. Price Index continued to decline and Inflation Expectation declined

According to the questionnaire survey of 5,000 industrial enterprises by PBC, in the fourth quarter of 2012, the purchasing price index of raw materials and the composite price index of production materials registered 60.7% and 61.6% respectively, down 7.5 and 7 percentage points' y-o-y. The anticipated purchasing price index of raw materials and the anticipated composite price index of production materials for the next quarter were 61.1% and 61.8% respectively, down 5.1 and 4.7 percentage points' y-o-y (Figure 6.5). Among which, 28.2% of entrepreneurs anticipated the composite price index of production materials would *go up*, down 9.8 percentage points y-o-y. 65.9% of entrepreneurs expected the index would *level off,* up 10.3 percentage points y-o-y, 5.3% of entrepreneurs anticipated the index would *go down*, down 0.5 percentage point y-o-y.

Figure 6.5 Movements of the Purchasing Price Index of Raw Materials and the Composite Price Index of Production Materials



Source: The survey of 5,000 industrial enterprises by PBC.

4. Domestic Sales Recovered Slightly with the Sluggish Performance of Export Order

The Domestic Order Index went down first, and then up, declining in general. In the first quarter of 2012, domestic order index was 47.7%, down 5.4 percentage points y-o-y, up 0.3 percentage point over the last quarter. It reversed the trend of consecutive decline for six quarters. Among which, 19.1% of enterprises believed domestic orders *falling*, while 14.6% of enterprises believed domestic orders *abundant*, the former is 4.5 percentage points higher than the latter. The Domestic Order Anticipated Index was 48.6%, down 3.9 percentage points y-o-y.

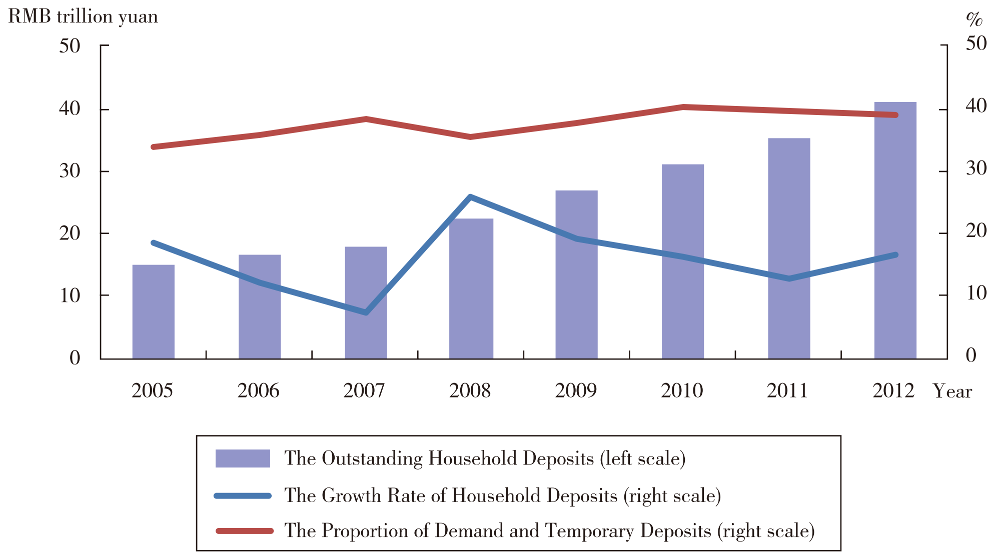
The Export Order Index went up first, and then fell, rising in general. In the fourth quarter of 2012, the Export Order Index was 47.1%, down 1.6 percentage points y-o-y, up 0.2 percentage point over the first quarter. In terms of region, the Export Order Index of enterprises in eastern region was down 1.9 percentage points y-o-y, central region was down 1.8 percentage points, and western region was down 0.8 percentage point. In terms of expectation, the Export Order Index in the fourth quarter was 47.9%, down 1.1 percentage points y-o-y.

III. Household Sector

The growth rate of household’s deposits rebounded. In recent years, with the rapid development of China’ economy, the total wealth of society increases notably and the total financial assets of household go up too.

Meanwhile, the structure of financial assets is gradually optimized, but the deposit still remains the major part of household financial assets. By the end of 2012, household deposit stood at RMB 41.02 trillion yuan, up 16.55% y-o-y, which is 3.85 percentage points higher than that of the last year and higher than that of 2010 too. In which, demand and temporary deposit accounted for 39.04%, keeping a rising trend over recent years.

Figure 6.6 Changes in the Household Deposits and the Proportion of Demand and Temporary Deposits



Source: The PBC.

Rapid Growth in Wealth Management Products. With residents' higher demands for the value hedge and increment, the diversified allocation of their financial assets, the wealth management products witnessed an accelerated development in 2012. At the end of 2012, the existing wealth management products in banks amounted to 31 000 with funds volume of RMB 6.7 trillion yuan, up 64.4% y-o-y, 50.3 percentage points higher than the growth rate of deposits during the same period. The average rate of return of these wealth management products was 4.32%. Consequently, they have been one of the most important wealth management tools for residents. The outstanding of trust program was RMB 7.47 trillion yuan, the total entrusted funds managed by the securities company was RMB 1.89 trillion yuan, the public fund and the asset of SMA (Separately Managed Account) run by fund companies was about RMB 3.62 trillion yuan. Quite a proportion of them were residents' financial assets. By the end of 2012, the market value of stock listed on A-share market held by individual investors was RMB 4.6 trillion yuan.

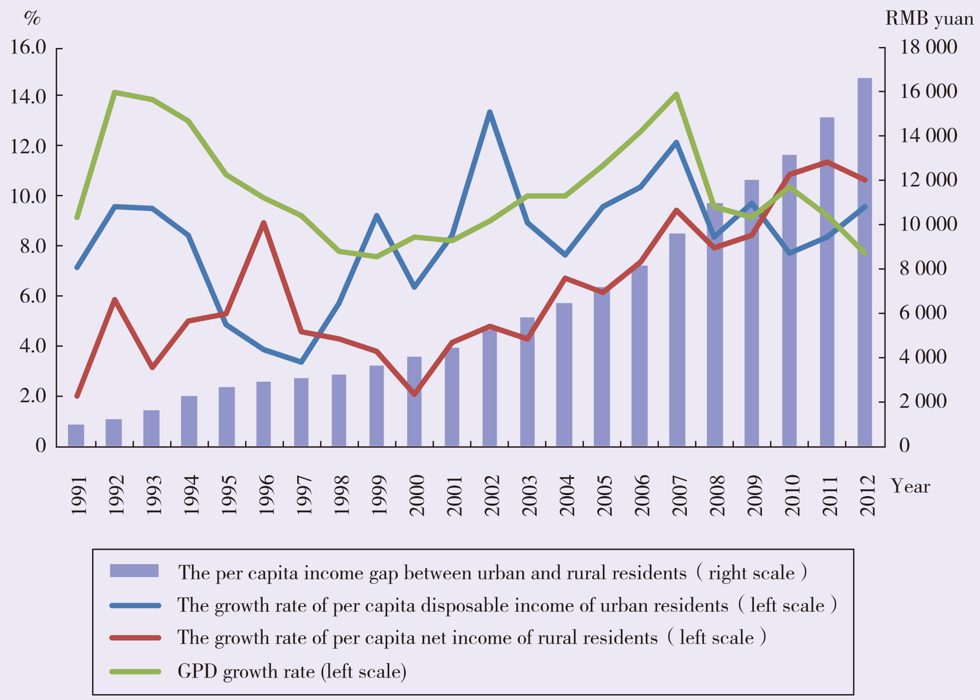
Box 21 Income Growth and Structure of Chinese Residents over Recent Years

From 1991 to 2009, the annual growth rate of per capita income for urban and rural residents was lower than the average GDP growth rate at the same period. Starting from 2010, the growth rate of per capita net income for rural residents exceeded the growth rate of per capita disposable income of urban residents and GDP growth rate. In 2012, the growth rate of per capita disposable income for urban residents exceeded GDP growth rate too, but the wide regional income difference of Chinese residents was not improved remarkably.

The income growth of rural residents exceeded that of urban residents starting from 2010. From 1991 to 2009, the per capita disposable income for urban residents increased by 8.3% annually, while the per capita net income of rural residents increased by 5.5 percent annually, both of them were lower than the average GDP growth rate at the same period (10.5%). The ratio of per capita income between urban and rural residents was expanded from 2.2 in 1990 to 3.3 in 2009. Starting from 2010, the growth rate of per capita net income of rural residents started to exceed that of per capita disposable income of urban residents and the GDP growth rate. From 2010 to 2012, the actual growth rate of per capita net income for rural residents was 10.9%, 11.4% and 10.7% respectively, 3.1 percentage points, 3 percentage points and 1.1 percentage points higher than the actual growth rate of per capita disposable income for urban residents at the same period, 0.5 percentage points, 2.1 percentage points and 2.9 percentage points higher than the GDP growth rate at the same period. The ratio of per capita income between urban and rural residents was decreased slightly to 3.1 in 2012, but the per capita income gap between urban and rural residents is widening, up from 824 yuan in 1990 to 16 648 yuan in 2012 (Figure 6.7).

Wide regional difference in the per capita income between urban and rural residents. In 2011, Shanghai has the highest per capita disposable income for urban residents and per capita net income for rural residents, that are, RMB 36 230 yuan and RMB 16 054 yuan respectively, while Gansu has the lowest per capita disposable income for urban residents and the per capita net income for rural residents, which are, 14 989 yuan and 3 909 yuan. The per capita disposable income for urban residents in eight provinces and municipalities exceeded national average (21 810 yuan), the per capita net income for rural residents in 12

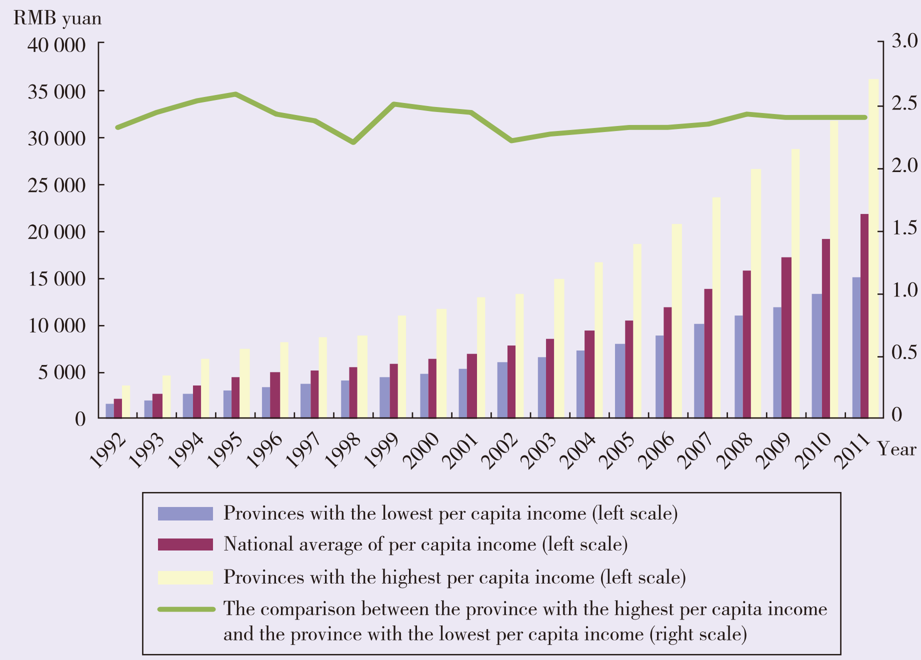
Figure 6.7 The Per Capita Income for Urban and Rural Residents and GDP Growth Rate



Source: The NBS.

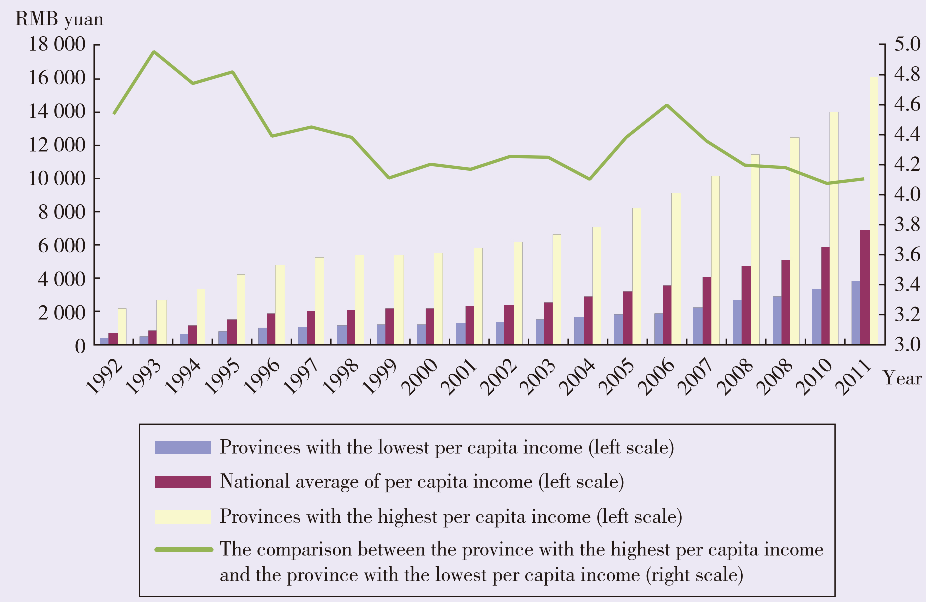
provinces and municipalities exceeded national average (6,977 yuan). From 1992 to 2011, the ratio of the highest per capita disposable income of the urban residents to the lowest among provinces fluctuated from 2.2 to 2.6, with an average of 2.4 (Figure 6.8). The ratio of the highest per capita net income of rural residents to the lowest among provinces fluctuated from 4.1 to 5.0, with an average of 4.37 (Figure 6.9). And there is a narrowing trend in the regional gap for per capita net income of rural residents. The higher the income, the lower income difference between urban and rural residents. In 2011, per capita income difference between urban and rural residents in Shanghai was 2.3, while the figure in Gansu was 3.8.

Figure 6.8 Provinces with the Highest and the Lowest Per Capita Disposable Income for Urban Residents



Source: The NBS.

Figure 6.9 Provinces with the Highest and the Lowest Per Capita Net Income for Rural Residents



Source: The NBS.

Over recent years, the income growth of residents and changes in income structure show that China has made positive achievements in balancing urban and rural development, narrowing the income gap between the urban and rural, promoting the urban and rural prosperity. As the next step, efforts will be made to adjust the distribution pattern of national income, intensify redistribution measures, achieve the synchronous development between the income growth of urban and rural residents and economic progress, and improve the share of residential income in the distribution of national income, so that the reform and development achievements can benefit all.

The Outstanding NPLs for personal loans increased, NPL Ratio kept going down. At the end of the year, the outstanding NPLs① (including non-business loans and business loans②) were RMB 277.1 billion yuan, up RMB 29.4 billion yuan over the beginning of the year. The NPL ratio was 1.7%, down 0.1 percentage points over the beginning of the year, up 0.2 percentage point y-o-y. Among which, the outstanding NPLs for domestic personal loans (excluding personal business loans) was RMB 69.9 billion yuan, up RMB 600 million yuan over the beginning of the year. The NPL ratio was 0.7%, down 0.1 percentage point over the beginning of the year. The outstanding NPLs for personal business loans were RMB 207.2 billion yuan, up RMB 28.7 billion yuan over the beginning of the year. The NPL ratio was 3.8 %, down 0.4 percentage points over the beginning of the year (Figure 6.10).

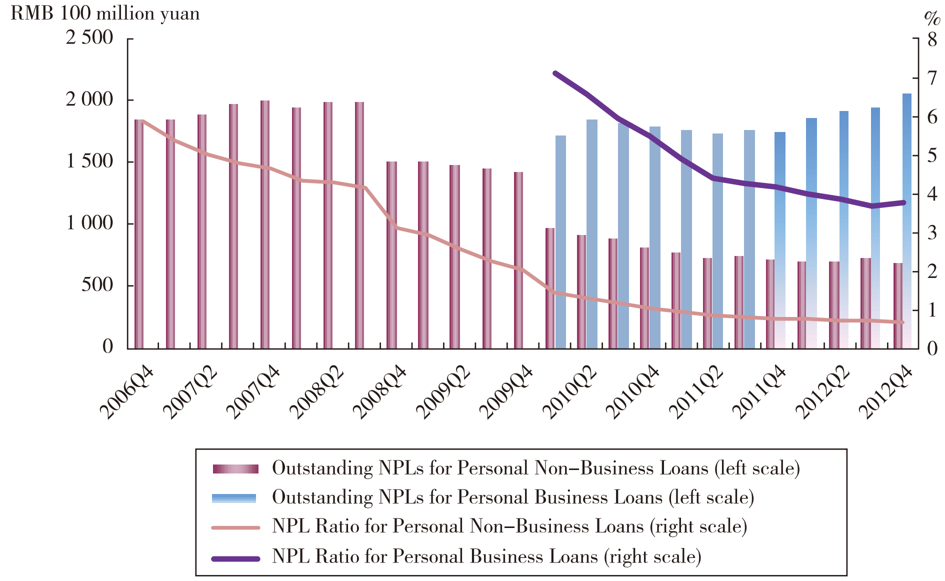
The Outstanding NPLs for Personal Mortgage Loans, Personal Credit Card Loans, and Personal Auto Loans went up. At the end of 2012, the outstanding NPLs for personal mortgage loans, personal credit card loans and personal auto loans was 21.1 billion yuan, 15.5 billion yuan and 3.4 billion yuan respectively, up 1.4 billion yuan, 5.3 billion yuan and 500 million yuan respectively. NPL ratio was 0.3%, 1.1% and 1.3% respectively. Among which, the NPL ratio for personal mortgage loans was with the same as that in

① NPL data is from the CBRC. The statistics scope in 2007 to 2008 for the data included policy banks, state-owned commercial banks, shareholding commercial banks, city commercial banks, rural commercial banks, rural cooperative bank, foreign corporate bodies and branches, branches of foreign banks, urban credit cooperatives, rural credit cooperatives, finance companies of enterprise groups, trust and investment corporation, financial leasing companies and auto finance companies. The data of postal savings banks was incorporated into the statistics scope after 2009.

② Personal business loans was a new index in 2011, its data can be traced to 2010.

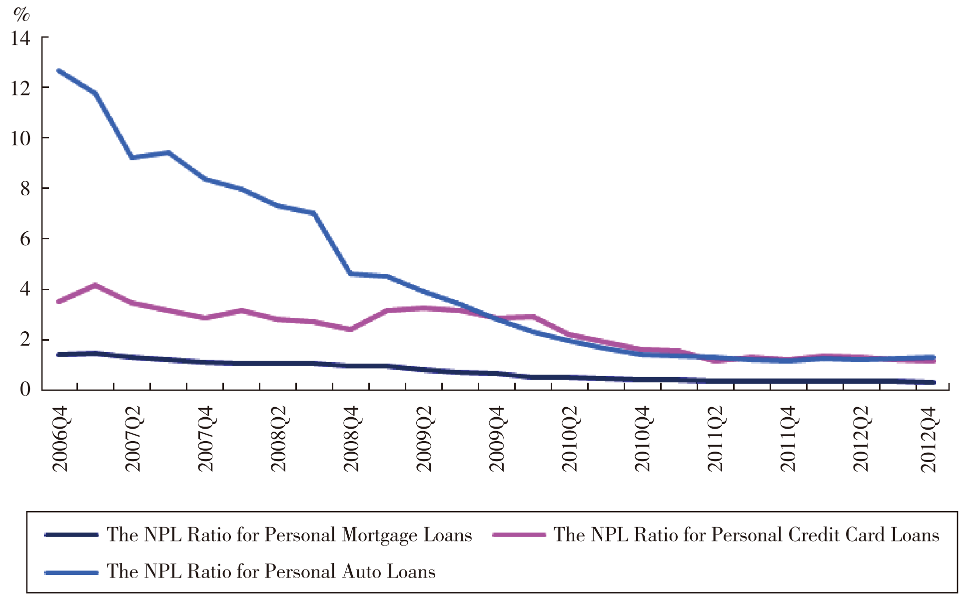
the beginning of the year, the NPL ratio for personal credit card loans was 0.1 percentage point lower than that in the beginning of the year, and the NPL ratio for personal auto loans was 0.2 percentage point higher than that in the beginning of the year (Figure 6.11) .

Figure 6.10 NPL in Personal Loans from 2007 to 2012



Source: The CBRC.

Figure 6. 11 NPL Ratio for Personal Non-Business Loans



Source: The CBRC.

Chapter Ⅶ

Financial Infrastructure

In 2012, steady progress has been made in the construction of financial infrastructure in China. Improvements made on the fronts of payment system, legislature concerning financial sector, accounting rules and standards, the management of credit information industry, and anti-money laundering have warranted the sound performance of the financial system.

I. Payment, clearing and settlement system

1. The set-up of the system pushed forward steadily

Financial infrastructure performed soundly. In 2012, the financial market infrastructure including payment system, bond settlement system, central counterparty and transaction database have been processing an increasingly larger amount of transactions, and the management and operation of such systems have been further improved. Firstly, various payment systems nationwide performed soundly, and the transactions processed by the systems increased rapidly. The total number and value of payment transactions processed by above-mentioned payment systems stood at RMB 19.112 billion and RMB 2508.29 trillion yuan, increasing by 23.1 percent and 25.9 percent respectively y-o-y. The second-generation payment system was under development. Secondly, clearing agencies including China Union Pay, clearing centers of urban commercial banks and rural credit banks processed a greater variety and larger size of businesses. Thirdly, transaction systems of China Government Securities Depository Trust and Clearing Co., Ltd. and China Bond Depository Trust and Clearing Company delivered sound performance, with a rapid growth in the value of securities depository trust and clearing transactions. The total value of securities deposited posted RMB 25.96 trillion yuan, up 18.08 percent y-o-y. The systems cleared a total of RMB 218 trillion yuan worth of transactions, 21.11 percent more compared with the previous year. Fourthly, China Foreign Exchange Trade System and Shanghai Clearing House played more important roles on the foreign exchange market and OTC financial market. The scope of foreign exchange net clearing business expanded to cover RMB foreign exchange forward and swap transactions, and the value of net clearing of spot bond transactions exceeded RMB 6 trillion yuan, demonstrating higher efficiency in clearing. The database of China foreign exchange trade system can basically deliver one-stop service for depository trust for data on the inter-bank market.

The legal system was further improved. The *People's Bank of China's Notice on Standardizing the Issuance of Magnetic Stripe Pre-paid Cards and Electronic Cash by Banking Financial Institutions*, and *Administrative Measures on Payment Agencies' Pre-paid Cards Transactions* were released, putting in place adequate supervision on the issuance, acceptance, use, recharge and redemption of pre-paid cards by payment agencies. The draft of *Regulations on Bank Cards* for soliciting public opinions was completed. Efforts were made to draft and amend provisions such as *Administrative Measures on the Management of Bank Card Acquiring*, finalize the overall plan on the reform of RMB bank accounts, and draft *Administrative Regulations on RMB Bank Accounts*.

Development of non-cash payment instruments gained momentum. In 2012, the volume of transactions processed by non-cash payment instruments continued to grow. The number and value of payment transactions processed by means of non-cash payment instruments such as bills and bankcards reached RMB 41.141 billion and RMB 1286.32 trillion yuan, growing by 21.6 percent and 16.5 percent y-o-y respectively. The volume of bankcard issuance continued to rise, and the cumulative credit card issuance increased slightly as a percentage of total bankcard issued. Steady progress was made in the application and promotion of financial IC cards. Major commercial banks started to issue financial IC cards, and gradually expanded its scope of application. The volume of transactions settled by means of remittance and entrusted receipt kept growing, albeit at a slower pace. Generally speaking, bankcard has become the most widely used non-cash payment instrument for Chinese residents by now, playing a vital role in providing convenience for the general public, stimulating consumption, and promoting the development of real economy. The penetration rate of bankcards[①] was as high as 43.5 percent. Meanwhile, the development of new ways of payment via digital TV, mobile phone, Internet and fixed phones gained momentum. Such innovative ways of payment became more mature, meeting the demands for payment services.

Supervision and management were further improved. Firstly, non-financial institutions' access into the payment market was better managed. By end-2012, a total number of 197 institutions acquired payment license, and the payment institutions accounting for a significant share of the market were already under the supervision of the PBC. Secondly, daily supervision and management over payment institutions were reinforced. An annual supervisory reporting system on payment institutions was established, combining legal person supervision and territorial supervision, and the special efforts were made on settlement reserves management, risk prevention and regulating operational activities. Thirdly, the mechanism to review law enforcement regarding payment and settlement businesses of banks and payment agencies was set up after in-depth study, and the *Manual for On-site Review of Payment and Settlement by Banking Financial Institutions* was completed. Fourthly, continued efforts were made to implement the real-name application and use of bank accounts, by finishing the draft for *Overall Plan on the Reform of RMB Bank Accounts*, and checking the authenticity of bank account users' personal information. Fifthly, strengthen the guidance to the Payment and Clearing

① It refers to the proportion of consumption settled by bankcard in total l retail sales, excluding the real estate transactions and wholesales.

Association of China, so as to coordinate the regulation of the PBC with the industry self-discipline by the Association.

Payment environment in the rural area made improvements. Such improvements played a very positive role in smoothing out the settlement and payment channel in the rural area, and promoting the upgrade and innovation of rural financial services. In 2012, in line with *Guiding Opinions on Improving Payment Service Environment in the Rural Area* and other relevant policy papers, continued efforts were made to promote the use of non-cash payment instruments and development of payment and settlement systems in the rural area, in order to improve financial service there. Services of helping rural residents with deposit withdrawal were provided nationwide, facilitating the payment and settlement channels in remote rural areas, and facilitating the provision, enquiry and withdrawal of various kinds of subsidies. The number of transactions under the migrant worker bankcard project totaled nearly 7.2 million, with a transaction value of RMB 20 billion yuan. Meanwhile, financial institutions operating in the rural area are encouraged to do all kinds of transactions via the payment system based on their conditions and business needs. By end-2012, more than 70 thousand rural financial institutions and their branches got access into the payment system of the PBC, greatly facilitating the channels for funds remitting and transfer in rural areas. Complementing platforms including rural credit banks payment and clearing systems successfully completed 86.668 million payment and settlement transactions, clearing a total value of RMB 2 trillion yuan.

Cross-border exchange and cooperation was further deepened. The PBC continued to be actively engaged in Committee on Payment and Settlement Systems (CPSS), Working Group on Payment and Settlement Systems under the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP-WGPSS), South East Asian Central Banks (SEACEN) and relevant international organizations, keeping good relationship with member agencies in the payment, clearing and settlement area. Reelected as the chairman agency of EMEAP-WGPSS, the PBC managed to have a louder voice in the development of payment and settlement in this region. Steady progress was made in promoting PBC-ECB (European Central Bank) bilateral meeting mechanism on payment and settlement, as well as in deepening cooperation on financial infrastructure between mainland and Hong Kong. The *Report on the Development of China's Payment System* was published to make China's payment system better known to the outside world.

2. Prospect for development

In the next step, in line with the *Guiding Opinion to the Development of China's Payment System* (*2011—2015*), the PBC will coordinate the development of the payment, clearing and settlement systems, and enhance the safety and efficiency of financial market infrastructure and retail payment market. First, efforts will be made to maintain the safe and stable operation of the payment system, make progress in the putting into operation the second generation payment system, and organize relevant agencies to construct the Cross-border Inter-bank Payment System (CIPS). Second, continued efforts will be made to promote and standardize the use of non-cash payment instruments, encourage innovation in various kinds of payment businesses, and promote the application and development of innovative payment instruments. Third, the PBC will reinforce supervision and management of the payment service market, guide relevant agencies to have a smooth transition in applying the new commissioning standard of using cards, and explore to apply different effective supervision models over new payment businesses. Fourth, efforts will be made to improve planning, guidance and statistical analysis on rural payment service environment, in order to expand payment service to all administrative towns and townships in rural areas. Fifth, the PBC will continue to deepen international exchange and cooperation on payment system, and to disseminate knowledge on and implement the *Principles for Financial Market Infrastructure* formulated by CPSS and International Organization of Securities Commissions (IOSCO).

Box 22 The release of *Principles for Financial Market Infrastructure*

After the outburst of the international financial crisis in 2008, the significance of building an efficient, transparent, well-regulated and complete financial market infrastructure has been a wide consensus of the international community. The FSB was very vocal in calling for strengthening the management of financial market infrastructure. Since February 2010, the CPSS and IOSCO started overall review on all existing international standards including *Core Principles of Systemically Important Payment System* (CPSIPS) , *Recommendations on Securities Settlement System* (RSSS) and *Recommendations on Central Counterparties* (RCCP) based on lessons drawn on the crisis and experiences from the implementation of current international standards. By identifying and removing discrepancies in different international standards, making stricter minimum requirements, providing more specific guidance, expanding the coverage of international standard to cover risk supervision and new types of financial market infrastructure, the review has greatly supported the FSB in improving core financial market infrastructure.

In April 2012, the CPSS and IOSCO jointly released the "*Principles on Financial Market Infrastructure*" (referred to as Principles hereinafter), defining payment system, centralized securities depository (CSD), securities settlement systems (SSS), central counterparties (CCP) and transaction repository (TR) as falling into the category of financial market infrastructure, coordinating and strengthening original international standards. The Principles are composed by a total of 24 principles in 9 areas, namely overall structure, credit and liquidity risk management, settlement, central securities depositories and exchange-of-value settlement systems, default management, general business risk and operation risk management, access, effectiveness and transparency, articulating 5 responsibilities of central banks, market regulators and other management agencies. The release of the Principles helped enhance supervision of management agencies, and reinforced risk management of financial market infrastructure.

At present, China has committed to accepting these principles at maximum within its jurisdiction. The World Bank, IMF and FSB will also adopt such principles in the future FSAPs. Central banks, market regulators and other relevant management agencies should prepare themselves for the implementation of these principles. FMIs are also expected to take appropriate and rapid actions to implement the Principles.

II. Legal Environment

1. The legal system governing the financial sector further improved

New laws and regulations were made. In 2012, the National People's Congress passed the *Law of the People's Republic of China on Securities Investment Funds*, incorporating non-public offered funds into the jurisdiction of the legal system for the first time, strengthening supervision over fund managers, shareholders and practitioners. The State Council approved *Administrative Provisions on Credit Information* (taking effect on March 15, 2013), revised and passed *Administrative Provisions on Futures Transactions,* making definitions concerning future transactions, stipulating that neither can future exchanges be established nor futures transactions be made unless approved. *Provisions on Mandatory Liability Insurance for Traffic Accidents of Automobiles* were passed, lifting restrictions for foreign insurance companies to participate in doing business in this area, which was a step forward in further opening up the insurance market. *Regulations on Agricultural Insurance* was released, providing insurance premium subsidies, tax and fee advantages, and fiscal support to agricultural insurance, and extending policy supports such as establishing huge disaster risk diversification mechanism.

More judicial interpretations were released. In 2012, *the Supreme People's Court and the Supreme People's Procuratorate's Interpretation on Several Issues concerning*

Application of Laws on Criminal Cases of Insider Trading and Leaking Insider Information, making interpretation on the constitution of a crime, standard and method of crime determination, calculation of penalty values and other relevant issues. The *People's Court's Guiding Opinion on Providing Judicial Guarantee to Mitigate Financial Risks and Promote Financial Reform and Development*, stipulating that efforts shall be made to crack down on criminal financial activities, penalizing illicit financial conducts, regulating exchanges, implement stricter law enforcement on financial cases, properly handle the trial of cases involving overdue financial claims, financial innovation and financial intellectual property, and to adopt various judicial measures to protect the safety of financial information.

Regulatory provisions and measures were made. The PBC released regulatory documents in line with its mandates on monetary policy, financial stability and financial services, making rules on issues in several areas such as payment institutions' issuance of pre-paid cards, cross-border settlement in RMB, gold and gold-derivative market and anti-money laundering, enhancing the capability of fulfilling its mandates according to law. Relevant regulators have reinforced their supervisions by making regulations and regulatory documents on capital management of commercial banks, private capital's access into the banking sector, supervision to ensure integrity on the securities futures market, asset management businesses of securities companies, trial businesses for asset management of securities companies, management of fund management companies, trial businesses of fund management companies' asset management for specific clients, supervision on non-listed public companies, management on shareholders holding controlling shares in insurance companies, and reinsurance businesses of property insurance companies. The release of all these regulatory documents has standardized and promoted the development of relevant industries.

International experiences on financial legal reform were learned. After the outburst of the global financial crisis, major economies and international organizations have carried out a series of reforms on their financial regulation systems and relevant international standards in order to strengthen supervision and better mitigate risks. In particular, efforts were made to bolster and improve macro-prudential framework, reinforce supervision and risk resolution of systemically important financial institutions, enhance supervision standards on financial market and financial products, and strengthen protection of interest and rights of financial consumers. The PBC has been following closely the reform process of standard setting bodies and major economies' legal system improvement in the financial area. The top-down design of institutional arrangements was reinforced to prevent and mitigate systemic risks. Specifically, efforts were made to improve the labor division, method and tools in maintaining financial stability, accelerate the establishment of deposit insurance system, improve market-based risk-resolution and bankruptcy system of financial institutions, strengthen the coordination of macro-prudential regulation and micro-prudential supervision, so as to prevent regulatory vacuum and arbitrage and better protect rights and interests of financial consumers.

2. Prospect in law-making

In 2013, continued efforts will be made to improve the legal system governing the financial sector in line with the needs for the reform and development of the financial industry. Further studies will be conducted to promote the amendment of *The Law on the People's Bank of China, Securities Law*, as well as the *Measures on Reporting Balance of Payment Data, Provisional Regulations on Cash Management* and *Administrative Regulations on Foreign Exchange Settlement, Sales and Receipt*. Active efforts will be made to formulate rules such as *Regulations on Deposit Insurance, Administrative Regulations on Financial Statistics, Regulations on Bankruptcy of Banking Institutions, Regulations on the Supervision of Listed Companies* and *Regulations on the Fund for Protecting Securities Investors*.

III. Accounting Standards

1. Accounting rules and standards keep improving

Steady progress has been made in making and amending accounting rules and standards. First, efforts were made to improve accounting standards of corporate sector in China according to *Roadmap on Sustained Convergence of Accounting Standard of China's Corporates with International Financial Reporting Standard*, so as to promote the convergence between domestic standards with international rules. Second, China and Europe recognized the effectiveness of the accounting standards of each other, facilitating economic and trade exchange as well as capital flows. Third, accounting standards including *Interpretation on Corporate Accounting Standards No*. 5 were issued to facilitate the development of financial market. Fourth, accounting methods dealing with interbank refinance for trade conducted by banking institutions and pilot for applying VAT to replace sales tax were developed.

2. Prospect for development

In the next step, continued efforts will be made to promote the reform and development in financial accounting. Chinese corporates' accounting standards will be continuously converging with international financial reporting standards. A series of accounting rules including accounting standards of small enterprises will be implemented. Active efforts will be made to promote enterprises supported by the central government and companies listed on the main board to have in place standardized, reasonable and effective internal control system in line with their real conditions. Studies will be made on the formulation of Standards on Accounting Informationization, to further standardize the process of accounting informationization. The implementation scope of general taxonomy of corporate accounting rules will be expanded, promoting its wide application in banking financial institutions. Meanwhile, efforts will be made to closely follow latest development of international financial reporting standards, actively engage in formulation and revision of international rules and promote international exchange and cooperation.

Box 23 Revision of the *Manual on Money and Financial Accounting* and Its Implications on Financial Statistics in China

The international financial crisis in 2008 revealed deficiency in financial statistics. In order to meet needs for statistical analysis, the IMF formally initiated overall revision of the *Monetary and Financial Statistics Manual* (*referred to as the Manual hereinafter*) at the beginning of 2012.

This revision was mainly composed by the following aspects: first, to expand the scope of data collection and application of the *Manual*. More detailed categorization of financial sector and financial instruments was made, covering new institutions and instruments crossing market, business and country, with the focus shifting from deposit-taking financial institutions to special purpose entities(SPEs), sovereign wealth funds(SWFs) and other non-banking financial institutions and innovative instruments. More content was included such as valuation and statistical processing of new type of financial instruments, and change in asset data as a result of factors other than transactions, optimizing statistical methodology. Efforts were also made to collect data on credit aggregate and liquidity aggregate, rather than focusing solely on broad money, reflecting activities in the whole financial system. Second, correlation with other statistical categories was enhanced. Efforts were made to strengthen linkage with macro economy statistics, financial regulation statistics, BOP and financial market statistics, further categorize financial assets items according to currencies, date of maturity and interest rate, paying special attention to funds flow statistics, adding all-social balance sheet accounting and setting up balance sheet accounting matrix. Third, more support was provided to monetary policy. Based on empirical experience of monetary statistics of different countries, and the influence of economic and financial development on the important aggregate indicators such as money, the PBC added new indicators such as credit aggregate and liquidity aggregate, as well as seasonal adjustment of time series of economic indicators.

China has been making proactive efforts

on the front of financial statistics. The development of total social financing and comprehensive statistics of financial sector has expanded the coverage of financial statistics. Standardization of financial statistics and the development of wealth management and fund trust statistics system, as well as efforts made on interest rate statistics have strengthened correlation between financial statistics and other macro-economic statistics. The revision of statistical caliber of money supply is an evidence of applying financial statistics to the formulation of monetary policy. All these efforts have laid a solid foundation for China to adopt the new *Manual* in the future, and provided experiences for its revision. At present, we can take the revision of the *Manual* as an opportunity to speed up setting up a unified, comprehensive and shared financial statistical system, strengthen statistical work in banking institutions, continue to improve statistics on money supply, coordinate money statistics and financial stability, establish sound interest rate statistical system, and implement standardization of money statistics, so as to enhance financial statistics.

IV. Credit Environment

1. Steady progress has been made in credit information and social credit system

Legal system related to credit information witnessed a breakthrough. On December 26th 2012, the *Administrative Provisions on Credit Information Industry* was approved by the meeting of the State Council standing committee, which was released on January 21, 2013 and took effect on March 15, 2013.

Box 24 Release of the Administrative Provisions on Credit Information Industry

Credit information industry is the industry providing credit information service in a market economy, playing an important role in preventing credit risks of financial institutions, and maintaining financial stability, and laying a solid foundation for modern social and economic institutional arrangements such as bankruptcy of individuals and financial inclusion.

Since the reform and opening-up, the credit information industry in China has started from scratch, and gradually developed into a relatively mature stage.

However, there remain the problems of relatively slow growth and irregularities in relevant activities, which cannot meet the requirements for credit-based economic development and social credit system, therefore highlighting the necessity of legislation and other institutional arrangements to regulate its development.

The release of the *Administrative Provisions on Credit Information Industry* (referred to as *Provisions* hereinafter) demonstrated that the China's credit information would develop in compliance with law in the future. *Provisions* apply to individuals and enterprises' collection, sorting, maintenance and processing of credit information, and their business activities in providing credit information to information users and other relevant activities. The *Provisions* has mandated the PBC as the supervisory authority of the credit information industry, and the PBC will supervise and regulate credit information industry and agencies operating financial credit information database. The *Provisions* have made requirements on the establishment of credit information agencies, as well as the rules by which the credit information businesses should follow. Agencies involved in personal credit information shall acquire access into business on approval basis, and the collection and use of personal credit information shall be preconditioned with consent. Information related to privacy should not be collected. The reporting of bad credit information shall proceed after notification and such information will be kept for 5 years. Agencies engaged in corporate credit information are accessed into business on a registration basis. The collection and use of corporate information are not required to be based on consent of the corporates. Credit agencies can collect information on corporates in multiple channels. The Provisions required that basic database of financial credit information shall be set up by the state, and be set up, operated and maintained by professional institutions, and take credit information from agencies reporting of credit information as required.

The launch of the *Provisions* provides legal basis for the operation of the credit information industry, facilitates better management of the credit information market, better regulates activities of credit information agencies, information provider and user, playing an important role in protecting rights and interests of information subjects, fostering and developing credit information industry and improving social credit environment.

Progress in building social credit system was made with well-coordinated efforts. National Development and Reform Commission and the PBC jointly took the initiative in the inter-ministerial conference on improving social credit system, organized relevant institutions to formulate *Outline for the Plan of Building Social Credit System* (*2013—2020*). Efforts were made to apply enterprise credit code nationwide, issuing a total of 18 million credit code cards for the whole year. Continued efforts were made to press ahead with building credit system for small and medium-sized enterprises (SMEs) and rural areas, paying special attention to the progress made in pilot areas. By end-2012, the PBC had established credit information files for more than 2.353 million SMEs that hadn't acquired credit from banks. Among this total, 290 thousand SMEs acquired bank loans, with outstanding value of RMB 5.6 trillion yuan. Efforts were also made to establish credit information files for 148 million rural households, recognized 97.84 million credible rural households. More than 110 million rural households with credit information files acquired loans, with outstanding value of RMB 1.76 trillion yuan.

Management of credit information was reinforced. The PBC organized commercial banks to review their credit information businesses, and imposed penalties on the leakage of personal credit information. Complaints filed by subjects of personal credit information were handled in a timely and appropriate manner. Efforts were made to promote the development of a unified financial credit information platform, encourage micro-credit companies, financing guarantee companies and other relevant agencies to get access into the financial credit information database, and carry out pilot project of credit rating. Fifteen micro-credit companies in Wenzhou were approved to access into the credit information system. Management of credit rating agencies was reinforced and efforts were made to set up the mechanism of joint conference of credit rating general managers and review committee of credit information reporting experts.

The credit information market developed in a well-regulated manner. By end-2012, the personal and corporate credit information database had collected information of 823 million natural persons and 18.588 million corporates and other organizations, and provided access of the two respective databases to 199 thousand and 133 thousand users for enquiry, thus putting in place important guarantee for commercial banks to prevent credit risks. The application of the account receivable pledge system and movable assets financing public registration system of the PBC was further expanded. By end-2012, the account receivables pledge system processed 754.4 thousand registrations and 987.5 thousand enquiries, while the movables financing public display system processed 79.2 thousand registrations and 32.9 thousand enquiries, greatly helping SMEs get more credit. The credit rating market further expanded, and a total of 52.1 thousand credit rating transactions were completed on the inter-bank bond market and credit market, increasing by 5.8 percent year on year, and credit rating reports were being increasingly important as a reference for market participants.

Outreach and education programs on credit information were carried out. Outreach and education programs on credit information with themes such as *Care about Your Credit Information* were conducted in rural areas, schools, enterprises and communities, which have disseminated knowledge on credit information and enhanced general public's awareness of credit information. It was estimated that approximately 30 thousand staff from the PBC and financial institutions organized more than 4 200 campaigns, disseminating 7 100 thousand pieces of promotion materials to more than 7 million people during the *Care about Your Credit Information* campaign alone.

2. Future development

In the next step, the PBC will implement the *Administrative Provisions on Credit Information Industry*, so as to improve credit environment for the operation of the financial system. Supporting institutional arrangements will be made at an accelerated pace, and standards for the credit information industry will be set up step by step. Efforts will be made to manage the establishment, information collection and use, internal control, practitioner and safety management of credit information agencies. Both on-site and off-site investigations will be adopted to exercise effective management over credit information businesses of commercial banks. Stricter management over credit information of credit information agencies and commercial banks, and leakage of personal credit information will be subject to more severe punishment. A thorough review of the credit information market will be carried out to press ahead with various credit information businesses. The financial credit information database will be improved to promote establishment of a unified credit information platform for the financial sector. Management of credit rating will be strengthened with special focus on improving the management over credit rating agencies. Pilot areas of credit information for SMEs and rural areas will be set up, and evaluation of grass-root credit environment will be conducted. The institution credit code will be applied to wider areas, and the economic ID system for institutions will make progress. More outreach and education programs on credit information will be carried out in order to foster a credit culture.

Box 25 Constructing a More Prudential Credit Rating System

A credit rating refers to the evaluation on the willingness and capacity of debt repayment of a debtor based on analysis of multiple factors influencing credit risks carried out by independent institutions. However, the 2008 international financial crisis and the European sovereign debt crisis in its aftermath highlighted that the credit ratings were pro-cyclical and heightened systemic risks.

At present, major economies and relevant international organizations have reached the following consensus on credit rating: first, reduce reliance on external credit rating, and investors should use credit ratings in an appropriate manner, so as to alleviate the pro-cyclicality and herding effect caused by credit rating reports; second, further improve the code of conduct and accountability of credit rating agencies, so as to fix weaknesses in way of commissioning, conflict of interests, internal control and transparency; third, strengthen supervision of the credit rating industry, and urge credit rating agencies to improve internal control and enhance the quality of rating.

Two decades of explorations and hand-on experiences brought remarkable progress in the development of China's credit rating industry. By end-2012, a total of 78 legal-person credit rating institutions were supervised by the PBC, with more than 2600 professionals and actualized profit of RMB 400 million yuan in 2012. Despite the progress, credit rating industry in China is still relatively weak in its overall strength, lagging behind internationally-recognized counterparts in terms of data accumulation, rating techniques and credibility.

Since 2003, the PBC has taken a series of effective measures to promote the development of credit rating industry, formulate guiding opinions to standardize the activities of credit rating agencies and make standards for credit rating industry. Efforts were also made to develop the credit rating default testing system, put in place management standards for credit rating agencies. In the next step, the PBC will draw upon lessons from the crisis and international experiences in credit rating reform, so as to enhance the independence, transparency and rating quality of credit rating agencies, bring the advantage of a late-comer into full play. Efforts will also be made to improve institutional arrangements on access and exit of credit rating agencies, industrial standards, business regulation and default rate testing, in order to strengthen rules and discipline of the market. The PBC will guide market participants to foster a rational view of credit rating, reduce excessive reliance on external credit rating, and promote large financial institutions to set up and improve internal credit rating systems, to integrate both internal and external credit rating.

V. Anti-Money Laundering

1. Improvements were made in the system of preventing and controlling money laundering risks

In 2012, global anti-money laundering landscape experienced profound changes. In February, the FATF passed *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation-the FATF Recommendations* (referred to as the *new Forty Recommendations* hereinafter), making important revisions to *Forty Recommendations for Anti-Money Laundering* and *Nine Special Recommendations on Counter-Terrorism Financing* released in 2003. Drawing upon international standards and based on China's specific conditions, anti-money laundering work in China has made steady progress.

The money laundering risk warning system was set up. Issuing *Risk Warning on Money Laundering*, the PBC warned financial institutions of money laundering risks in the forms of drug dealing, underground money shops, illicit fund-raising and bankcard-related crimes, and shared with them the general features of funds flow in money laundering in a timely manner, encouraged and guided financial institutions to set up an indicator system for detecting abnormal transactions based on their business lines and money laundering risks.

Efforts were made to explore setting up a risk-based anti-money laundering supervision system. The PBC allocated anti-money laundering resources reasonably, and studied on reinforcing supervision over institutional arrangements and internal control system on anti-money laundering of legal person financial institutions. Money laundering risk evaluation indicator system was set up to assess comprehensively their internal control systems on anti-money laundering, effectiveness of identification of product and client-related risks, completeness of compliance risk management framework and resilience from impairs of financial institutions. The *Administrative Measures on Anti-Money Laundering and Counter-Terrorism Financing of Payment Institutions* was released, putting payment agencies under anti-money laundering regulation. On-site AML investigations were conducted at 189 financial institutions and 5 payment agencies in 2012.

Efficiency of AML investigation was enhanced. In 2012, the PBC received 4 800 reports of important suspicious transactions filed by financial institutions, and the public security authorities filed investigations into 100 cases based on such reports, a higher ratio compared with last year. The PBC cooperated with public security authorities in the investigation of 547 cases suspected of money laundering, and helped cracked 343 cases. Important clues were provided to the public security authorities in cracking cases involving disturbance of public order and financial stability.

International cooperation will be pursued actively. In 2012, on the platform of AML Inter-ministerial Conference, the PBC formulated the *Action Plan on Improving Anti-Money Laundering and Counter-Terrorism Financing for China, delivering the commitments made by the Chinese government earlier*. In February, FATF concluded the follow-up assessment on China which had lasted for 4 years, making China the first developing country that meets FATF recommendations.

Box 26 Content and Influence of the *New Forty Recommendations of FATF*

FATF is the most authoritative AML and CTF organization widely acknowledged by the international community. The new Forty Recommendations passed by the FATF plenary in February 2012 was more detailed than the *Forty Recommendations on Anti-Money Laundering* and the *Nine Special Recommendations on Counter-Terrorism Financing*, presenting a risk-based approach, enhancing targeting, flexibility and feasibility of the standards, and attaching greater importance to overall effectiveness of the AML and CTF system. Its advantage was demonstrated in the following aspects:

First, the importance of risks was further highlighted in the new forty recommendations, requiring member countries to reasonably allocate resources and take measures based on risks of money laundering, terrorism financing and other criminal activities. Second, targeted financial sanctions were incorporated by the new forty recommendations, which is a new concept, and involve both terrorism financing and proliferation of weapons of mass destruction. According to relevant UN Resolution, punishments including freezing assets and forbidding financial transactions of any specific persons and entities shall be implemented without any delay. Third, four technical revisions were made to the way of doing due diligence on clients, providing more clear-cut guidance for financial institutions and certain non-financial industries and professions. Fourth, enlarge the coverage of politically public figures to include that of member countries and international organizations, keeping in line with UN Anti-Corruption Convention. Fifth, the new standards apply to remittances that are both direct and indirect, and both domestic and cross-border. Sixth, financial groups shall set up AML and CTF system in line with its risks at the group level, and apply such system to all branches and subsidiaries. Seventh, financial institutions were required to strengthen due diligence investigation on natural persons, legal persons, other legal arrangements and financial institutions-related transactions according to “public statement” of FATF, and to build the capacity of taking compulsory measures accordingly.

2. Future prospect

Going forward, the PBC will further improve the current AML legal system in a risk-based manner in line with our specific circumstances and in reference to the *New Forty Recommendations* in order to enhance the effectiveness of the AML system in China. Efforts will be made to formulate national AML strategy for the next five years, carry out pilot program on national money laundering risk assessment, and expand the pilot program of money laundering risks of financial institutions. The PBC will also further improve and revise existing AML laws and regulations, launch provisions on freezing assets involving terrorist activities and prepare for the 4^{th} round of FATF assessment.

Chapter VIII

Macro-prudential Regulation

In 2012, international community continuously promoted the research and formulation of international standards and rules on macro-prudential regulation, major economies made efforts to expand the application of macro-prudential policy and instruments. Against the backdrop of stabilized domestic economic growth, China continued to enhance macro-prudential framework, further improved dynamic adjustment of differentiated reserve requirements, explored counter-cyclical capital instruments, researched policy measures to resolve “too-big-to-fail” problem, strengthened monitoring and assessments on systemic risk, effectively safeguard the soundness of financial system.

I. International Developments on Macro-prudential Regulation

In 2012, international organizations continuously enhanced capital and liquidity requirements on banking sector, strengthened supervision on Systemically Important Financial Institutions (SIFIs), steadily put effective resolution regime in place, continued to strengthen supervision of shadow banking, actively promote reform of OTC derivatives market, expedited reform of credit rating agencies, and made positive progress on macro-prudential policy.

1. Improving macro-prudential policy on banking sector

Promoting the adoption of Basel III. Following the timeline set by Basel Commitee on Banking Supervision(BCBS), member jurisdictions should draft domestic regulations by the end of 2013, and start implementing new regulatory standards since the early of 2013, meet the standards by the end of 2018. In 2012, BCBS assessed the progress of implementation of Basel III in member jurisdictions. By November 2012, there are 11 jurisdictions- including China- had issued new regulation. However, U.S. stated that the implementation of Basel III in U.S. would be in due course, still EU hadn’t made detailed implementation plan. Given the most of large banks are located in U.S. and EU, the global implementation of Basel III is likely to be postponed.

Enhancing liquidity requirements. In January 2013, BCBS released the revised rules on Liquidity Coverage Ratio (LCR), setting a 100% minimum LCR requirements in normal times, revising the definition of high-quality liquid assets (HQLA) and net cash outflows. HQLA are comprised of Level 1 and Level 2 assets. Level 1 assets generally include cash, central bank reserves, and certain marketable securities backed by sovereigns or central banks, and there is no limit on the extent to which a bank can hold these assets to meet the LCR. Level 2 assets include government securities, covered bonds and corporate debt securities, residential mortgage backed securities and equities that meet certain conditions. Level 2 assets may not in aggregate account for more than 40% of a bank’s stock of HQLA. The LCR will be introduced as planned on 1 January 2015, but the minimum requirement will begin at 60%, rising in an equal annual step of 10 percent points to reach 100% by 1 January 2019.

Revising Core Principles. BCBS improved the 2003 Core Principles for effective banking supervision, and published the new Core Principles in September 2012. The number of new Core Principles increased from 25 to 29, the original Principle 1 was split into 3 individual Principles, and 2 new Principles regarding corporate governance and public disclosure were added. The new Core Principles gave more attention to global systemically important banks (G-SIBs), requiring greater supervisory intensity and adequate resources commensurate with risk profiles and systemic importance of banks, and emphasizing the importance of applying a system-wide, macro perspective to the micro-prudential supervision of banks.

2. Strengthening supervision on SIFIs

Updating list of G-SIBs. In November 2012, Financial Stability Board (FSB) updated the list of G-SIBs using end-2011 data as well as their allocation to buckets with their corresponding additional loss absorbency requirements. Bank of China was included and allocated in the lowest bucket. Compared with the list published in November 2011, the number of G-SIBs was reduced from 29 to 28, two banks- BBVA and Standard Chartered- have been added to the list, and three banks- Dexia, Commerzbank and Lloyds- have been removed from it. Additional loss absorbency requirements for G-SIBs will be phased in starting from 2016.

Establishing framework of D-SIBs. At the request of G20 Cannes Summit, BCBS issued *a framework for dealing with domestic systemically important banks* in October 2012, asking members to develop assessment and supervisory framework for Domestic Systemically Important Banks(D-SIBs) and setting out 12 principles. First, the assessment methodology should reflect the impact of failure on the local financial system and the local economy, the indicators are comprised of size, interconnectedness, substitutability and complexity, and some degree of national discretion is allowed. Second, national authorities should undertake regular assessments of the systemic importance of the banks in their jurisdictions and that the interval between D-SIB assessments should not be longer than the G-SIB assessments interval. The assessment methodology should be publicly disclosed. Third, home authorities should assess banks for their degree of systemic importance at the consolidated group level, while host authorities should assess subsidiaries in their jurisdictions. Fourth, home authorities should impose higher loss absorbency (HLA) requirements that they calibrate at the parent and/or consolidated level, and host authorities should impose HLA requirements that they calibrate at the subconsolidated/subsidiary level. Home authorities should impose the higher of either the D-SIB or G-SIB HLA requirementsin the case where the banking group has been identified as a D-SIB in the home jurisdiction as well as a G-SIB. Fifth, the HLA requirement should be met fully by Common Equity Tier 1(CET1), other appropriate policy measures could be taken.

Extending the G-SIBs Framework to G-SIIs. In May and September 2012, International Association of Insurance Supervisors(IAIS) released *Global Systemically Important Insurers: Proposed Assessment Methodology* and *Global Systemically Important Insurers: Proposed Policy Measures* for consultation, proposing a set of policy measures on global systemically important insurers(G-SIIs). First, assessment methodologies are based on quantitative indicators and qualitative supervisory judgments. 18 quantitative indicators fall into five categories: size, cross-jurisdictional activity, interconnectedness, non-traditional insurance and non-insurance activities, substitutability (Table 8.1), supervisory judgments would apply different risk weights to different business segments. Second, policy measures mainly include enhancing consolidated supervision on groups, strengthening risk management, constituting liquidity management strategies and measures in normal and pressure scenery, and setting effective resolution regime.

Table 8.1 Assessment indicators for systemic importance of G-SIIs

Category (and weighting)	Individual indicators	Weighting
Size（5%-10%）	Total assets	2.5%-5%
	Total revenues	2.5%-5%
Cross-jurisdictional activity（5%-10%）	Revenues derived outside of home country	2.5%-5%
	Number of countries	2.5%-5%
Interconnectedness（30%-40%）	Intra-financial assets	4.3%-5.7%
	Intra-financial liabilities	4.3%-5.7%
	Reinsurance	4.3%-5.7%
	Derivatives	4.3%-5.7%
	Large exposures（top 10 counterparties）	4.3%-5.7%
	Turnover	4.3%-5.7%
	Level 3 assets①	4.3%-5.7%
Non-traditional insurance and noninsurance Activities (40%-50%)	Non-insurance holder liabilities and non-insurance revenues	6.7%-8.3%
	Derivatives trading（CDS）	6.7%-8.3%
	Short term funding	6.7%-8.3%
	Financial guarantees	6.7%-8.3%
	Variable annuities	6.7%-8.3%
	Intra-group commitments	6.7%-8.3%
Substitutability（5%-10%）	Premiums for specific business Lines	5%-10%

Sources: IAIS *"Global Systemically Important Insurers: Proposed Assessment Methodology"*.

① Level 1 Assets are based on unadjusted, quoted prices for identical assets in an active market. Level 2 Assets are based on quoted prices in inactive markets, or whose values are based on models - but the inputs to those models are observable either directly or indirectly for substantially the full term of the asset. Level 3 Assets are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement.

3. Putting effective resolution regime in place

Implementation of *Key Attributes*. In 2012, FSB made efforts to support implementation of *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "*Key Attributes*") in member jurisdictions. In January, member jurisdictions reported to FSB that the status of financial institutions' resolutions regime and next steps according to the requirements of *Key Attrributes*. In August, FSB undertook the thematic peer review on resolution regime, the findings include: resolution regimes are most advanced for banks and progressively less so for insurers, securities or investment firms and Financial Market Infrastructures(FMIs); most jurisdictions lack powers to take control of the parent or affiliates of a failed FI, particularly if the financial holding companies or significant operational affiliates are unregulated; cross-border effectiveness of resolution measures remains unclear, and resolution authorities in most jurisdictions either lack powers to impose a temporary stay on the exercise of contractual acceleration or early termination rights in financial contracts; funding arrangements are not well-developed; most jurisdictions have no explicit requirement in statute or rules for RRPs for domestic SIFIs. FSB, together with other standard setters would develop guidance on application of *Key Attributes* to non-banking financial institutions, as well as resolution of financial conglomerates. Currently, FSB, working with International Monetary Fund(IMF), World Bank(WB) and other Standards Setting Bodies, have preliminarily finished the assessment methodology of *Key Attributes*, and plan to undertake pilot assessment on some jurisdictions from March to June 2013.

Effective resolution of G-SIFIs. Currently, Crisis Management Groups (CMGs) have been established for nearly all of the G-SIBs, except for Wells Fargo, other 27 G-SIBs have CMGs. All CMGs have draft recovery plans, most have developed high-level resolution strategies, and signed the Cross-border Cooperation Agreements (COAGs).

4. Strengthening supervision on shadow banking system

According to the "two-steps" approach proposed by FSB in 2011, in 2012, supervision on shadow banking system was pushed forward in the following areas.

Enhancing monitoring of shadow banking system. Since 2011, FSB started annual monitoring of shadow banking system. In November 2012, *Global shadow banking monitoring report* found that the size of the total system reached USD 67 trillion in 2011, equivalent to 111% of the aggregated GDP of all monitored jurisdictions. The share of shadow banking system in total financial intermediation has decreased from the peak 27% in 2007 to 25% in 2009—2011, and the aggregate size was around half of total banking assets. Shadow banking entities seemed to be more dependent on bank funding and were more heavily invested in banking assets. The US has the largest shadow banking system, with assets of USD 23 trillion in 2011. 17 out of 25 monitored jurisdictions saw continuous growth of shadow banking system after the financial crisis; half of them are emerging and developing economies.

Strengthening regulation of shadow banking system. FSB, working with BCBS, and International Organization of Securities Commissions(IOSCO), researched policy measures on shadow banking system from 5 specific areas. First, mitigating the spill-over effect between the formal banking system and shadow banking system. BCBS has been strengthening the resilience of the banking sector against risks posed by shadow banks, increased the capital requirements applied to banks' re-securitisation exposures, enhanced the banks' internal capital adequacy assessment process under Pillar 2 for securitisation risk, reputational risk and implicit support, and enhanced the Pillar 3 disclosure requirements related to securitisation. Moreover, BCBS is developing detailed policy recommendations on scope of consolidation, large exposures and bank's investment in funds. Second, reducing the susceptibility of Money Market Funds (MMFs) to "runs". In October, IOSCO issued 15 policy recommendations intended to provide the basis for common standards for the regulation of MMFs across jurisdictions, including MMFs should be explicitly defined in collective investment schemes regulation, should hold a minimum amount of liquid assets to deal with redemptions and fire sales. MMFs that offer a stable net asset value should be subject to measures designed to reduce the specific risks and should be required, where workable, to convert to floating NAV. Internal credit risk assessment practices should be strengthened and mechanistic reliance on external credit ratings should be avoided. Disclosure to investors should be improved, and the regulatory framework applicable to the use of repos by MMFs should be strengthened as well. Third, mitigating systemic risks posed by other shadow banking entities. In November, FSB proposed that jurisdictions should indentify shadow banking risks by referring to 5 economic functions, including management of client cash pools with features that make them susceptible to runs, loan provision that is dependent on short-term funding, intermediation of market activities that is dependent on short-term funding or on secured funding of client assets, facilitation of credit creation and securitisation and funding of financial entities, and provided a set of optional tools, such as limits on leverage, limits on assets concentration, redemption gates, and imposition of redemption fees. Fourth, improving the incentives associated with securitisation. In November, IOSCO, in coordination with the BCBS, published its policy recommendations, including risk retention requirements, standardization of securitisation, enhancing disclosure of issuers. Fifth, dampening risks and pro-cyclical incentives associated with secured financing contracts such as repos, and securities lending. In November, FSB recommended to improve regulatory reporting, market transparency and corporate disclosure, introduce minimum standards for haircut practices, set up reporting requirement for fund managers facing end-investors, limit risks associated with cash collateral reinvestment, strengthen collateral valuation and management practices, use Central Counterparties(CCPs), and change bankruptcy law treatment of repo and securities lending transactions.

5. Promoting OTC derivatives market reforms

Setting the target of reforms. G20 leaders committed that all standardized OTCderivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and centrally cleared, by the end of 2012; OTC derivatives contracts should be reported to trade repositories, and non-centrally cleared contracts should be subject to higher capital requirements. In April 2010, the FSB's OTC Derivatives Working Group constituted by the Committee on Payment and Settlement Systems(CPSS), IOSCO and European Commission was established, and made 21 recommendations in the *Implementing OTC Derivatives Market Reforms* published in October 2010, including promoting standardization, central clearing, reporting to trade repositories, and use of organized trading platforms as well as assessment of reforms.

Reforms are underway. The remarkable progress has been achieved in **central clearing**. In February 2012, IOSCO published the *Report on Requirements for Mandatory Clearing* setting out recommendations for authorities in establishing a mandatory clearing regime for standardized OTC derivatives. In April 2012, CPSS and IOSCO jointly published *Principles for Financial Market Infrastructures* (*PFMIs*), achieving an important milestone in the global development of a sound basis for central clearing of all standardized OTC derivatives. The legislative process is underway in some jurisdictions, the US Commodity Futures Trading Commision(CFTC) has finalized regulations regarding central clearing, and the EU has issued regulations regarding market infrastructures, setting out central clearing requirements on financial derivatives. As for **reporting to Trade Repositories(TRs),** most countries have issued the consultative papers on establishing trade repositories, and relevant reporting requirements, however, due to reporting formats, the (Legal Entity Identifier)LEI and data aggregation and other technical issues, comprehensive reporting of transactions to TRs haven't be fully in place by end-2012. As for **exchange and electronic trading platforms,** IOSCO has completed the international guidance for organized trading, setting forth the 7 common characteristics of organized platforms, including access provisions, transparency requirements, trading rules, operational efficiency, resiliency, structural arrangements, market surveillance capacities, and non-discrimination between comparable platform participants. In 2012, the follow-on analysis undertook by IOSCO described that the progress member jurisdictions were relatively slow, the US was still the only jurisdiction that had passed legislation with requirements for pre- and post- trade transparency and proposed detailed regulations, the EU made legislative proposal to introduce pre- and post- trade transparency requirements, and Japan submitted draft legislation that includes provisions to improve the transparency of derivatives markets. As for **standardization**, the OTC Derivatives Supervisors Group (ODSG) led by FSB, working with the largest derivatives dealers and major market participants, is advancing the use of standardized derivatives.

6. Reducing reliance on external credit rating agencies

FSB issued the *Principles for Reducing Reliance on CRA Ratings* in October 2010, and stated "standard setters and regulators should incentivize a transition to a reduced reliance on CRA ratings over a reasonable timeframe. In February 2011, IOSCO published *Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies*, revealing the objectives of the four IOSCO CRA Principles have been embedded into regulations in member jurisdictions. Since then, the progress in this area was relatively slow. In June 2012, G20 Los Cabos Summit further called for work by national authorities and standard setting bodies in ending the mechanistic reliance on credit ratings to be accelerated. In November 2012, FSB report the *Roadmap and workshop for reducing reliance on CRA ratings* to G20 Finance Ministers and Central Bank Governors, which consists of two tracks: First, work to reduce mechanistic reliance on CRA ratings through standards, laws and regulations. Second, work by authorities to promote and require that financial institutions strengthen and disclose information on their own credit risk assessment approaches as a replacement for mechanistic reliance on CRA ratings.

7. Others

Addressing data gaps issues. FSB, together with IMF submitted *Financial Crisis and information gaps* to G20, making 20 recommendations in financial sector risk monitoring, international network interconnectedness. Currently, FSB is taking forward to implementation of "data gaps and systemic linkage" project, i.e., setting up a data-hub in BIS, data of G-SIBs will be provided by national financial authorities and shared in some specific groups. This project will be carried out in 3 phrases, the data providing and sharing will be expanded gradually, Phrase I has started in the early of 2013.

Implementing Legal Entity Identifier (LEI) system. In order to improve information management of global financial transactions participants, better identify counterparties, improve oversight of global financial system, FSB initiated "Legal Entity Identifier (LEI)" system, making unique identification codes for all financial transactions' participants. At the request of G20, the LEI system was launched in March 2013.

Box 27 CGFS: Operationalising the selection and application of macroprudential instruments

In December 2012, Committee on the Global Financial System(CGFS) published *Operationalising the selection and application of macro-prudential instruments*, discussing the practical issues regarding operation of macro-prudential policy and making suggestions on timing of application of macro-prudential instruments (MPIs).

Timing of application of MPIs. MPIs should be tightened when the financial cycle is booming and the real economy is strong, MPIs cannot be applied as long as a systemic risk event fails to materialize when the real economy is weak. During the downswing of the financial cycle, it is important to differentiate whether the downswing of the financial cycle coincides with a financial crisis or not. In a crisis context, MPIs may need to be released to avoid excessive deleveraging, while in a situation that output growth is very weak and crisis isn't gonging to happen, release of MPIs may be helpful to soften the impact of the downturn, but if the real economy is booming, the application of MPIs depends on specific situations. The report said that the policymakers should select appropriate indicators based on three criteria including relevance for the MPIs, ease of data availability and simplicity as the signal to tighten or release MPIs accordingly. The policymakers also have to take into account the uncertainty in measuring systemic risk, if there is a clear sense of an underlying vulnerability, the MPIs can be implemented in a gradual manner with ensuring it can be adjusted swiftly and rapidly.

Transmission mechanism of MPIs. Tightening MPIs during the upswing of financial cycle could enhance the resilience of financial system in a direct fashion. For instance, raising capital requirements means that banks have more buffers to weather negative shock, raising liquidity requirement means that banks would reduce the reliance on volatile short-term funding, the ability of banks to weather liquidity stress would be enhance, and the contagion risk and the spillover effects to real economy can be contained. Furthermore, tightening MPIs also have impact on credit cycle. For instance, actions taken by banks to respond to a capital shortfall, like increasing lending spreads, decreasing dividends and bonuses, issuing new capital or reducing asset holdings, as well as other actions like adjusting profiles of assets and liabilities to respond to higher liquidity requirement can curb demand for credit and reduce the overall credit supply. During the downswing of financial cycle, if there is not a crisis, the transmission mechanism is similar to that in the upswing periods, but in an opposite direction. If there is a crisis, releasing MPIs would help financial institutions hold enough buffers to absorb losses, thus enhancing the resilience of financial system. However, if there is a severe crisis, in case losses and liquidity demands exceed buffers, retained earnings, external funding or capital injection can be implemented so as to improve the overall capital and liquidity conditions in financial system.

Coordination and cooperation between different policies. MPIs interact with other policy in practice. First, transmission channels for different policies are bound to overlap. Raising liquidity requirements may affect the demand for central bank liquidity, thus impacting on monetary policy operation. Second, there probably exist conflicts between different policy instruments, especially in the circumstances where real economy and financial cycle move in different directions. For example, during the periods that high productivity growth that put downward pressure on inflation but, at the same time, risk triggering irrational exuberance in financial markets, macro-prudential policy may conflict with monetary policy. Equally, during the downswing of financial cycle, macro-prudential policy may conflict with micro-prudential policy. In that case, coordination between policies should be strengthened, while ensuring central banks' key role in macro-prudential policymaking.

II. Major Jurisdictions' Progress in Macro-prudential Policy

1. United States

Financial Stability Oversight Council (FSOC) identified and prevented systemic risk. In 2012, FSOC performed it's mandates in following areas: First, publishing annual reports, analyzing financial stability condition in US through macroeconomic environments, financial developments, stocktaking the working progress of mitigating potential risks, calling for the further reform measures. Second, developing assessment methodology of systemically important financial institutions. In April, the report on assessment methodology of systemically important non-banking financial companies, proposed a three-stage process. In the first stage, the Council selects some non-banking financial companies by applying qualitative thresholds. In the second stage, the Council conducts assessment by developing a analytical framework consisting of 6 categories. In the third stage, the Council determines whether to subject a nonbank financial company to Federal Reserve supervision and prudential standards. In July, according to assessment indicators set by Dodd-Frank Act as well as the characteristics of financial market infrastructures, the Council designated 8 systemically important financial market utilities including clearing house, payment companies, which will subject to Federal Reserve and other supervisors prudential standards.

Regulatory scope was expanded. In 2012, CFTC and Securities and Exchange Committee(SEC) issued a series of rules and policies, strengthening financial market transparency and soundness. First, a set of measures including market operation, risk management, trade reporting and position limits was issued for OTC derivatives, requiring large swap dealers hold more capitals, and more collateral for high-risk transactions. Second, new rules on private funds and fund managers registration were issued, canceling exemption for registration of private funds facing sophisticated investors, limiting exemption for registration of commodity fund managers with specific qualifications. Third, future dealers were required to fulfill their collateral protection obligation in the model of "legally separated, operational mixed".

Supervisory standards were enhanced. First, Federal Reserve(FED) issued proposed regulations on US operations of systemically important foreign financial companies, applying to all banking organizations with total consolidated assets of $50 billion or more, which would be classified in different groups according to their US subsidiaries' assets, subject to different prudential standards correspondingly. Second, FED, Office of Comptroller of Currency(OCC) and Federal Deposit Insurance Corporation(FDIC) jointly released guidance on banking stress testing, asking banks with consolidated assets of $10 billion supervised by three authorities establish, implement and maintain stress testing framework in line with the principles provided by the guidance. Third, FED confirmed that the "Volker rule" would come into effect since 21 July, 2014, requiring banks assess on their business and investment, develop and put the compliance plans in place, keep the relevant reports and records.

Resolution strategy of SIFIs was issued. In connection with the implementation of the FSB's *Key Attributes*, In December 2012, FDIC and Bank of England jointly published the first cross-border cooperation strategy on resolving global banks, proposing a resolution strategy allowing authority intervene at the top of the groups, the strategy will be implemented by home authority, and the subsidiaries (domestic and foreign) carrying out critical activities would be kept open and operating, the critical services provided by banks could continue. The losses would be apportioned to shareholders and unsecured creditors rather than taxpayers; the relevant senior management would be removed, thereby ensuring market discipline.

2. United Kingdom

Legislative process had been accomplished basically. In January 2012, HM Treasury submitted *Financial Service Bill* to the Parliament, and in December, the Bill was approved, which fundamentally changed tri-partite system consisting of Bank of England, HM Treasury, Financial Service Agency, provided for the establishment of the Financial Policy Committee (FPC) within the Bank of England, while the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) taking the responsibilities respectively. The new system will be in operation since 1st April 2013, the FPC will be charged with identifying, monitoring and addressing risks to the financial system as a whole. In March 2012, interim FPC proposed three instruments including counter-cyclical capital buffer, sector capital requirements, limits on leverage ratio to be granted, which was accepted by HM Treasury and the legislative consultation was issued in September 2012.

Banking reform was promoted. In June 2012, HM Treasury issued white paper *Banking reform: delivering stability and supporting a sustainable economy*, setting out reform measures from following three areas. First, ring-fencing vital banking services, achieving full separation of retail and investment banking. The ring-fenced banks are prohibited to operate outside of euro areas, or trade with investment firms, funds management companies, insurance companies, or underwrite securities. But still are permitted to provide simple hedging service to clients. Ring-fenced banks must be genuinely independent from other parts of the group in terms of legal position, business activity and profits. Second, enhancing banks' loss-absorbency capacity. The ring-fenced banks are required to hold an additional 3% equity buffer on top of the Basel III minimum standards and 3.5% non-equity capital buffer, with a minimum equity-to-RWAs ratio of 10%, and a minimum Primary Loss-Absorbing Capacity (PLAC) of 17%. The UK-headquartered G-SIBs are required to hold an additional 4% PLAC requirement, the PLAC requirement is 17%. Third, fostering a strong, diversified and competitive banking sector. The barriers to entry banking sector should be reduced, if necessary, some banks could be split by the government to enhance their competitiveness.

Supervision of financial market infrastructures was enhanced. In December 2012, Bank of England published *Approaches to the supervision of Financial Market Infrastructures*, planning to strengthen supervision from the following aspects including governance, loss-absorbency capability, recovery and resolution plan, transparency of operation, information disclosure. Bank of England is responsible for risk assessment on financial market infrastructures, if necessary, can take measures to intervene.

3. European Union

European Systemic Risk Board(ESRB) continued to perform macro-prudential mandate. ESRB started to publish risk dashboard, covering interlinkages and composite measures of systemic risk, macro risk, credit risk, funding and liquidity, market risk, profitability and solvency, including Composite Indicator of Systemic Stress (CISS) developed by Macro-prudential Research Networks (MaRs) reflecting systemic risk in a timely and dynamic manner. Meanwhile, ESRB made recommendations on how to fulfill its mandates, how to perform macro-prudential mandate by national authorities, made warnings on retailed business and foreign loans as well.

Banking union had made remarkable progress. In May 2012, chair of Commission of European Union set the aim of establishing banking union. First, establishing a Single Supervisory Mechanism (SSM), and unifying supervisory rules in European Union. Second, setting up European deposit insurance scheme, enhancing credibility of current deposit insurance system. Third, establishing European resolution regime, orderly resolving failed institutions, and safeguarding taxpayers' interests. In October, European Council reached an agreement on the SSM, asking the legislation framework would be finished before 1Janurary 2013, and the operational implementation would take place during 2013. In December, European Council approved the legislative proposals, stated that the SSM would be composed of the European Central Bank(ECB) and national competent authorities, the ECB would play the key role in the SSM, be responsible for oversight of banking institutions in Euro Zone, including issuance and withdrawal of licenses, assessment on merger and acquisition plan of banks, ensuring banks' compliance with capital, risk exposures, liquidity requirements, while the responsibilities, such as consumer protection, money laundering and payment services would remain in national authorities. In order to eliminate the potential conflicts of interest between the objectives of monetary policy and prudential supervision, a separate supervisory board would be set up within the ECB. The ECB will assume the above supervisory tasks on 1 March 2014 or 12 months after the entry into force of the legislation.

Structural bank reform was promoted. A high-level expert group on structural bank reforms established by European Commission published the report in October 2012, proposing the separation of banks' proprietary trading and other risky activities, setting separate "trading entity" and "deposit bank" which engage in specific high-risk business and deposit-taking and lending business respectively. Separation would be taken in case of the total value of trading assets exceeding EUR 100 billion, or the share of trading assets in total assets reaching some specific proportion. Any loans, loan commitments or unsecured credit exposures to hedge funds (including prime brokerage for hedge funds), Structured Investment Vehicle (SIVs) and other such entities of comparable nature, as well as private equity investments, should be assigned to the trading entity. Deposit bank also could provide hedging services to non-banking clients and securities underwriting except for remained traditional banking business. The report also recommended extending separable scope in line with the recovery and resolution plan, clarifying the position of bail-in instruments, optimizing measurement of capital requirements, and enhancing corporate governance.

4. Germany

Institutional framework of macro-prudential policy was improved. *The Financial Stability Act* was passed by the lower house of parliament in October 2012, strengthening cooperation of Ministry of Finance, Deutsche Bundesbank and Federal Financial Supervisory Authority (BaFin) in the field of financial stability. The Act provides for the establishment of financial stability committee in Germany, comprised of 9 voting representatives and 1 non-voting representative. The Bundesbank in charge of analyzing issues that are crucial to financial stability, identifying threats, submitting reports and policy measures to the committee, the BaFin is in charge of implementing macro-prudential instruments, the Bundesbank assess the implementation of macro-prudential policy, and report to the committee. The committee should report to the Parliament annually, elaborating on the financial stability in Germany as well as the problems of financial supervision.

III. China's Achievements in Macro-prudential Policy

In 2012, China continued to strengthen macro-prudential policy, further improve dynamic adjustment on differentiated reserve ratio, and explore counter-cyclical capital instruments, research policy measures on systemically important systemic institutions, enhance risk monitoring and early warning on systemic risk, improve crisis management and risk resolution regime, has been making great progress.

1. Improving counter-cyclical macro adjustment mechanism

China has been focusing on macro issues and financial stability from the macro-prudential perspective, continuously enriching and improving macro adjustment tools and measures, and strengthening macro-prudential framework. Currently, China's macro adjustment framework consists of quantitative adjustment, price-based adjustment and macro-prudential instruments. The PBC focus on not only price indicators like interest rates, but also quantitative indicators including money supply growth, making risk warnings through window guidance, implementing credit policy and dynamic adjustment on differentiated reserve ratio, and strengthening financial macro adjustment.

Drawing lessons from international financial crisis, the PBC started to research systemically macro-prudential policy since the middle of 2009, and introduced the dynamic adjustment on differentiated reserve ratio in 2011, which is clear, transparent, and flexible, combing credit supply with the capital and soundness of banks, taking into account the phrase of economic cycle, having the role of guiding in advance and self –discipline, helping to enhance soundness and resilience of financial institutions, and with the function of bi-directional counter-cyclical adjustments, different from the one-size-fits-all management. In 2012, at the request of national financial working conference, the PBC continued to improve counter-cyclical macro-prudential framework as an important part of macro-adjustment mechanism, adjust the parameters of dynamic adjustment mechanism on reserve ratio, fully play the role of counter-cyclical adjustment as well as preconditioning and fine-tuning of policies. In the early of the year, against the backdrop of downward economic indicators and changing economy climate, the PBC downgraded the macro-economic climate parameter, properly increased the weights of some credit policies in soundness parameters, such as credit extended to rural areas, farmers, agricultures as well as credit to Small and Medium Enterprises(SMEs), and guided financial institutions to optimize credit extension and further support the real economy. Dynamic adjustment on differentiate reserve ratio, coordinating with interest rates, open market operations, reserve requirement and other traditional monetary policy instruments, has achieved positive results, credit increased steadily, and the soundness of financial institutions was enhanced. By the end of the year, M_2 grew by 13.8%, up 0.2 percentage point y-o-y, nearly reaching the target of 14%. Overall total social financing registered 15.76 trillion yuan, increasing 2.93 trillion yuan over last year. Monetary conditions were basically in line with the need of promoting sustained and sound economic development and keeping price stable.

Box 28 Cross-border Capital Flows and Management

In recent years, along with the expedition of globalization and integration of economy, cross-border capital flows have eventually become the key element of influencing global economic and financial development and stability. On one hand, it helps countries improve efficiency of fund allocation and competitiveness of financial sector, foster productive investment and smooth consumption, and diversify the investment, adjust imbalance of Balance of Payment (BOP). On the other hand, due to the high volatility of cross-border capital flows especially the short-term capital flow, as well as the relative large amount, the drastic change in short term would impact the individual and global economic and financial stability.

Since this global financial crisis, along with the implementation of easing monetary policies of major economies, as well as the increasing uncertainty of global economy and financial system, risk preference changed sometimes, the amount and volatility of cross-border capital flows have been amplified, there has eventually become an international consensus that it's necessary to appropriately manage cross-border capital flows. IMF also changed the opinion of free capital flow that they insisted for a long time, realized that the role of necessary capital management ought not to be denied. Only the economies with developed financial system could benefit from free capital flows, yet the economies with undeveloped financial system need to strengthen management on cross-border capital flows.

There are a variety of measures to manage capital flows. Take management on capital inflows as example, the instruments include more flexible exchange policy, with tolerance of domestic currency appreciation; accumulation of foreign reserve; implementing macro-prudential policy, and setting requirements on investing to stock market and real estate market. In recent years, a few of emerging market economies take a set of measures including Tobin tax, zero interest rate reserve, proportional risk management, etc.

China has experienced double surpluses in both current account and capital account for quite a long time. In 2012, there were some new trends in cross-border capital flows in China. Before September, capital inflow slowed down, especially there was net outflow in capital account, as domestic economy growth become slow, and European sovereign debt crisis got eased to some extent. After September, pressure of cross-border capital inflow was increased as the domestic economy got stabilized while remaining slow, and major advanced economies continued to implement easing monetary policies. According to statistics of SAFE, from September to December 2012, banks' foreign exchange settlement maintained surplus for 4 consecutive months, total amount reached USD 86.9 billion, accounting for 79% of overall surplus in 2012. Given above situation, China positively explored to change foreign exchange management mechanism, carried out equilibrium management on fund inflow and outflow, keenly monitored cross-border fund bi-directional flows, and enriched policy measures to prevent big swings of cross-border fund flows. In the next stage, comprehensive measures should be taken to properly tackle risks of cross-border capital flows, foreign debt management system would be reformed, introducing debt ratio management, containing foreign debt within a reasonable size, and adjusting currency structure and term structure, some original measures could be considered to be maintained and implemented, such as price-based and quantitative instruments could be used when capital flows abnormally. Supervision of financial derivatives should be improved, limiting or prohibiting complicated derivatives transactions decoupling with real economy while encouraging proper financial innovations.

2. Strengthening Supervision on SIFIs in China

In 2012, the PBC, CBRC, Ministry of Finance and National Audit Office, based on assessment methodology developed by G20/FSB and domestic circumstances, enhanced regulatory requirements to reduce the possibility of failure, as well as improved risk resolution and market exit mechanism to strengthen market discipline and reduce moral hazard.

First, banks, securities companies, insurance companies and financial holding companies are all subject to the assessment, with different assessment indicators and methodologies. According to the principles set by BCBS in *A framework for dealing with domestic systemically important banks*, the PBC and CBRC have been researching and developing systemically importance assessment methodology and supervisory measures for commercial banks, taking into account the size, interconnectedness, substitutability and complexity, trying to identify the domestic systemically importance banks.

Second, if necessary, higher additional capital requirements, counter-cyclical adjustment and appropriate early correction measures can be applied on the basis of risk profiles of D-SIFIs. *Administrative Measures for the Capital of Commercial Banks (for trial implementation)* made by CBRC set an additional capital requirement, i.e. 1% of risk-weighted assets. Referring to *Principles on supervision of financial conglomerates*, the PBC and other financial supervisors are developing supervisory framework of financial holding companies, improving consolidated supervision.

Box 29 Joint Forum released *Principles for the Supervision of Financial Conglomerates*

Financial conglomerates are defined as any group of companies under common control or dominant influence, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors, generally with large size, broadened business, structural complexity, high interconnectedness, playing a significant role in economic and financial stability, as well as causing high cost to the financial system in case of failure. The financial crisis that began in 2008 highlighted the systemically importance of financial groups and the urgency of supervising financial conglomerate as a whole. In 1999, Joint Forum constituted by BCBC, IOSCO, IAIS amended the original *Principles for the Supervision of Financial Conglomerates* (*hereinafter referred to as "The principles"*), and published the new one.

The Principles aims to provide an internationally uniform guidance for national authorities, standard setters and supervisors, enhancing consistent and effective supervision on financial conglomerates especially cross border conglomerates. *The principles* emphasize that the key of supervision of financial conglomerates is avoiding double or multiple use of capital, assessing overall risk, and reducing supervisory arbitrage. The 29 principles can be classified into 5 aspects: the first one is supervisory powers and authority, granting supervisors the necessary powers and authority to enable comprehensive group-wide supervision, providing supervisors with operational independence, necessary information gathering rights as well as corrective actions while ensuring accountability. The second one is supervisory responsibility, indentifying supervisory authority of financial conglomerates, which is in charge of comprehensive group-level supervision and coordination of relevant supervisors, strengthening responsibilities in minimum prudential standards, assessing operation, and implementing corrective actions. The third one is corporate governance. Financial conglomerates should establish consistent, transparent corporate governance framework, ensure that board members and senior managers possess experience and qualifications, appropriately define the strategy and risk appetite of the financial conglomerate, and implement an appropriate remuneration policy that is consistent with its risk profile. The forth one is capital adequacy and liquidity. Financial conglomerates should maintain capital adequacy on a group-wide basis, avoid double or multiple use of capital, prevent excessive leverage, intra-group capital transfer and capital arbitrage, carry out stress testing and scenarios analysis in capital replenishment planning, and ensure the liquidity is sufficient across the financial conglomerate to meet funding needs in normal times and periods of stress. The fifth one is risk management. Financial conglomerates should establish and foster risk management framework and culture, truly reflecting risk concentration, intra-group transactions and risk exposures on a group-wide basis, assess risks of new business and appropriateness of outsourcing, and off- balance sheet products should be brought within group-wide supervision.

The Principles improved in following areas: First, the scope of application is expanded. Except for the financial conglomerates which conduct financial activities in at least two of the regulated banking, securities or insurance sectors, it can also be applied to other financial groups which conduct activities in one of these regulated sectors while also conducting material activities in any other financial sectors. Second, the concept of "group-wide basis" is highlighted. *The Principles* focus on unregulated entities in the group, including middle-level holding company, unregulated parent company and subsidiary, special purpose entity etc. Third, supplemental role of *the Principles* is stressed. *The Principles* focus on structural complexity and blind spots of sectoral supervision, which is supplement not substitute for sectoral supervision.

3. Strengthening monitoring and assessment of systemic risk

In 2012, with the complex international and domestic economic and financial environment, the PBC took great efforts to strengthen monitoring and assessment of systemic risk.

First, risk monitoring of key industries and areas has been improved. Given the new features of financial risks in China, the risk monitoring of key areas was intensified, such as Local Government Financing Platform, real estate market, industries with over-capacity and mutual guarantee of enterprises. The monitoring of non-banking institutions with financing functions as well as private lending have been further expanded, the risk reporting system of non-banking institutions and private financing like guarantee companies, pawn shops, micro credit companies, rural mutual cooperatives has been continuously improved, emergency planning has been in place, and counter measures for private lending risks arising in some individual regions has been taken.

Second, cross-sector, cross- market and cross-border risk monitoring has been strengthened. Assessment and analysis on interconnectedness of financial system, linkage between economy and financial system as well as cross-border linkage of economy and finance were enhanced, and regional and systemic potential risk were fully reviewed. Systemic risk monitoring, assessing and early warning system were further improved, financial network model based on inter-bank payment data was improved, reflecting the linkage of financial institutions. Risk monitoring of cross-sectoral business such as wealth management products, risk assessment and warning of financial holding companies and groups integrating industrial and financial business have been carried out.

Third, on-site assessment of financial institutions was pushed forward. In order to better judge geniality of data collected through off-site monitoring, and enhance comprehensive analyzing capability, since 2011, the PBC has explored to conduct on-site soundness assessment of financial institutions, inspecting potential risks and problems, and urging them to correct timely. At end-2012, more than 500 comprehensive on-site assessments and specialized on-site assessments have been conducted.

Fourth, stress testing was carried out. At end-2011, the PBC financial stability stress testing group was set up, and conducted the first stress test on 17 major commercial banks, focusing on credit risk sensitivity and macro economic scenarios. In 2012, scope of stress testing was further expanded; market risk and liquidity risk were brought into the testing, to make financial stability assessment more forward-looking and scientific.

Box 30 Analysis on Contagion Risk of Banking Institutions

Based on financial network model, we make a further dynamic mapping and update on overall stability and structure of the entire financial network by using data from inter-bank payment and settlement system from 2007 to 2012.

From the movements of major indicators on financial network stability of China from May 2007 to December 2012, breadth (B), depth (D) and intensity (I) indicators experienced downward after upward trend. Compared to historical trend, financial stability indicators were fairly stable, and the average value increased (Figure 8-1).

We select June 2012 as the time point for updated analysis on structural characteristics and movements of payment network composed by large commercial banks, policy banks, joint stock banks and foreign banks, the results are as follows:

Large commercial banks. When there are liquidity shocks coming from large commercial banks respectively, on average around 37 banks would be affected more or less. The spillover would last for 5 rounds on average, and the proportion of affected fund exceeds 14% on average. If all of large commercial banks are regarded as a whole, the spillover would last 7 rounds, and most of institutions would be affected. Compared to June 2011, large commercial banks still have strong impact on the network.

Policy banks. When there are liquidity shocks coming from policy banks, on average 26 institutions would be affected, the spillover could last up to 7 rounds, and the proportion of affected fund rises to 3.5% on average. In general, the impact of policy banks was enhanced, yet the overall impact was rather stable.

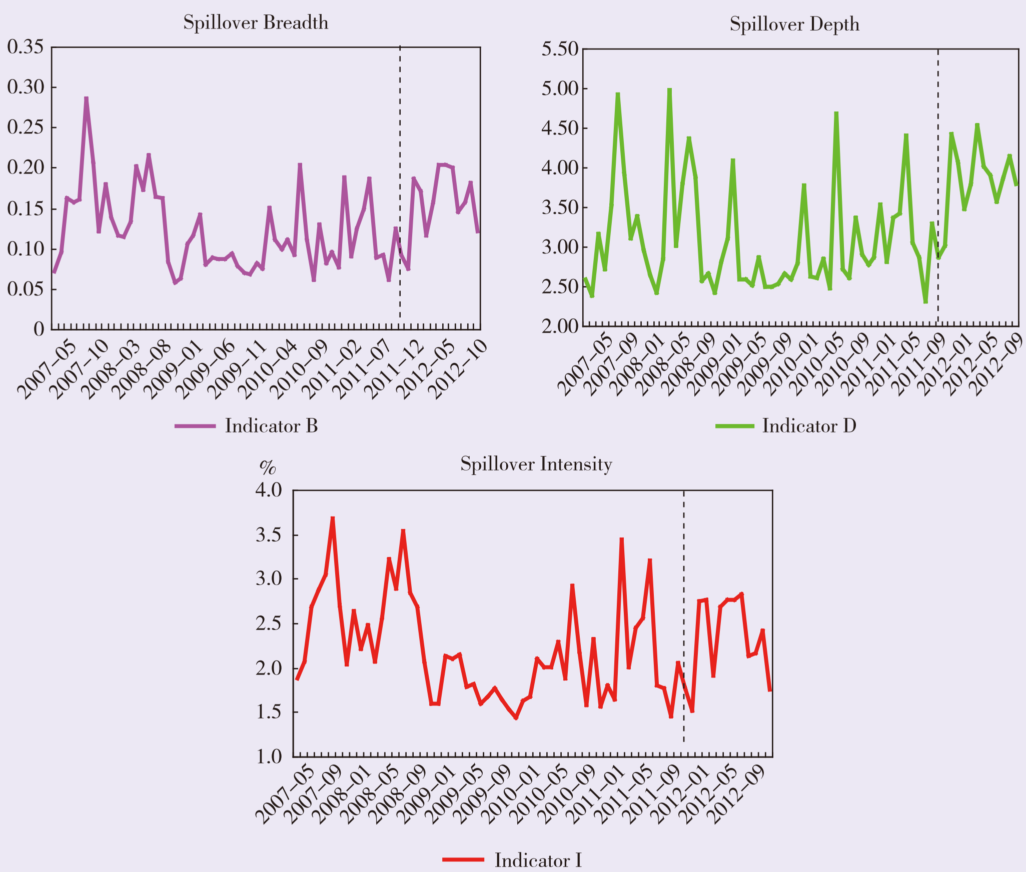
Joint-stock commercial banks. When there are liquidity shocks coming from joint-stock commercial banks respectively, on average 22 institutions would be affected, the spillover would last 5 rounds and the proportion of affected fund would nearly be 5%. It shows that the impact of joint stock banks on the network has been expanded compared to June 2010, but still is lower than that of large commercial banks.

PSBC. Compared to the past situation, Postal Savings Bank of China's(PSBC) impact on the network was enhanced substantially. During the year of 2012, although the affected institutions are mainly foreign banks, the number of affected institutions reached 29 on average, the rounds of spillover last also increased to 6. All above phenomenon showed that the role of PSBC in the network was experiencing some active change.

RCCs. Similar to the PSBC, if all of Rural Credit Cooperatives(RCCs) are regarded as a whole, the number of institutions been affected and the rounds of spillover lasting obviously increased. The number of affected institutions reached 34 in June 2012, which include some policy banks, the spillover would last 4 rounds, affecting 8% of the total funds. As a sub-group, the RCCs' role in the network was strengthened.

Foreign banks. The role of foreign banks in the network is also enhanced. In June 2012, when there are liquidity shocks coming from individual foreign banks, on average 13 institutions would be affected, the spillover would last nearly 5 rounds and affect 1% of transaction volume. This shows the impact of foreign banks is still relatively weak.

Figure 8.1 Movement of Financial Network Stability Indicators in 2007—2012

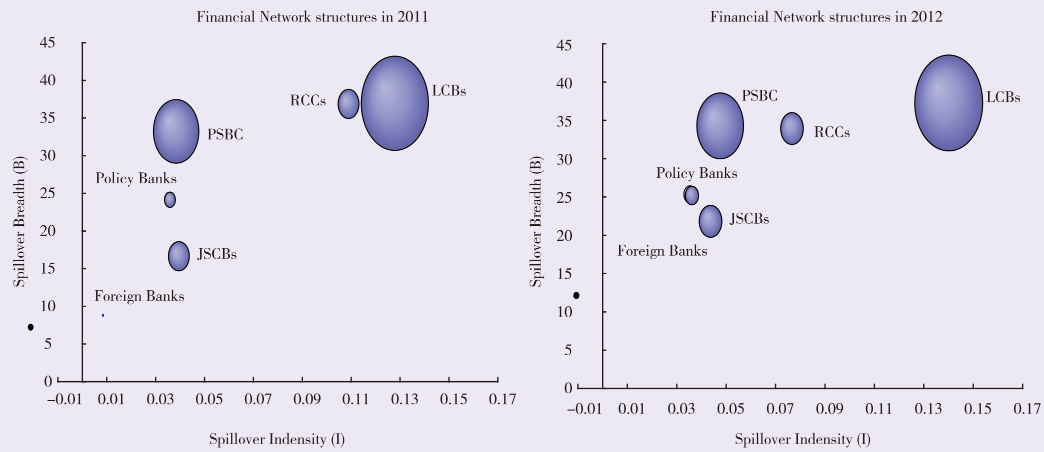


Sources: The PBC.

In summary, there is not a big change of financial stability network structure in China and the network stability foundation remains solid. But it's notable that during February to August, the average value of network stability indicators are rather high, which is greatly influenced by market liquidity and macro economy.

Financial Network Structure in 2011, 2012

Figure 8.2 Comparison of Financial Network Structures in 2011 and 2012



Source: The PBC.

Special Topic Ⅰ

The Banking Sector Stress Tests

I. The Snapshot of the Stress Tests

At the end of 2012, PBC organized 17 systemicaly important commercial banks to conduct Financial Stability Stress Tests of 2013. The tests were composed of credit risk stress test, market risk stress test and liquidity risk stress test. The tests, based on the end of 2012 balance sheets data of 17 commercial banks, was to assess the soundness of the commercial banks amid negative shocks.

Scope. The tests covered 17 banks including the large commercial banks (LCBs) and the joint-stock commercial banks (JSCBs). The LCBs included ICBC, ABC, BOC, CCB and BOCOM; And JSCBs included China Merchants Bank, Shanghai Pudong Development Bank, China CITIC Bank, Industrial Bank, China Minsheng Banking Corporation, Everbright Bank, Huaxia Bank, Guangdong Development Bank, Pingan Bank, Evergrowing bank, China Zheshang Bank, and Bohai Bank. As of end-2012, aggregate assets of the above banks, which were highly representative, accounted for about 63 percent of the total assets of the overall banking institutions.

Approach. The tests followed both top-down approach and bottom-up approach. In top-down approach, PBC collected data in given format from the 17 commercial banks and conducted tests. The bottom-up tests aimed to assess the risk profile of individual banks or various groups of commercial banks, which was carried out by banks themselves. The PBC was in charge of compiling the tests results and analyzing it.

Methodology. The credit risk stress test included sensitivity stress test and scenario stress test. The sensitivity stress test directly assessed the impact of credit risk exposures deterioration in key areas; the scenario stress test gauged the changes of overall NPL ratio and CAR in banking system during periods of macroeconomic downturn. The market risk stress test mainly estimated the changes of CAR of the commercial banks due to the volatile interest rate and exchange rate. The liquidity risk stress test measured how the policy factors and macroeconomic factors affected liquidity ratio of the commercial banks.

Stress Scenarios①. The scenario tests of credit risk choose GDP growth rate, M_2 growth rate and CPI annual rise as the stress indicators to characterize the macroeconomic downturn. The sensitivity stress test of credit risk selected aggregate credit assets and NPL rate, default or losses in 7 key areas as the stress indicators. Stress test on interest rate risk of banking book selected the shift of deposit and loan interest rates in parallel as well as narrowing interest margin as the stress indicators; stress test on the interest rate risk of trading book used the RMB-bond yields ratio as the stress indicator. The stress indicator of exchange rate risk stress test was RMB/USD exchange rate.

① The stress scenarios were set based on the results of questionnaires to external economic experts, and should not be assumed to represent PBC’s judgements on macroeconomic condition.

The liquidity stress test selected bond price, NPL ratio, deposit scale, interbank deposit (borrowing) scale and legal deposit-reserve ratio as indicators.

Table1 Scenarios for the Financial Stability Stress Test

Types of Risk	Types of Test	Stress Target	Stress Scenarios
Credit Risk	Scenario Stress Test	Aggregate credit assets	➢ Mild: GDP growth rate down to 8% ➢ Medium:GDP growth rate down to 5.5% ➢ Severe:GDP growth rate down to 4% (M_2 growth rate and annual CPI were based on experts' opinions)
	Sensitivity Stress Test	Aggregate credit assets	➢ Mild: NPL ratio① up 100% ➢ Medium: NPL ratio up 250% ➢ Severe: NPL ratio up 400%
		Loans to Yangtze river delta region	
		Customer concentration	➢ Mild: the top 1 largest group(legal entity) customer defaults ➢ Medium: the top 2 largest groups(legal entities) customers default ➢ Severe: the top 3 largest groups(legal entities) customers default
		Loans to LGFPs	➢ Mild: NPL ratio up 5 percentage points② ➢ Medium: NPL ratio up 10 percentage points ➢ Severe: NPL ratio up15 percentage points
		Loans to overcapacity industries	
		Loans to export industries	
		Exposures to on-and-off-balance sheet wealth management products③	➢ Mild:10% loss of on-and-off-balance sheet wealth management products ➢ Medium: 20% loss of on-and-off-balance sheet wealth management products ➢ Severe: 30% loss of on-and-off-balance sheet wealth management products
		Real estate loans	➢ Mild: NPL ratios of residential mortgage loans and real estate developing loans (including land reserve loans) up 3 and 5 percentage points respectively ➢ Medium: NPL ratios of residential mortgage loans and real estate developing loans (including land reserve loans) up 4.5 and 10 percentage points respectively ➢ Severe: NPL ratios of residential mortgage loans and real estate developing loans (including land reserve loans) up 7.5 and 15 percentage points respectively

① Assuming that the initial NPL ratio is X %, up n percent means the NPL ratio becomes X %(1+n percent).

② Assuming that the initial NPL ratio is X %, up n percentage points means the NPL ratio becomes (X+n) percent .

③ In terms of the investment orientations of wealth management products, the exposure tested in this stess test was credit wealth management products, exclusive of products invested in bonds and deposits, capital market trust or overseas wealth management products, etc..

concluded

Types of Risk	Types of Test	Stress Target	Stress Scenarios
Market Risk	Interest rate risk stress test	Banking book	**Interest rate parallel shifting risk:** ➢ Mild: both deposit rate and loan rate up 25 bps ➢ Medium: both deposit rate and loan rate up 50 bps ➢ Severe: both deposit rate and loan rate up 75 bps **Benchmark interest rate risk:** ➢ Mild: deposit rate up10 bps, while loan rate down 20 bps ➢ Medium: deposit rate up 20 bps, while loan rate down30 bps ➢ Severe：deposit rate up 30 bps, while loan rate down 40 bps
		Trading book	➢ Mild: bond yield curve up 50 bps ➢ Medium: bond yield curve up 100 bps ➢ Severe：bond yield curve up150 bps
	Exchange rate risk stress test	Banking book and trading book	➢ Mild：RMB appreciating/depreciating 10% against USD ➢ Medium：RMB appreciating/depreciating 20% against USD ➢ Severe：RMB appreciating/depreciating 30% against USD
Liquidity Risk	Scenarios stress test	Banking book and trading book	➢ Mild: 4% of loans due within 30 days turn to NPLs, bonds' price down 3%, deposits down 4% , interbank deposits and borrowing down 5% ➢ Medium: 7% of loans due within 30 days turn to NPLs, bonds' price down 5%, a deposits down 6%, interbank deposit and borrowings down 10%, reserve requirement up 0.5% ➢ Severe: 10% of loans due within 30 days turn to NPLs , bonds' price down 5%, deposits down 8%, interbank deposits and borrowings down 10%, reserve requirement up 0.5% up 1%

II. Overall Results of the Stress Tests

1. Credit risk

The banking sector showed strong resilience to credit shocks. The results of the Sensitivity Test and the Scenarios Test of aggregate credit risk showed banks' stable assets quality and solid capital position. The banking sector, represented by the 17 commercial banks, remained resilient to macroeconomic shocks and performed soundly.

The result of the Sensitivity Test indicated that, under the severe shock where the overall NPL ratio rise by 400%, the CAR of the banking system would fall from 12.92% to 11.37% (Figure1). In particular, the CAR of LCBs would decrease by 1.76 percentage points while the CAR of JSCBs would decline by 1.07 percentage points (Figure2). When the mild, medium and severe shocks to the credit exposures to the 7 key areas occurred, the CAR of banking sector would remain high. Even in the severe shock, the CAR would be more than 11.62%.

Figure 1 The Sensitivity Stress Test for Aggregate Credit Assets: Overall

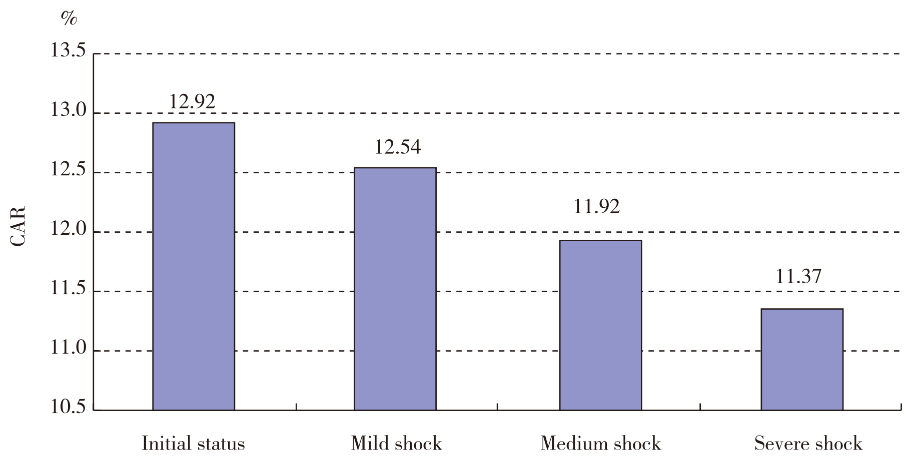
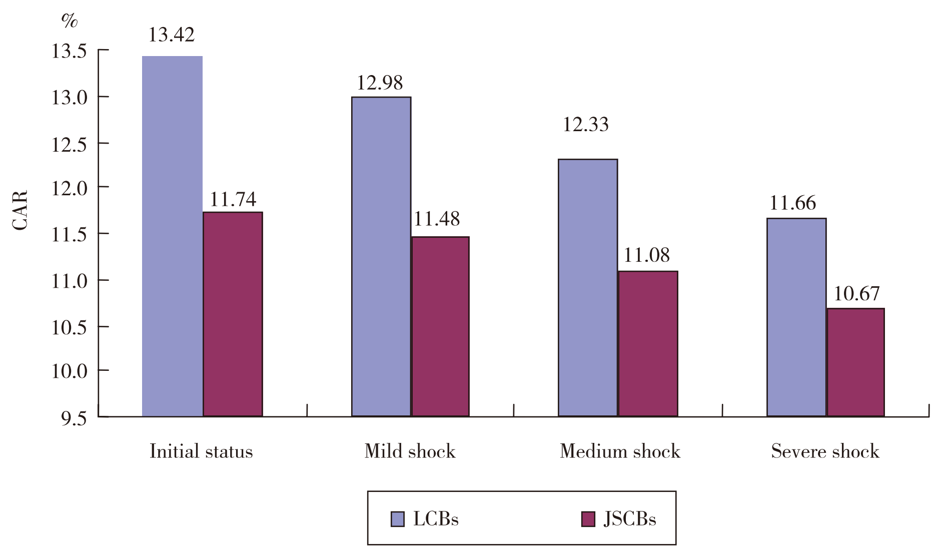
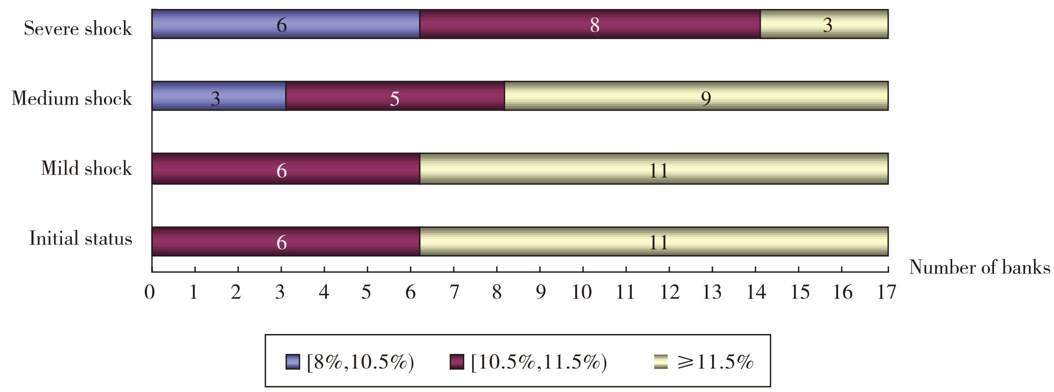


Figure 2 The Sensitivity Stress Test for Aggregate Credit Assets: by group



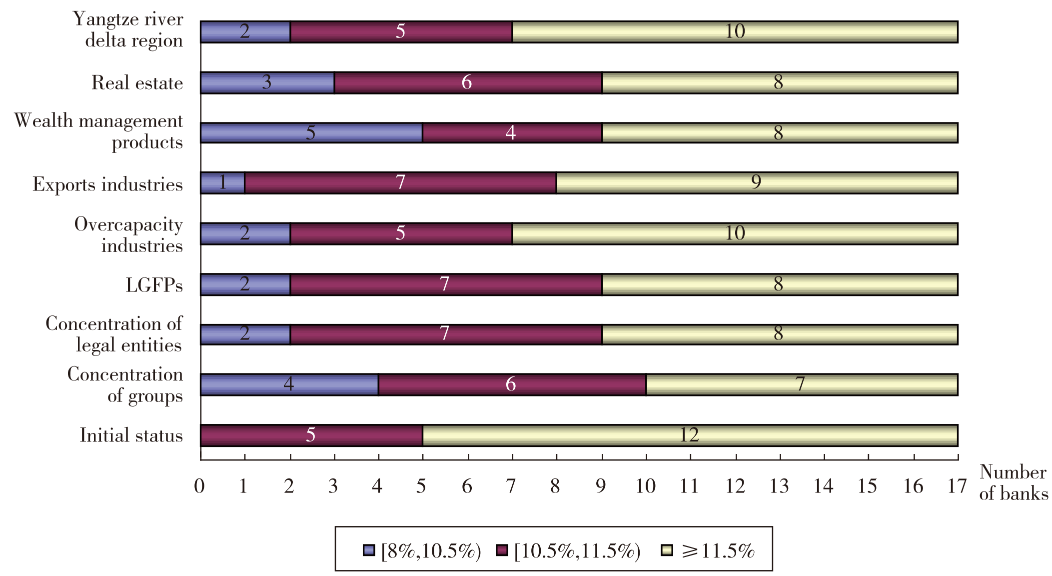
The Scenarios Stress Test of credit risk showed that, under mild, medium and severe shocks, the overall CAR of banking sector would decrease to 12.40, 11.33 and 9.77 percentage points respectively. Although the medium and severe shocks would have significant impact on the banking sector, the high CAR under such shocks suggested that China's banking sector were resilient to macroeconomic shocks and performed soundly. Under the initial status, the CARs of 11 commercial banks would be higher than 11.5%, while under the mild, medium and severe shocks, the number would decrease to 11, 9 and 3 respectively(Figure 3).

Figure 3 Distribution of Banks CAR: the Scenario Stress Test



Attention should be attached to risks in several key areas. According to the results of Sensitivity Test of credit exposures to 7 key areas, risk in areas such as real estate, on- and off- balance sheet wealth management products, as well as customer concentration risks needed more attention (Figure 4). In terms of the types of institutions, due to the differences in capital adequacies, risk exposures and asset qualities, the resilience was different from bank to bank.

Figure 4 Distribution of Bank's CAR: the Sensitivity Stress Test (Severe Shock)



2. Market risk

The interest rate risk of banking book was under control. The result indicated that, under severe shock (both deposit and loan interest rates up 75 bps), the CAR of banking sector merely fell by 0.08 percentage point (Figure 5).Under mild, medium and severe shocks, while deposit rate went up and loan rate went down, the overall CAR of banking sector fell by 0.31, 0.25 and 0.73 percentage point respectively (Figure 6).

Figure 5 Interest rate parallel shifting risk of banking book

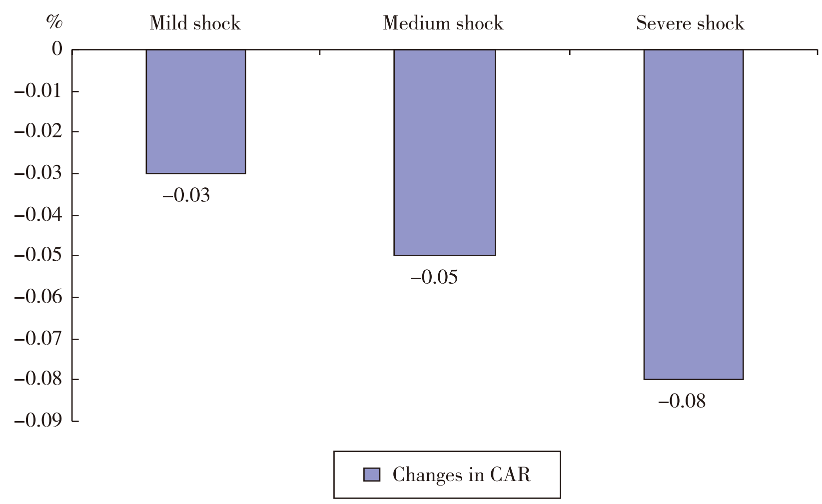
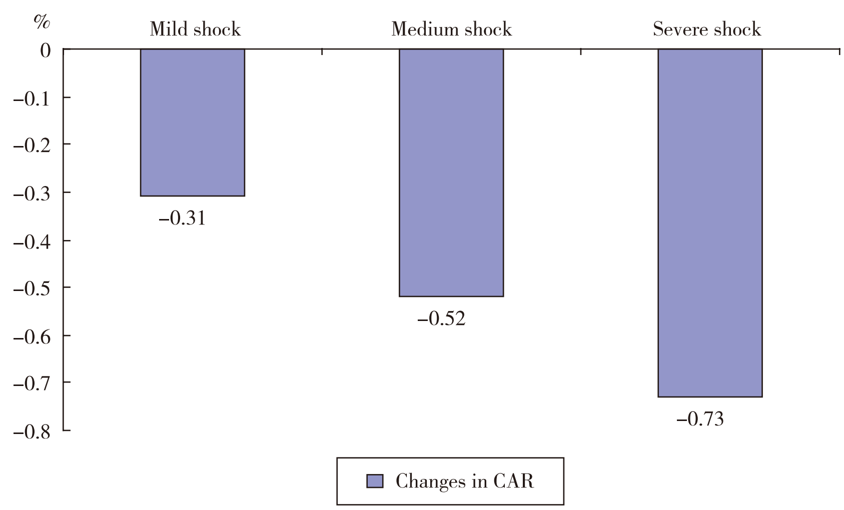


Figure 6 Benchmark interest rate risk of banking book



The interest rate risk had relatively small impact on trading book. The result under severe shock indicated that, even though the bond yield curve up 50 bps, the CAR of 17 banks would drop slightly, the CAR of banking sector only decreased by 0.012 percentage point (Figure7). In particular, the CAR of JSCBs declined more than that of LCBs, revealing JSCBs were more sensitive to upswing of bond yield curve (Figure 8).

Figure 7 Interest rate risk of the trading book

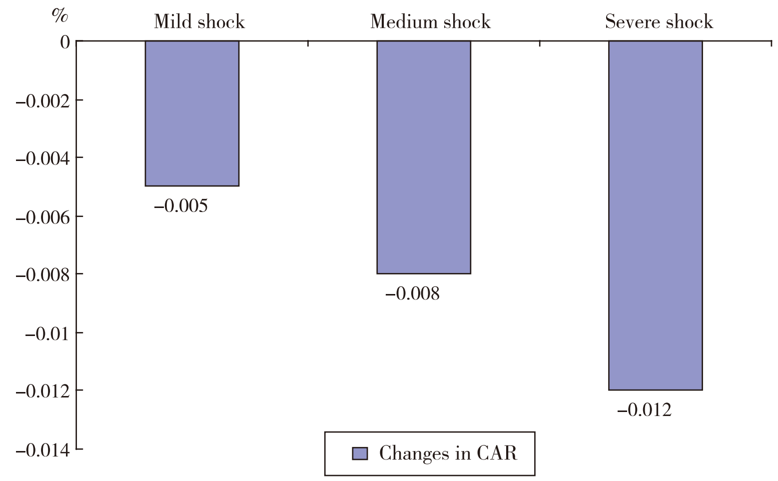
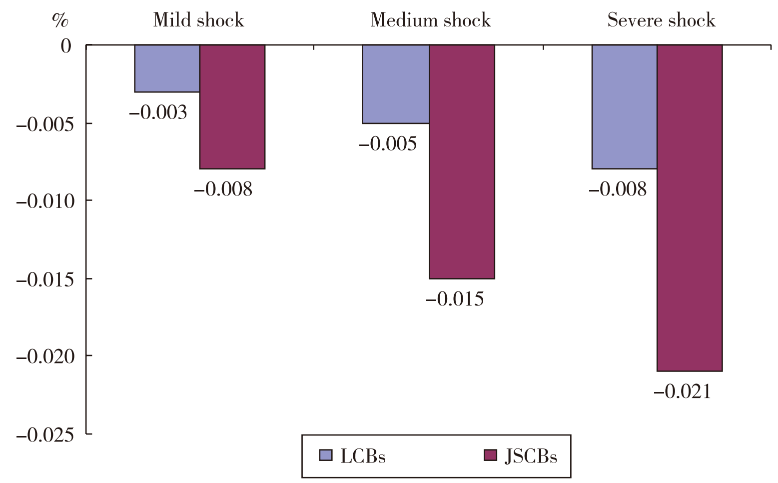


Figure 8 Changes of CAR caused by interest rate risk of the trading book: by group



The change of exchange rate had limited direct impact on banking sector. The result indicated, even in the severe shock, the CAR of banking sector decreased by 0.08 percentage point (Figure 9). In particular, the CAR of JSCBs dropped a little more than that of LCBs under the same shocks (Figure 10).

3. Liquidity risk

The Liquidity Risk Stress Test was conducted by the banks themselves. All the commercial bank's results showed that the impact of liquidity risk was relatively small. Even under severe shock, only 1 bank's liquidity ratio fell below the requirement[①].

① The core indicators of commercial banks（for trial implementation） issued by CBRC requires the liquidity ratio of a commercial bank should be above 25%.

Figure 9 Direct Exchange Rate Risk

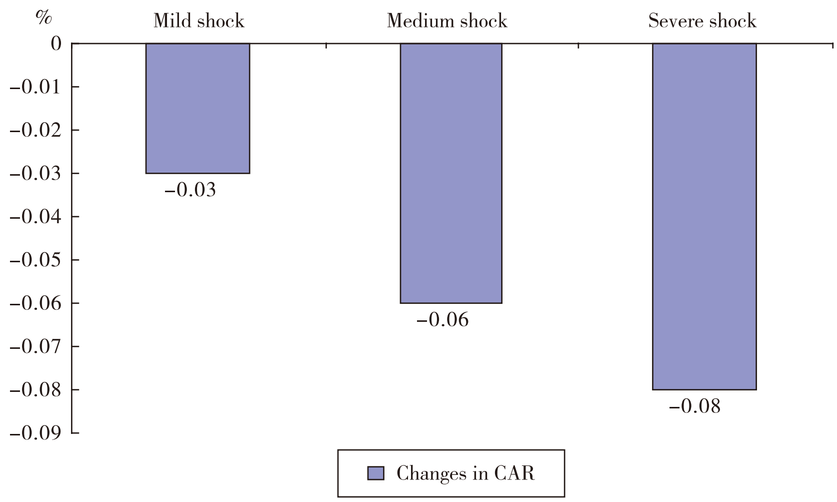


Figure 10 Changes in CARs Caused by Direct Exchange Rate Risk: by group

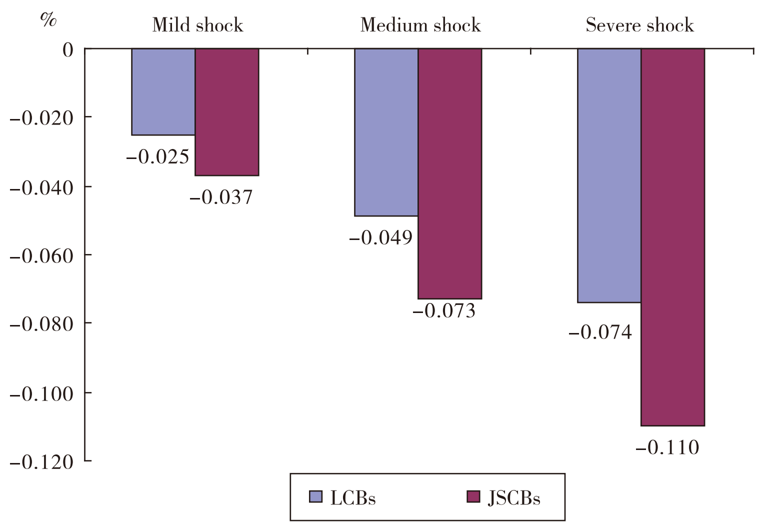
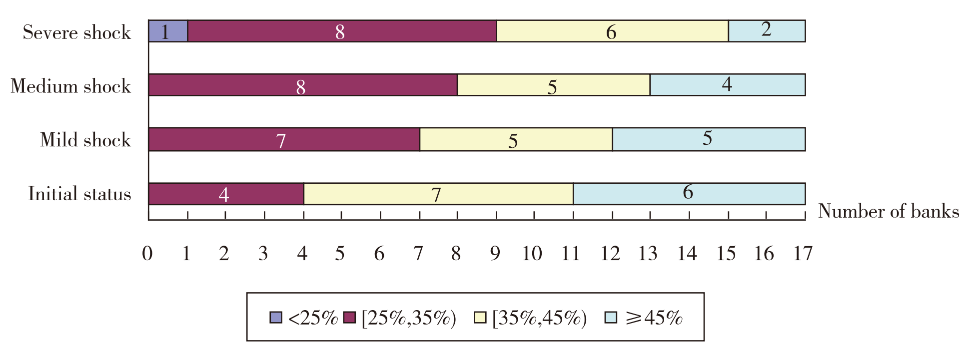


Figure 11 Distribution of bank's liquidity radio: liquidity risk



Special Topic II

The Establishment of a Modern Financial Corporate System: Reform and Outlook

In order to enhance financial institutions' support to domestic economic and social development, it is crucial to deepen reforms of financial institutions and establish a modern financial corporate system. In recent years, under the leadership of the Communist Party of China (CPC) Central Committee and the State Council, the People's Bank of China (PBC), working with relevant authorities, pushed forward with reforms, opening-up and development of the financial sector, grasped the opportunity of stable and relatively rapid domestic economic growth before outburst of the international financial crisis, restructured and reformed financial institutions at the micro level, and developed a modern financial corporate system. This brought a momentous change to the overall landscape of China's financial sector.

I. Reform Background

In 1993, *CPC's Decisions on Issues related to Establishing the Socialist Market Economy* approved by the Third Session of the 14th CPC Plenary Conference stated that, in the process of establishing the socialist market economy, "the policy of putting public ownership as the main body and simultaneously developing various economic sectors must be adhered to; a modern corporate system with clear ownership, rights and responsibilities, and separation of government and enterprises, should be established in line with the market need" and that "financial system reform should be speeded up". Thereafter, China launched a series of reforms. It separated commercial business from policy business in state-owned specialized banks and pushed forward with the transformation of state-owned specialized banks into commercial banks. After the Asian Financial Crisis, China carried out a series of measures on state-owned commercial banks, such as issuing treasury bonds of RMB 270 billion yuan to recapitalize them, disposing of non-performing asset worthy of RMB 1.4 trillion yuan and establishing four asset management companies, so as to mitigat financial risks to some extent.

In the 21st century, China got rid of the negative impact of the Asian Financial Crisis and its economy began to boom. However, with the feature of 'market-emerging plus transitional economy', the shortcoming of the then rigid financial system emerged. In the aspect of ownership, there was no clear investor representation, so that there was no clear mandate to preserve and increase the value of state's assets. In the aspect of operations, since there was no separation between government and enterprises, local government had significant influence on financial institutions through administrative interference. The latter usually granted loans as instructed by the local government. In the aspect of corporate governance, the management held powers both in decision making and daily operations, so that there was no effective oversight mechanism. In the aspect of operation system, the standards were low in financial accounting, asset classification and information disclosure, making the data invalid in reflecting enterprises' real condition of the asset quality and operation. In the aspect of incentive and constraint mechanisms, the personnel and salary structure was rigid and the egalitarianism was prevailing, which made it hard to incentivize the staff. In the aspect of external supervision, there was no sufficient prudential supervision, with inadequate supervisory power and means. All these factors pushed up the proportion of non-performing loans (NPLs) of financial institutions, especially the commercial banks, and banks were faced with inadequate capital. In 2002, large commercial banks reported a NPL ratio of 25%, whereas market believed the ratio was between 35% and 40%. Some people even pointed out that, referring to stricter loan classification criteria, the NPL of large commercial banks might had reached 50%. At the same time, rural credit cooperatives also suffered from high NPLs, and a large number of small and medium-sized financial institutions had potential risks. As Delong Group's risks emerged, the risks of the securities sector and the capital market fully emerged, too, and risks of some insurance companies also increased. Some major international media described China's financial sector as "extremely risky". For example, there were reports saying that "China's financial sector was a large time bomb, which could explode anytime", and "China's commercial banks were technically bankrupt."

In such severe circumstances, the CPC Central Committee and the State Council took a series of decisive measures and pushed forward the joint-stock reform of state-owned commercial banks. In 2003, the CPC adopted *CPC's Decisions on Issues related to Developing the Socialist Market Economy* in the Third Session of the 16th CPC Plenary Conference. It was clearly stated that "Commercial banks, securities companies, insurance companies and trust firms, etc., should be transformed into modern financial corporate with adequate capital, strict internal control, safe operations, quality services and high profitability", "state-owned commercial banks, if qualified, should be reformed into joint-stock banks, accelerating disposal of NPL and replenishment of capital, in order to pave the way for them to go listed", and that "reforms of policy banks should be deepened".

II. Reform Process

Since 2003, under the leadership of the CPC Central Committee and the State Council, the PBC, working with relevant authorities, developed a financial institution reform strategy of "focusing on the two ends and dragging the middle" gathering resources to solve key problems, promoting ownership reforms of large commercial banks deepening reforms of rural credit cooperatives, as well as market-based reforms of other financial institutions.

1. Reforms of large commercial banks have made a breakthrough

In order to speed up the reform process, the State Council established a steering group for pilot joint-stock reform of state-owned commercial banks. The office of the steering group was set in the PBC, and the group took the responsibility of conducting researches, designing reform plans and facilitating the reform process, etc. Based on the experiences gained from China's reform of the economy and the financial system, the steering group made it clear that the overall goal of large commercial bank reform was "to establish a standard corporate governance framework, change the operation mode, and gradually transform them into modern commercial banks with clear ownership, adequate capital, strict internal control, safe operation, quality services, high profitability and international competitiveness". In order to realize this goal, the PBC took innovative measures to recapitalize large commercial banks with foreign reserves, and worked with relevant authorities on the "four-step" plan of writing off capital losses, stripping off non-performing assets, recapitalizing with foreign reserves, and letting them go listed at home and abroad.

First, writing off capital losses. According to the basic concept of financial accounting, if large losses occur in a company, they must be charged off by capital. Any denial of this process results in the transfer of losses to other places. Before the reform in 2003, there was no five-category classification for assets in the China's then banking sector. Banks neither drew enough provisions nor wrote off non-performing assets in a timely manner, which resulted in the accumulation of non-performing assets. During the reform, the Bank of China and the China Construction Bank used resources such as provisions, profits before provisions and capital, etc., and wrote off a loss of RMB 500 billion yuan.

Second, striping off and resolving non-performing assets in line with the market principle. The four asset management companies joined in public auctions to bid for non-performing loans. They disposed of the assets package by resale of NPLs or other market-based means. This procedure demonstrated fairness, justice and openness, and introduced market competition to strengthen market discipline, maximizing the value recovered from the non-performing assets. At the same time, efforts were made to introduce stricter external auditing, investigate misconducts, reduce losses, and reduce moral hazard. During the reform, Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB) and Bank of Communications (BOCOM) wrote off and disposed of a total amount of non-performing asset of RMB 2 trillion yuan.

Third, foreign reserves were used in bank recapitalization. Several types of national resources were considered for large commercial banks' financial restructuring, including the resources of large commercial banks themselves, which would take comparatively longer time and would incur uncertainty; direct fiscal injection, which could largely deteriorate the then fiscal condition; and the national foreign reserves. Since one of functions of foreign reserves is to maintain the stability of the financial system, using foreign reserves to recapitalize large commercial banks became a possible choice. Starting from December 2003, China injected USD 80 billion into BOC, CCB, ICBC and ABC, which won positive comments at home and abroad.

Fourth, large banks went listed in domestic and overseas exchanges. The main objective was to make the capital market play its full role of external discipline, oversight and stimulus, to establish a brand new market incentive and constraint mechanism, to bring reforms to large banks' operations and to make them real market-based players. When going listed, the banks flexibly chose the timing of issuance at H-share and A-share markets, which ensured the successful issuance with reasonable price. After October 2005, the five largest commercial banks started their IPOs and all went listed in the A-share and the H-share markets.

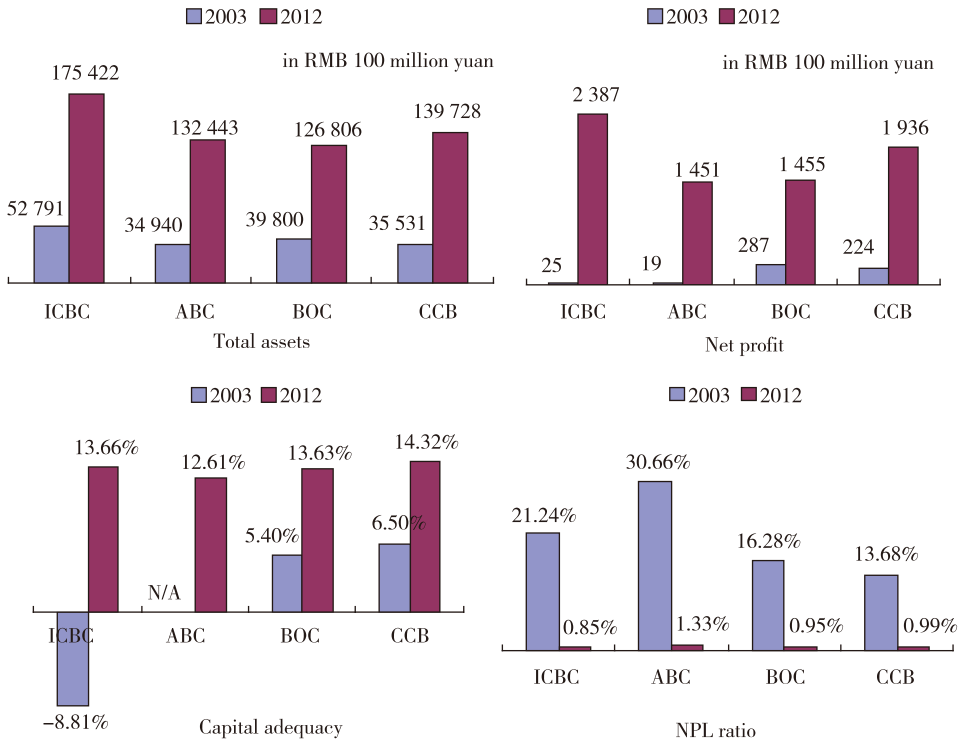
At the time when the plan of large bank reforms was initially proposed, challenges emerged. On the one hand, the large commercial banks had large amount of non-performing assets and their capital adequacy and risk resilience were low. On the other hand, there were different voices from domestic and foreign media, institutional investors at home and abroad felt confused and even questioned the proposal. When preliminary accomplishments were achieved, however, there was a tendency to be over-optimistic and urge to share the fruits. They didn't fully understand that the reform was a long-term, tough and complex task. There was also another opinion that the state-owned assets were cheaply sold and the reform damaged financial safety, which brought pressure to the authorities. The PBC, together with relevant authorities, took great effort in communicating with the public. Meanwhile, it firmly stuck to the reform plan. In the later stage, the reform was gradually accepted domestically and by the international community, and the experience was promoted in various areas.

Large commercial banks also registered great accomplishments, with comprehensive improvement in their corporate governance, internal control and management capability. A market-based capital replenishing mechanism was established, which enhanced external constraints and the banks' financial sustainability. The banks' international status and competitiveness were also enhanced. By the end of 2012, the five largest banks, namely the ICBC, ABC, BOC, CCB and BOCOM, registered a capital adequacy of 13.66%、12.61%、13.63%、14.32% and 14.07% respectively. Their NPL ratio was 0.85%、1.33%、0.95%、0.99% and 0.92%. Their net profit in 2012 was RMB 238.691, 145.131, 145.522, 193.602 and 58.373 billion yuan. According to the ranking by the British period *the Banker* in July 2012, the ICBC, CCB, ABC, BOC and BOCOM's net profit ranked the 1st, 2nd, 3rd, 5th and 12th globally, and their tier 1 capital ranked the 3rd, 6th, 10th, 9th and 30th, respectively.

2. Initial progress was made in the reform of rural credit cooperatives

Rural credit cooperatives are the major players in the rural financial system. They have made substantial contributions to the rural economic development. However, they accumulated relatively large risks due to unclearly-defined ownership and their weak operation and management systems. In order

Figure 1 Financial performance of large commercial banks



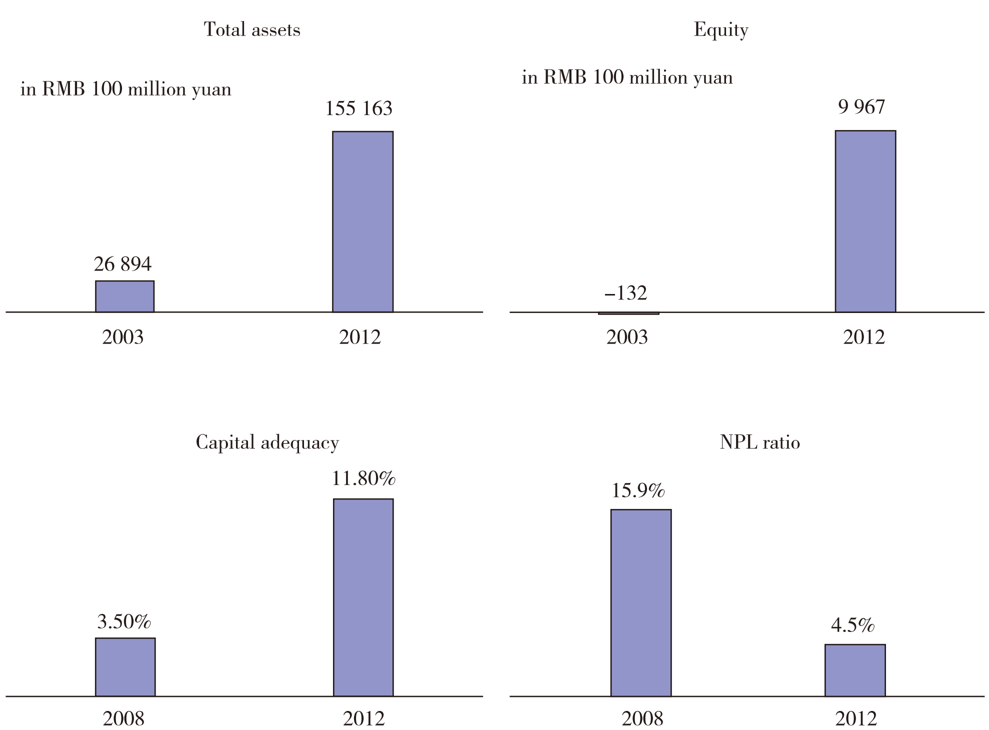
Source: Annual reports of large commercial banks.

to push forward with reforms of the rural credit cooperatives, the PBC proposed to exchang non-performing assets held by rural credit cooperatives with central bank notes in equal amount, and develop a financing policy with positive incentives, improve the ownership and management system, achieving the goal of “setting up a new mechanism with money”.

In June 2003, the State Council decided to launch pilot reform programs on rural credit cooperatives in 8 provinces (municipalities) including Zhejiang and gradually expand the programs nationwide. The PBC designed and implemented the positive financing incentive mechanism. The PBC decided to align the cash of central banks’ special notes or payment of central bank’s special loans with the reform results of rural credit cooperatives, so as to fully mobilize the local government and rural credit cooperatives to support and participate in the reform, leading rural credit unions to step up gradually. The first step is that, if the PBC approves the rural credit cooperative’ plan to increase capital adequacy and lower NPL ratio, the PBC will issue a warrant of issuing special notes. In the second step, if the rural credit cooperative meets the capital adequacy and NPL requirements, the PBC would issue special notes. The third step is that, if the rural credit cooperative makes substantial progress in clearly defining its ownership, improving the corporate governance and strengthening the internal control, the PBC will cash the notes. By the end of 2012, through both special central bank notes and special loans, the PBC provided more than RMB 170 billion yuan to rural credit cooperatives. At the same time, the Ministry of Finance (MOF) actively supported the reform by developing favorable policies related to income tax and sale tax. From 2003 to 2009, the total tax reduction exceeded RMB 70 billion yuan. Since 2010, the MOF continued to implement a preferred sale tax of 3% for rural credit cooperatives, and disbursed RMB 8.85 billion yuan to those rural credit cooperatives suffering losses from subsidies for inflation-proof savings.

With the reforms, the ownership system, governance structure and internal control of rural credit cooperatives was improved notably, assets quality and profits were increased continuously, and their role was further enhanced as the main force in supporting the agriculture sector. By the end of 2012, outstanding loans from rural credit cooperatives registered RMB 3.87 trillion yuan, which accounted for 5.76% of the outstanding loans by financial institutions nationwide. The agriculture-related loans and the loans to farmers were RMB 5.3 trillion yuan and RMB 2.6 trillion yuan respectively. The capital adequacy and NPL ratio were 11.8% and 4.5% correspondingly. A total of 1804 county or municipal-level rural credit cooperatives were established. Some of the rural credit cooperatives were merged into rural commercial banks or rural cooperation banks, with their numbers reached 337 and 147 respectively by the end of 2012.

Figure 2 Financial situation of rural credit cooperatives



Source: The PBC.

3. Reforms of other banking financial institutions were further promoted

Reform of policy financial institutions was steadily promoted. Policy financial institutions play a unique role in the social and economic development. At the macro level, they effectively support national development strategies, whereas at the micro level, they make up for the shortcoming of commercial banks. Since 2007, the PBC, working with relevant authorities, steadily promoted the reform of policy financial institutions. At present, initial progress has been made in the reform of China Development Bank (CDB). In 2007 and 2008 respectively, the CDB had capital injected by the state and became a joint-stock corporate. A standard corporate governance and good decision making mechanism has been set up. In December 2012, the ceremony for reforms and recapitalization of the China Export &Credit Insurance Corporation as well as the first Board of Directors meeting were held, making a important step in furthering the reform and strengthening its policy functions. Besides, the PBC also conducted detailed researches on the mandate, business scope, risk management and governance structure of the China Export-Import Bank and the Agriculture Development Bank, promoting the internal reforms of the two institutions.

Commercialization of financial asset management firms witnessed positive progress. As disposal of large commercial banks' non-performing assets were basically finished and the non-performing assets in the financial system gradually decreased, the four financial asset management firms needed to transform business model. Since 2008, China actively promoted reform of financial asset management firms in line with the principle that "each firm should have its specially-designed policy". With time ripened for each firm, reforms were duly conducted. Since 2010, pilot reforms were conducted in Cinda Asset Management Corporation and Huarong Asset Management Corporation. The goal was to establish and develop a modern financial corporation system. Their main business was to resolve the non-performing assets and provide market-oriented financial services. Besides, the Orient Asset Management Corporation and the Great Wall Asset Management Corporation were also actively making preparations for the commercialization reform.

The PBC, the MOF and other relevant authorities, drawing on experiences of large commercial banks, promoted the reforms of CITIC Group, Everbright Group and the Guangfa Group, improving their corporate governance, streamlining management structure, introducing strategic investors, and enhancing capital position, management and services. Meanwhile, a number of joint-stock commercial banks, such as the CITIC Bank and Bank of Beijing, established modern financial corporate system based on their own efforts in financial restructuring, introducing strategic investors, improving corporate governance, conducting IPOs and going listed. Besides, the PBC, together with other authorities, steadily promoted pilot program of integrated financial services. Financial institutions speeded up their progress in cross-sector investments, and financial holding companies gradually emerged and steadily developed. The integrated financial services allowed them to improve their business structure, benefiting from synergy effects, and enhance their cross-cycle operating capacity to some extent.

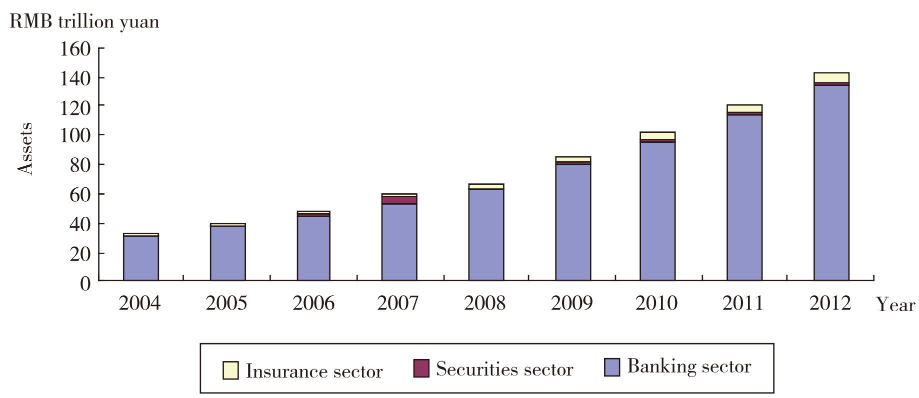
4. Reforms of securities and insurance sectors were steadily promoted

Comprehensive restructuring of securities companies. From 2005 to 2006, there was an outbreak of risks in the securities sector. Drawing on experiences of large commercial banks reform, taking Central Huijin Investment Ltd and the China Jianyin Investment Ltd. as platform of capital injection and reconstructing, the PBC, working with relevant authorities, stepped up with the reforms and restructuring of large securities and insurance companies. First, in line with the principle of combining administrative instructions with market operations, authorities promoted the recapitalization and restructuring of 9 large securities companies including the China Galaxy Securities by means of shareholders capital injection, liquidity support and introducing strategy investors. The reform improved their corporate governance, effectively mitigated risks, and maintained stability of the securities market. Second, the PBC and other relevant authorities proposed general plan and basic principle of resolving Delong Group, actively cooperated and resolved difficulties in the process of risk resolution, and finally made Delong Group exit smoothly from industrial and financial sector, keeping the losses of the state and creditors at the minimum level. Third, the PBC properly tackled 28 high- risk securities companies, researched and developed a series of policies related to purchase of individual creditors' claims and clients' securities trading settlement funds, carefully worked on the approval, issuance and management of financial stability relending, ensuring that fund gaps for purchase of individual creditor's claims and clients' trading settlement funds were made up, containing the negative effect on the social and financial stability.

Reform and restructuring of insurance companies. In 2006, in dealing with the operating difficulties and inadequate capital faced by the China Reinsurance (Group) Corporation, the PBC and other authorities developed a reform plan with the content of fund injection by the state, enhanced corporate governance and going public, which was later approved by the State Council. Besides, the PBC also worked with relevant authorities and promoted the restructuring of New China Life and China United Property Insurance Company through recapitalization by the Insurance Protection Fund. With reform and restructuring, insurance companies' capital adequacy was enhanced, equity structure was improved, and the competitiveness and resilience were steadily strengthened.

Since 2003, China has made substantial accomplishments in the financial institution reform, financial sector witnessed historic changes. Their business was strengthened, market confidence was improved, services were upgraded and their international competitiveness was enhanced. The increasing stability and safety of the financial system laid a solid foundation for China to go through the international financial crisis and keep a continuous, healthy economic growth. It also contributed to the stability of the international financial system. By the end of 2012, total asset of the banking sector registered RMB 133.62 trillion yuan, 4.64 times of that at the end of 2012. Commercial banks' CAR was 13.25% and the provision coverage ratio reached 295.51%. Total assets of securities companies (not including client's assets) registered RMB 1.11 trillion yuan and assets under management of fund companies was RMB 2.87 trillion yuan, up 1.06 times and 20.76 times respectively compared with those at the end of 2002. Total assets of insurance sector were RMB 7.53 trillion yuan, up 10.33 times from the end of 2002. These achievements were highly acknowledged by the IMF and the World Bank in China's first Financial Sector Assessment Program (FSAP).

Figure 3 Assets of China's financial sector



Source: The PBC.

III. Main experiences gained from the reforms

During the process of financial reforms and the establishment of the modern financial corporate system, the PBC didn't confine itself to conventional theory, but made audacious explorations and active innovations, gradually come into some forward-looking practices with typical Chinese characteristics.

Firstly, the market-oriented principle was followed firmly. The PBC actively promoted market-based equity restructuring of financial institutions, with private and overseas capital absorbed to form a multiple equity structure. The Central Huijin Investment Ltd. came into being and recapitalized banks on behalf of the state. It was made clear that the company, as the representative of the state capital, should independently exercise shareholder's rights. When setting up joint-stock limited companies, requirement for a modern financial corporate were met, such as clear ownership, adequate capital, strict internal control and secured operations. A modern corporate governance structure was established. An operation system, comprising mutually constraint decision-making power, execution power and supervisory power, was gradually developed.

Secondly, limited resources should be concentrated to cope with key problems. At the beginning of reforms, there were many difficulties to deal with. As the then fiscal strength was relatively weak, the PBC carefully studied every possible solution and considered their impacts on fiscal deficits, inflation and macro-economy. By comparing the pros and cons, the PBC creatively brought forward that recapitalizing large commercial banks by foreign reserves and replacing rural credit unions' non-performing assets by central banks notes, effectively resolving the key problems of resources allocation in the reform.

Thirdly, the financial system should be "online" repaired. The rationale for online repair is that the economic function of the financial system cannot be terminated for repair ("offline repair") and the financial system must continue functioning to support the social and economic development. Therefore, problems should be resolved as the financial institutions continue operating. The practices show that, as the government assumed a forward-looking perspective and took preventive measures to resolve the systemic risks and vulnerabilities in the financial system, this "online repair" was an effective and efficient way to maintain financial stability. By comparison, if "offline repair" were used, where the government didn't take forward-looking and preventive measures but wait until the outbreak of the crisis, which led to the collapse of the financial system and bankruptcy of large financial institutions, it would incur huge costs to the real economy. This "online repair" experience was learnt and practiced by the U.S. and some European countries during the international financial crisis.

Fourthly, great emphasis should be given to the financial health and restructuring of financial institutions at the micro level. The financial sustainability of financial institutions is the micro basis of financial stability. A good system cannot work well without the healthy financial condition of micro-level financial institutions. Moreover, unless these micro bodies function well, the monetary policy transmission mechanism won't work properly, which would impair the basis of macro-economic management. Therefore, central bank must seek the healthiness of both the entities at the micro-level and the whole financial system. Based on careful study of key problems in financial institutions, the PBC integrated limited resources and took effective measures, starting with finance restructuring and emphasizing on the corporate governance and risk management, and comprehensively improving the health of micro-level financial institutions. The previous insolvent financial institutions became adequately capitalized. Financial institutions came from "technical bankruptcy" to healthy operations, which largely eliminated the soft financial constraints. Financial institutions began to price products and services on their own, laying a fundamental basis for the liberalization of interest rates.

Fifthly, capital market should play an important incentive and constraint role. Going public is a significant step in the thorough reform of financial institutions' corporate governance. The PBC actively pushed forward with financial institutions' going listed and developed overall plans for the timing for the IPOs and which exchange should be used. As a result, the PBC had capital market play the role of external constraint, supervision and incentivizing. Though going public, financial institutions' capital strength, brand effects and recognition of investors and consumers were enhanced essentially.

Sixthly, financial soundness standards should be enhanced. During the reform, the PBC emphasized that real and high-quality common share capital should be injected and maintained, that information disclosure, accounting and auditing practices should be improved, and that financial institutions should faithfully report their financial and operation performance. Large commercial banks, which went listed abroad, were asked to comply with international accounting standards and corporate governance standards. This ensured that the fruits of reform can be on display in the internationally accepted standards, and increased international recognition of the reform of large commercial banks. Meanwhile, the PBC and the China Banking Regulation Commission actively participated in the review of international financial standards, put forward the implementation of Basel III in China, promoted establishment of banking regulatory framework in line with international standards.

IV. Outlook

At present, China is in the process of industrialization, application of information and communication technologies, urbanization and agricultural modernization. It faces strategic tasks to speed up the shift in economic growth model and structural adjustments. This calls more for the financial sector to support the economic development. Challenges to China's financial sector also come from the changing international financial circumstances and increasing globalization. *The 12th Five Year Plan for Financial Sector Development* pointed out that efforts should be made to promote the reform, opening-up and development of financial sector in all fronts, and to substantially improve its comprehensive strength, international competitiveness and risk resistance. The 2012 National Financial Work Conference asked for the strengthening of financial institutions' corporate governance and pushing forward with the development of modern financial corporate system. Therefore, in this new era, continued effort should be taken to deepen the financial reform firmly, further the financial opening up, and develop a modern financial system that can maintain macro-economic stability and effectively support economic development.

Efforts should be made to improve the modern financial corporate system and

strengthen corporate governance. Financial institutions should have more effective mechanism for decision-making, execution and checking-and-balancing power. Boundary of mandates of shareholder's meeting, board of directors, board of supervisors and senior management should be clearly defined. Disclosure and transparency should be enhanced, and insider control should be prevented. Corporate governance should be implemented faithfully in the daily operation and risk management. Diversified ownership of financial institutions should be promoted, with less monopoly and more free access. Effective personnel management mechanism should be developed, and arrangement for nomination and qualification of board of directors and board of supervisors should be improved. A market-based mechanism of higher management election should be explored. The quality of financial sector personnel should be enhanced, with a comprehensive improvement in their professionalism and ethic level. Risk governance and internal control of financial institutions should be strengthened, the internal drive for changing growth model should be promoted, and scientific and reasonable incentive and constraint mechanisms should be established.

Financial institutions' business model should be changed to ensure their sustainable growth. The capital constraint mechanism of commercial banks should be strictly applied in order to improve the efficiency of the capital The extensive business model with only emphasizing capital consumption and profiting from large scale capital and interest spread, should be shifted to a more intensive growth model with risk and profit balanced, and quality and efficiency improved. Challenges from market-based interest rate reform should be properly dealt with, and financial institutions should improve their risk pricing ability, expand intermediate business and continue improving their capital structure. Securities companies should provide professional and quality service, deepen and widen their business and have a diversified profit-making model, with more customized products and services provided. Insurance companies should be encouraged to have a better-tailored development model and improve quality of products, services and management, in order to better satisfy the social needs.

Perspective on market access should be changed, to create a more competitive, diversified and open financial service system at the grass-root level. Great efforts should be taken to develop small-and-medium-sized financial institutions, which have advantages of cost and information in servicing the SMEs. In particular, more emphasis should be placed on the development of community banks and small non-deposit-taking financial institutions in order to increase competition in the grass-root financial services market. Private capital should be encouraged and guided to invest in these financial institutions. Private lending activities should be standardized. Non-credit financing should be encouraged to provide more financing channels for small-and-micro enterprises and the agriculture-related sector. Supervisory resources at the county level should be reorganized and optimized, county-level SME financial institutions should have easier market access, and financial innovation should be encouraged.

More quality services should be provided by the financial sector to support the development of real economy. The development of China's financial sector, to a large extent, benefited from the real economic growth. It should be insisted that the aim of developing the financial sector is to better develop the real economy. It should be ensured that credit extension is targeted at the real economy to solve the financing difficulties of the real economy in an efficient manner. Efforts should be made to curb credit decoupling with the virtual economy, prevent the virtual economy over-recycled and overheated. The principle of servicing the real economy should be deeply rooted in the doctrine of financial institutions. With improvement in their operations, management, credit structure and financial product innovation, financial institutions should increase their support to key areas and weak links in the economy and comprehensively enhance their service quality, in order to realize a harmonious development of the real economy and the financial sector.

The financial sector should continue to open up and Chinese financial institutions' international competitiveness should be strengthened. When compared internationally, Chinese financial institutions still lag behind their foreign peers in their operation management and competitiveness, etc. Therefore, while encouraging more overseas financial institutions to come to China, competitive domestic financial institutions should also be encouraged to go abroad and compete in the global market. Relevant institutional arrangements should be in place to guide financial institutions to form a scientific and reasonable overseas expansion strategy, to establish adequate reserve of international talents, and to gradually develop China's large multinational financial institutions. Financial institutions should be encouraged to expand their international operations in a sound and steady manner. Pilot programs of integrated financial services should be steadily implemented in order to improve the business structure and the overall servicing capabilities of financial institutions.

The development of deposit insurance regime should be speeded up and a favorite environment should be created for financial institutions' development. The establishment of a deposit insurance system is contributive to a fair competitive environment. It can also facilitate commercial banks to reform their operation mechanism on market basis and increase their flexibility in financial innovations and risk sharing mechanism. Without a deposit insurance regime, the state takes the de facto responsibility of implicit guarantee. This could result in weakening commercial banks' risk-constraint mechanisms, where they would chase high profits and take high risks. At present, the preconditions for the launch of deposit insurance regime have been in place. The plan has been checked and discussed repeatedly for many times. Consensus has also been basically achieved among all sides, and the regime can be set up at a proper time.

Special Topic III

Pilot Programs on Regional Financial Reform

Over the past several years, regional financial reform, which is compatible with the characteristics of local economy and finance, has become an important part of China's financial system reform. This kind of reform is often specially set, and carried out in the form of pilot programs or test zones. It follows market principles and lets the bottom-up market force play the leading role. The local initiative and creativity, as well as the first-mover spirit are encouraged. And the reform is guided to be in line with economic system reform and the overall financial reform. The real practice of the regional reform has proved that it improves the effective allocation of financial resources, stimulates local growth momentum and provides strong support for the transformation of regional economic development pattern.

I. Regional Financial Reform is an Important Part of China's Financial Reform

In terms of reform path, the financial reform of China could be perceived from two dimensions. The first dimension is the overall financial reform, which is implemented in a top-down manner nationwide. And the institutional design of this kind of reform is centrally decided, for example, the shareholding reform of large commercial banks, the rural credit cooperatives reform, the market-based interest rate reform, and the RMB exchange rate formation mechanism reform. The second dimension is specialized financial reforms, which includes regional financial reform. Based on local realities and in line with the regional characteristics, this kind of reform usually adopts the mode of pilot program first, experience sum-up later and comprehensive popularization in the end, and gives full play to the bottom-up market force. The regional and overall financial reforms complement with each other and are mutually reinforced.

Regional financial reforms put great emphasis on being compatible with local characteristics and usually share the following features: first, reforms take into consideration of the actual conditions of local economy and finance, encourage its initiative and creativity, exploit potentials and improve allocation efficiency of financial resources. Second, those reforms often have one or several financial innovation at the core, with a basket of supporting policies, such as industrial, tax and financial policies, and take comprehensive consideration of all aspects concerned. Third, there are various forms for this kind of reforms, for example, the development of a regional financial center, the building of a comprehensive pilot financial reform zone, and the implementation of specialized supporting reform. Fourth, almost all the regional financial reforms are initialized by local or market entities. Some reforms are spontaneous, some are pushed forward at both provincial and ministerial levels after achieving major accomplishments, and some are approved directly by the State Council.

II. Typical Cases of Regional Financial Reform

In the beginning of the reform and opening up, China set four special economic zones, including Shenzhen, Zhuhai, Shantou and Xiamen, which not only promoted the economic development of the region and even the country, but also provided rich experience for the deepening of the reform. With the development of the financial industry in China, the overall financial reform, featuring shareholding reform of large commercial banks, has achieved prominent breakthroughs. Since the launch of the *Opinions of the State Council on Propelling Shanghai to Accelerate the Building of an International Financial Center* in 2009, China has been steadily pressing ahead with pilot programs of regional financial reforms. There are as many as twenty programs in the progress or under the researches, including the Wenzhou's comprehensive financial reform in Zhejiang province focusing on standardization and legitimization of private lending, as well as the pilot program in the Pearl River Delta and Qianhai area featuring financial opening-up and close cooperation among Guangdong province, Hong Kong and Macau.

1. The building of an international financial center in Shanghai

Against the background of globalization and heated financial competition worldwide, and in order to keep Shanghai as a prime example for economic growth and an engine for China's development, as well as to facilitate its optimization and upgrading of industrial structure and transformation of economic growth mode in April 2009, the State Council issued *Opinion of the State Council on Promoting the Development of Modern Service Industry and Advanced Manufacturing of Shanghai into an International Financial Center and International Shipping Center*. This is an important measure set by the CPC and the State Council from a strategic and overall perspective, with the aim of accelerating modernization and opening up of China. It is an inevitable choice for realizing scientific outlook on development, accelerating the transformation of economic growth mode, breaking resources and environmental constrains, and promoting comprehensive, balanced and sustainable economic and social development. The core task of building Shanghai into an international financial center is to relentlessly explore the breadth and depth of the financial market and put in place a relatively developed, multifunctional and multi-layered financial market system, with reform measures in the following aspects:

Strengthening financial market system development. Pilot project of revenue bonds, study and develop foreign currency bonds and other kinds of bonds, push forward pilot programs for listed commercial banks to access exchange bond market, and explore bonded futures delivery services by domestic futures exchanges in special areas supervised by the Customs. Foster securities investment funds, social security funds, insurance assets, enterprise annuities, trust plans as well as other institutional investors, and explore offshore reinsurance business. Following the state's overall plan of capital account and financial market liberalization, gradually increase the share and size of overseas investors in

Shanghai's financial market, expand the issuance of RMB bonds by international development institutes step by step, steadily move forward domestic issuance of RMB bonds by overseas companies, and introduce RMB shares issued by qualified overseas companies in due time. Under the framework of mainland-Hong Kong financial cooperation, actively explore Shanghai and Hong Kong's securities products-collaboration, and advance mainland-Hong Kong financial cooperation and interactive development.

Stepping up financial institution and business system building. Develop investment banks, fund management companies, asset management companies, money brokerage companies, financial leasing companies and finance companies of enterprise groups, which can boost market functions. Give impetus to qualified financial institutions to pilot program of integrated financial services, nurture and attract financial holding groups of comprehensive business competency and international competitiveness, and explore to establish financial supervision coordination mechanism. Develop equity investment companies (funds) and venture capital firms, and do a good job in piloting Shanghai financial development investment funds. Develop commercial bank's M&A lending service, encourage individuals to purchase commercial endowment insurance, and pilot individual-income-tax deferred pension insurance products at appropriate time. Based on the overall process of China's financial liberalization, steadily push forward financial sector opening-up, and support the pioneering efforts of securities joint venture and fund management joint venture in Shanghai in this regard.

Enhancing financial services. Vigorously develop e-trading, promote the interconnection of varied financial information systems and market trading systems to lower transaction costs and improve efficiency. Optimize financial service facilities and layout planning, further improve unified and efficient modern financial support systems that serve market transactions, including registration, custody, clearing and settlement, and enhance the efficiency and service capability of Shanghai's financial market. Bolster the planning and building of Lujiazui and other major financial clusters, lift service functions of financial clusters in an all-round way. Build China's financial information service platform and global information service market in Shanghai.

Improving financial development environment. Perfect financial law enforcement system, set up fair, just and effective financial dispute handling and arbitration mechanisms and explore the establishment of specialized financial court and arbitration agency in Shanghai. Intensify the building of social credit system, improve the basic database for business and personal credit information underpinned by a unified financial credit platform, and promote credit information sharing. In line with the needs of Shanghai financial reform and innovation, constantly optimize financial supervision system, improve supervision model, and put in place market-oriented, innovation-promoting, information-sharing and risk-controlling financial supervision platform and mechanism.

2. Comprehensive financial reform in Wenzhou, Zhejiang Province

Since China's reform and opening-up, Wenzhou model is among the most vital economic growth models in China's market economy process. In recent years, due to lack of adaptive adjustments, Wenzhou's economy has suffered major development bottleneck, a host of economic and social problems such as "runaway" bosses and private lending chaos begin to emerge against specific macroeconomic backdrop. To actively resolve Wenzhou's private lending crisis, work out an effective path to private lending legitimization and standardization, ease financing difficulties of SMEs and build up more experience for overall financial system and mechanism reform, the State Council decided in March 2012 to set up a test zone for comprehensive financial reform in Wenzhou. Twelve tasks are set forward, which are matched by the following policy measures.

Vigorously promoting legitimization and standardization for private lending. Since the launch of the reform, Wenzhou has set up four private lending service centers, which offer comprehensive services ranging from registration to notarization and evaluation for both supply and demand sides of private funds. 6 private capital management companies have also been set up, providing the service of capital investment consultation, capital management and project investment. Until now, private funds worth RMB 560 million yuan has been injected into Wenzhou in forms of bonds and equity. With the *Administrative Measures for Private Lending in Wenzhou, Zhejiang Province* drafted and the *Compilation Methodology for Interest Rate Indices of Wenzhou Private Lending* formulated, the composite interest rate index of Wenzhou private lending is published regularly. Wenzhou financial reform plaza is established as a comprehensive financial services platform featuring property right exchange, banking counters, intermediaries and micro-credit companies. With 13 entrusted companies and 2 listed trading companies, it is a frontrunner in Zhejiang in terms of transaction value. A local financial administration bureau has been established in Wenzhou, which is responsible for on-site inspection, supervision and management of local financial institutions. Financial arbitration tribunal, financial criminal investigation squad and financial court are set up, building a complete and specialized financial enforcement system.

Further bolstering financial infrastructure. The PBC has taken the lead in introducing credit query services into Wenzhou's private lending registration center and promotes the incorporation of village and township banks and micro-credit companies into the credit system. With accelerated credit information collection and e-processing for rural households and SMEs, by the end of 2012, the system had covered 1.401 million rural households and 12 000 SMEs without lending record. Financial comprehensive statistics platform and Wenzhou financial monitoring and reporting platform have been tentatively established. In December 2012, some securities companies, insurance companies, credit guarantee companies, pawn houses and other financial institutions have started to submit their data on trial.

Improving financial organization system. The introduction of strategic investors and the capital and share increase scheme are going well for the Banks of Wenzhou with 72.47 percent of private equity placement completed and RMB 660 million yuan in equity expansion. 6 village and township banks and 11 bank branches have started to operate. The two rural cooperative banks, Lucheng and Longwan, have transformed into rural commercial banks with private equity share boosted. Foreign banks are encouraged to establish their branches in Wenzhou. Capital and share increase scheme is pushed forward for mutual fund cooperatives. 31 micro-credit companies have been set up. Securities companies are also encouraged to establish branches in Wenzhou. Shanghai Securities first, and then CITIC Securities have already opened their branches in Wenzhou. Moreover, efforts are made to introduce insurance companies to Wenzhou. Three insurance companies have been newly set up.

Relentlessly raising financial service level for SMEs. Strengthen small and micro business credit service innovation, introduce diversified collaterals such as equity, patent, right to use sea areas, forest tenure, pollution discharge right and land contract management right, pilot repayment models such as credit-boosting, installment and revolving loan based on annual audit, effectively easing business difficulties of SMEs in getting and repaying loans. Facilitate the linkage of banks and companies, organizing promotion events for bank and business collaboration and small and micro-business financing services, and launching small and micro-business incubation scheme featuring 10 000 companies and funds worth RMB 10 billion yuan. Promulgate the *Guiding Opinions on Accelerating the Establishment of Modern Enterprise System and Promoting the Building of Regional Capital Markets*, and accelerate the standardization of SME's transformation. The framework agreement and supervision agreement on regional advantage-collective direct debt financing cooperation for Wenzhou have been signed. Wenzhou municipal government has embarked RMB 100 million yuan as direct debt financing funds for SMEs in Wenzhou.

3. Pilot zone of comprehensive financial reform and innovation in the Pearl River Delta and Qianhai Shenzhen-Hong Kong modern service industry cooperation zone in Shenzhen

As the international financial crisis of 2008 spreads and festers, sharp decline in external demand, fluctuating raw material prices and structural conflicts have hit hard the real economy of the Pearl River Delta. To push forward the reform and development of the region and minimize the adverse impact of the crisis, the State Council decided in June 2012 to launch financial reform and innovation in the Pearl River Delta and Qianhai of Shenzhen. The reform aims at propelling urban finance reform and innovation, enhancing financial integration, fostering closer cooperation among Guangdong, Hong Kong and Macao, exploring multiple ways to capital account convertibility, and setting up a financial cooperation zone of international competitiveness and global influence in close collaboration with Hong Kong international financial center, underpinned by Pearl River Delta financial industry and in alignment with Guangdong's export-driven economy. The reform features the following measures:

Impelling financial product and service innovation and stepping up the building of modern financial market system and financial organization system. Facilitate the access of state-level hi-tech park enterprises in Guangdong to the open share transfer market for national non-listed public companies. Encourage and guide private capital into financial sector. Move forward the pilot program of RMB settlement for cross-border trade and investment, gradually augment RMB circulation and use overseas, and pilot capital account convertibility in Hengqin New District and Qianhai.

Promoting staggered financial development in the Pearl River Delta and optimizing resources allocation. Accelerate the building of modern financial system and top tier financial services cluster in Guangzhou. In Shenzhen, speed up financial reform and innovation centered on demonstration window for opening up experiment, and further the mutual investment and financial cooperation between Hong Kong and Shenzhen. In Fuoshan, guided by efforts to build up Guangdong hi-tech financial services zone, forge a modern financial industry backing base that radiates the Asia-Pacific region. In Meizhou, speed up rural financial reform and innovation. In Zhanjiang, promote financial reform and innovation that coordinates urban and rural development.

Raising regional financial cooperation level. Innovate on RMB business and financial supervision cooperation among Guangdong, Hong Kong and Macao, steadily carry out RMB settlement for direct investment from Hong Kong and Macao, perfect Guangdong-Hong Kong- Macao joint anti-money laundering mechanism, and promote mutual recognition of financial professional credentials as well as talent exchange and training cooperation among Guangdong, Hong Kong and Macao. Where policy allows, support the efforts of qualified Guangdong financial institutions and companies to list on Hong Kong exchanges, issue RMB bonds and trust investment funds in Hong Kong, and allow Hong Kong legal-person banks in Guangdong to engage in sales of securities investment funds. Under the framework of ECFA, gradually deepen Guangdong-Taiwan financial cooperation and pilot cross-strait financial cooperation in Dongguan.

Supporting Qianhai's spearheading role in financial reform and innovation to serve as a demonstration window for China's financial liberalization. Pilot cross-border

RMB lending business in Qianhai, Shenzhen, support locally registered companies and financial institutions to issue RMB bonds in Hong Kong, and explore the establishment of parent fund for Qianhai equity investment. Under the framework of CEPA, moderately lower the threshold for Hong Kong financial institutions to establish offices and engage in financial business in Qianhai.

4. Pilot zone of real economy-servicing financial reform in Quanzhou, Fujian Province

To further enhance the ability of finance to serve the real economy, the State Council decided in December 2012 to pilot comprehensive reform in Quanzhou, with a view to stepping up financial support for small and micro-businesses, improving rural finance services, standardizing private financing, perfecting financial risk prevention mechanism, and establishing and upgrading a diversified financial organization system that serves the real economy. The reform includes the following measures:

Stepping up financial support for small and micro-businesses and improving finance services to rural areas. Guide financial institutions to strengthen cooperation with technology-based small and micro-businesses, and open a special channel of loan approval. Roll out intellectual property right hypothecation loan, share rights-pledged loans for hi-tech companies and insurance of science and technology, and promulgate administrative measures for relevant insurance subsidies. Encourage qualified banking institutions to set up village and township banks in county areas of Quanzhou, and convert rural credit cooperatives into rural commercial banks. Guide financial institutions to boost credit support for agricultural modernization champions, farming, forestry, animal husbandry, fishery, agricultural science and technology, and rural infrastructures such as commercial irrigation and water conservation, and explore lending backed by the right to use sea areas and collective forest tenure.

Strengthening financial cooperation among Quanzhou, Taiwan, Hong Kong, Macau and overseas Chinese. Under the framework of CEPA, guide Hong Kong and Macau financial institutions to set up branches in Quanzhou or invest in Quanzhou legal-person financial institutions, propel qualified companies to go to Hong Kong for IPO and refinancing, impel Quanzhou enterprises or overseas affiliated enterprises to issue RMB bonds in Hong Kong. Encourage qualified Taiwan financial institutions to settle in Quanzhou and allow regulatory requirements-complying Taiwan companies registered in Quanzhou to go public and hold equity in local legal-person financial institutions in Quanzhou. Encourage regulatory requirements-complying financial enterprises established by overseas Chinese financial institutions to set up legal-person entities and branches in Quanzhou, and support overseas Chinese business' practice to hold equity in Quanzhou financial institutions.

Regulating private financing and expanding direct financing. Guide private funds to access the real economy in forms of equity and bond investment, pilot investment funds in petrochemicals, footwear and textile, and endorse the establishment of venture capital guidance funds. Support the transformation of qualified micro-credit companies into village and township banks, and pilot regional advantage-collective bills. Run private capital management and services companies on trial, establish and improve private financing registration and management system as well as monitoring system, and do a good job in private financing tracking and early warning. Where policy allows, standardize the development of property right exchange in brand property right, technology property right, pollution discharge right, water right, carbon emission right and collective forest tenure.

5. Rural financial reform pilot in Lishui, Zhejiang

In April 2012, the PBC and Zhejiang Provincial Government jointly launched a pilot program for rural financial reform in Lishui, focusing on forest tenure mortgage loans, rural credit system building and farmer-helpful withdrawals by bank card. Until now, it has scored positive results.

Deepening the business of forest tenure mortgage loans and increasing collaterals in credit for farmers, rural areas and agriculture. A forest resources circulation platform featuring three centers and one agency both at city and county level has been established, namely, forest tenure management center, forest resources collection and reserve center, forest tenure exchange center and forest resources inquiry and assessment agency, thus forming a complete system ranging from forest tenure assessment, registration, mortgage, guarantee to NPL handling. It has pioneered three new models of forest-backed lending in Zhejiang, namely, micro revolving loans for forest farmers, direct forest tenure mortgage loans and loans guaranteed by forest resources collection and reserve center.

Establishing a fully-covered and dynamic rural credit system and addressing the lagging problem of rural credit system. A model of government-supported, PBC-led, multi-parity-participated and common-benefited was adopted to comprehensively assess rural household credit and establish a three-in-one credit database that covers rural households, residents and companies. With the credit information of 380,000 rural households in the credit database, city-wide information sharing on rural household credit was achieved and a dynamic management system for rural household credit information was established. By the end of June 2012, credit assessment had covered all of Lishui’s administrative villages and 92 percent of rural households.

Achieving full coverage of farmer-helpful withdrawals by bank card and improving weak rural financial infrastructures. With a geographical division of labor between Postal Savings Bank of China and rural credit cooperatives, shops in administrative villages were selected as agents to pioneer administrative villages-full coverage of farmer-helpful withdrawals by bank card through the model of “POS machine + electronic cash register + safe”. All kinds of rural subsidies are coordinated to issue by one card.

On the whole, the above regional financial reform pilots draw on local actualities, deepen institutional and mechanism innovation, actively build diversified financial systems in line with local economic and social development, enhance the financial system’s ability to serve real economy, provide pioneering reference for national financial reform and economic development, and comply with China’s economic reform’s basic experiences featuring overall impetus, breakthroughs at key points and integration of departments and regions at different levels. In the process, the initiative of various parties was stimulated and a financial reform model that marries top-down design and bottom-up drive has initially taken shape, which aligns national deployment with market choice, strikes a balance between financial reform and other kinds of reform, among subset reforms under the financial reform, between the government and the market, thus making a reform path of sound institutional evolution.

III. Outlook

As bottom-up tentative financial reform efforts, regional financial reform pilots are bound to meet new situations and problems, such as overstepping current policies, inadequate coordination mechanism, and blurring department responsibilities. Regional financial reform pilots should correct deviations in progress, control risks and rhythm, and effectively prevent possible negative effects such as spillovers and unfairness. While proceeding with the pilots, the localities should plan scientifically, deploy rationally, tap into respective advantages and achieve staggered competition and differential development. Guidance should be given to the public to face up to the long-term, arduous and complicated nature of financial reform, reasonably understand the objective and meaning of the reform, rationally understand the relationship between financial reform and economic operation, refrain from attributing cyclic and structural economic problems to the financial reform. Public opinions should be guided to appraise the effect of the reform fairly, avoiding the misunderstanding that the reform can have immediate effect. The effect of reform should be evaluated objectively from the mid- and long-term perspective of improving financial efficiency and financing structure. Meanwhile, economic and legal policy support and comprehensive coordination should also be enhanced.

Moving forward, relevant authorities will keep paying close attention to the overall design of the reform as always, press ahead with major top-down financial reform while encouraging local initiative for reform, carry on regional financial pilot programs, incentivize innovation and accumulate experience for gradual popularization.

Special Topic Ⅳ

Shadow Banking

As an integral part of financial market in a broad sense, shadow banking plays a positive role in facilitating social investment and financing. However, since being closely related with the regular financial system, and subject to little or no supervision, its implications on financial stability bear no negligence. Therefore, China should draw upon international experiences, take hold of our own national practice, bring the positive role of shadow banking into full play, and keep a watchful eye on it to safeguard financial stability more efficiently.

I. A Bird's Eye View of Definitions and Characteristics for Shadow Banking Internationally

The origin of the word Shadow Banking could date back to 2007, when the former Managing Director of Pacific Net Ventures Limited, Mecox Lane put forward with the shadow banking to stand for all the leveraged non-bank investment conduits, instruments and institutions. Former U.S. Treasury Secretary, Timothy Geithner called them parallel banking system. In *Global Financial Stability Report, 2008*, the International Monetary Fund (IMF) used the word near-bank for such sort of financial institutions and activities.

After international financial crisis broke out, shadow banking has been widely cited by international organizations, governments and academia. However, national financial systems and regulatory frameworks are far cry from one another, there is not an agreed-upon and clear-cut definition for shadow banking till now. Among a variety of definitions, those formulated by Federal Reserve Bank of New York and Financial Stability Board (FSB) are more representative. Federal Reserve Bank of New York defined shadow banking as credit intermediation engaged in maturity, credit and liquidity transformation, which can not gain liquidity support from central banks or credit guarantee from public sectors, including finance companies, issuers of asset-backed commercial papers, special purpose finance companies, structured investment vehicles, credit hedge funds, money market mutual funds, securities loan institutions and government-sponsored entities, and so forth. While FSB broadly described shadow banking as credit intermediation involving entities and activities outside the regular banking system, and narrowly ring-fenced it to the credit intermediation which could potentially cause systemic risks and regulatory arbitrages due to maturity/liquidity, leverage and non-performed credit transformation, and with the activities mainly concentrated in such fields like money market funds, asset securitization, securities margin trading, repos, etc.

According to Global Shadow Banking Monitoring Report 2012[①] published by FSB,

① The monitoring radius covers all the 24 member states of FSB and Chile, whose total GDP accounts for 83% and total financial assets account for 90% of the global ones. In addition to commercial banks, central banks, public policy financial institutions, insurance companies and pension funds, the broadly described shadow banking in this report also includes other financial intermediaries.

during the times leading up to the recent global financial crisis, assets of global shadow banking ballooned from 26 trillion U.S. dollars in 2002 to 62 trillion U.S. dollars in 2007. After the crisis broke out, the total assets of shadow banking edged down to 59 trillion U.S. dollars in 2008 but quickly backed on track of growing, which stood at 67 trillion U.S. dollars at the end of 2011. Its share to global GDP dropped from 128% in 2007 to 111% in 2011, so did the share to total assets of financial institutions, which declined from 27% in 2007 to around 25% during 2009 to 2011. Internationally, shadow banking are mainly homed in U.S., European Union, and UK. Although has been shrinking largely since 2008, the size of U.S. shadow banking still tops the globe. In 2011, total assets of shadow banking in U.S., European Union, and UK stood at 23 trillion, 22 trillion, and 9 trillion U.S. dollars respectively, with the percentages to shadow banking assets across the globe registered at 35%, 33%, and 13%, while these figures in 2005 were 44%, 31%, and 9% respectively.

Although differs in definitions, shadow banking plays similar roles in regular banking intermediation, and has some features in common such as high leverage, unstable funding resources, falling short of credit support from central bank. Shadow banking transforms those opaque and risky long-term assets into short-term liabilities which seem to be less risky or even risk free. As a result, once confidence collapses, "run" is followed. When asset price is climbing and margining rate for secured funding is running low, the leverage will be further jacked up through securitized financing. Meanwhile, since being intertwined with regular banking system, shadow banking relies heavily upon bank funding, therefore, risks can easily spillover into the regular banking system, even be amplified in manifolds through the longer and more opaque transforming channels.

II. Policies taken by international organizations and major economies to strengthen supervision over shadow banking

In 2008, ensuing the breakout of international financial crisis, international organizations such as FSB delved into the regulatory policies for shadow banking. Regulations and policies were launched by U.S., Europe and Japan, and supervisory tools for shadow banking were sharpened.

1. International organizations

In October 2011, FSB published *Shadow Banking: Strengthening Oversight and Regulation*, in which put forward with the basic approaches and specific suggestions to strengthen the regulation of shadow banking. In November 2012, FSB published series report *Strengthening Oversight and Regulation of Shadow Banking(Consultative Document)*, thrashing out the overall direction and policy options for monitoring and supervising the shadow banking system.

Moreover, FSB put forward out a two-step approach to safeguard against shadow banking risks. First, cast the monitoring net wide and keep a close eye on all non-bank credit intermediation to ensure the net covers all areas where shadow banking-related risks might potentially arise. Second, narrow the focus on the subset of non-bank credit intermediation involving systemic risk and regulatory arbitrage.

On the monitoring front, FSB argued that authorities should assess the size and development of shadow banking based on Flow of Funds, Balance Sheet and other regulatory data. Importance should be attached on special fields where systemic risks could be triggered, such as term and liquidity transformation, credit risk shift and leverage, etc. Monitor should be flexible and forward-looking to fend off systemic risks and regulatory arbitrage caused by shadow banking innovations and mutations. Over the summer of 2012, FSB conducted its second annual monitoring exercise targeting at the shadow banking system. In comparison with the first one, this round of exercise added new insights on interconnectedness between banks and non-bank financial entities, and planned to perfect the monitoring exercise next year by obtaining more accurate data on assets/liabilities as well as expanding activity-based and risk-based monitoring.

In the regulatory regard, FSB, BCBS and IOSCO jointly published five general principles for regulating the shadow banking system. First is focus: regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates. Second is proportionality: regulatory measures should be proportionate to the risks shadow banking poses to the financial system. Third is forward-looking and adaptable: regulatory measures should be forward-looking and adaptable to emerging risks. Fourth is effectiveness: regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions. Fifth is assessment and review: regulators should regularly assess the effectiveness of their regulatory measures and make adjustments as necessary.

Based on the general principles mentioned above, FSB, BCBS and IOSCO suggested supervising shadow banking from five fronts. Firstly, tightening the regulation over bank's interactions with shadow banking entities, hammering out specific policy measures in three areas such as scope of consolidation, large exposures and bank's investment in funds, and ironing out the spillover effects between regular banks and shadow banking. Secondly, deepening reforms for money market funds, through improvements in investments, valuation, liquidity management, offering net asset value, use of credit ratings, disclosure and repos, pushing the supervision into a higher level, minimizing the "run" risk. Thirdly, putting more efforts on regulating other shadow banking entities, according to management of client cash pools with features that make them susceptible to runs, dependence on short-term loans, intermediation of market activities that is dependent on short-term funding or on unsecured funding, facilitation of credit creation, and securitisation and funding of financial entities, identifying and assessing risks in other shadow banking entities, introducing policy toolkits including capital and liquidity requirements, leverage caps, asset concentration limits, redemption threshold, redemption fees, and so forth. Fourthly, supervising the securitization activities, through requiring issuers retaining some risk positions, improving disclosures, encouraging standardisation of securitization products, allaying systemic vulnerabilities and negative incentives caused by securitization. Fifthly, regulating securities funding market, in particular securities lending and repos, mitigating risks by improving regulatory reporting, enhancing market transparency, strengthening disclosures, clarifying minimum standards for haircut practices, limiting risks associated with cash collateral reinvestment, and establishing central clearing system, etc..

2. Major Jurisdictions

Putting shadow banking under regulation. *Dodd-Frank Wall Street Reform and Consumer Protection Act* encloses private equities and hedge funds into the regulatory radius, prescribing that private equities, hedge funds and other investment advisory firms with the capital over 100 million U.S. dollars should register at the Securities and Exchange Commission (SEC), while those with the capital falling short of 100 million U.S. dollars should register at state regulatory authorities. European Council requires that hedge funds, private equity funds with the capital over 100 million euros should get the approval of home countries, disclose risk exposures and performance to host countries, and meet the minimum capital requirement.

Lifting up the regulatory threshold. U.S. set up capital and margin requirements for entities involving in swap trading, introduced new measures to strengthen the supervision over money market funds, stipulated that high liquidity securities assets of money market funds must meet certain requirements, further reduced money market funds risks by restricting investment in risky bonds and shortening portfolio duration. European Union set up the minimum capital standards for alternative investment funds. UK improved the regulation over financial products like mortgage and credit derivatives, and enhanced the supervision over hedge funds.

Boosting recovery and sound performance of securitization market. U.S. requires securitization institutions must retain at least 5% credit risks when shifting or selling any kind of assets by issuing asset-backed securities, in addition, securitization institutions are not allowed to hedge or transfer retained credit risks directly or indirectly.

Standardizing derivatives trading. U.S. introduced a package of new measures concerning capital, margin and reporting of derivatives trading, which requires all standardized derivatives must be traded on the regulated platforms and subject to central clearing. Derivative tradings are jointly supervised by SEC and Commodity Futures Trading Commission. European Union and UK both require derivatives must meet the standards, and introduced central clearing system to enhance the counterparty risk management of OTC derivatives. With regard to OTC derivatives, Japan established central clearing and trading information reporting system.

Isolating shadow banking from regular banks. The Volcker Rule bans large-sized financial institutions from high-risk proprietary trading. When a bank invests in hedge funds and private equity funds, the capital it plans to pump should not exceed 3% of funds' capital. This cap is also applied to the bank's lever 1 capital. Besides, banks should not bail out the funds they invested in.

III. Development and Implication of Shadow Banking in China

Due to its own financial market, financial system and regulatory framework, China's shadow banking is not quite the same with those generally defined by international organizations. However, many entities are stealing the limelight from all circles of society for running banking business but not in the name of banks. With reference to the international definitions, and taking our national situation into full account, we define China's shadow banking as credit intermediation involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation, which could potentially cause systemic risks or regulatory arbitrage.

In China, there are some non financial institutions engaged in funding activities, such as small loan companies, pawn shops, credit guarantee companies, private equity funds, rural mutual financial organizations, and various private lending institutions. These institutions and the business bear resemblances as shadow banking. By the end of 2012, China had 6 080 small loan companies, with the loan balance 592.1 billion yuan; 6 084 pawn shops, with pawning balance 70.61 billion yuan; 8 590 credit guarantee companies, 16 000 pilot projects of impoverished villages mutual development funds. Some off-balance-sheet wealth management products(WMP) pool the cash together to achieve maturity transformation, while some trust schemes roll the short-term funds over time and again into the medium and long-term projects. More than that, money market funds buy financial bonds, invest in banking deposits, engage in money market repo trading, etc., which no doubt increase the bank credit and social credit, while buying corporate bonds and short-term financing bills back up the enterprises with debt capital. By the end of 2012, China's money market funds reached RMB 707.541 billion yuan.

With regard to size and risk, China's shadow banking is dwarfed by its international counterparts. The financing channels are similar to those in the traditional banking, and the access to capital and credit from regular banking system is limited. China's shadow banking seldom resorts to financial derivatives to create credit; on the contrary, driven by financing demand, its operations only partially substitute the commercial banking loans. China's shadow banking mainly tailors to enterprises, particularly medium and small-sized ones which do not have access to regular banking loans. Therefore, the leverage is not so high, with the major risk lying in illegal operations.

As a result of financial market evolvement, shadow banking, to some degree, shoulders the financing burden with banks upon which are heavily dependent for financing, and meets the financing demand of real economy. Investment channels are branched out for residents and enterprises. The whole financial market gets a shot in the arm by shadow banking in liquidity and dynamics. Price discovery of financial market is more acute, while investment and financing efficiencies are further enhanced.

If effective oversights are not in place, shadow banking will harbor high risks. Firstly, it will counterbalance the effectiveness of macro control and financial management. Some shadow banking entities pump the capital into local government financing platforms(LGFP), real estate sector, and industries with high pollution, high energy consumption and excess capacity, driving a wedge into the macro control and economic structural adjustment. Secondly, risks will spill over into the traditional financial system. Shadow banking is interconnected with traditional financial system in funding resources and business, if the fire wall is not in place, risks will spread across the industries and markets. Some enterprises gain funding from commercial banks and shadow banking simultaneously, they probably pay back the shadow banking with the funding raised from commercial banks. Thirdly, shadow banking will affect the daily operations of regular financial institutions. The earning ratios of some shadow banking products are unreasonably high, which misleads the clients and fuels the unfair competition, crowding out some business of regular financial institutions. Fourthly, parts of shadow banking are not standardized supervised. Some non financial institutions like small loan companies, pawn shops, credit guarantee companies, all tend to expansion, pay little attention to risk management, and the daily operations are not put under the regulatory umbrella, as a result, operating beyond the business lines becomes widespread.

IV. Strengthen Monitoring and Management to Fend off Potential Risks of Shadow Banking

For problems and potential risks posed by shadow banking in its development, authorities should supervise wisely, build up statistical monitoring system, deepen financial reforms like interest rate liberalization, and forge a diversified and multi-layered financial system to fend off regional and systemic financial risks.

Press ahead with the management of shadow banking. For shadow banking engaged in liquidity transformations, capital and liquidity requirements should be imposed accordingly, and disclosure should be enhanced to improve the transparency. Fire wall needs to be built to fend shadow banking risks off the traditional banking system. Management over the small loan companies, credit guarantee companies and pawn shops should be reinforced, cap the leverage and remedy illegal operations in a timely manner. Central bank should put shadow banking on its financial statistical list, and optimize statistical system of social financing. Authorities should beef up information sharing and regulatory coordination to improve contingency plans, take advantage of international experiences to thrash out a proper regulatory radius, and improve regulatory standards and requirements.

Encourage financial reforms and innovations to bolster the real economy. At the fundamental demand that finance should serve the real economy, regulatory authorities should promote the build-up of multi-layered financial market, increase the amount of direct financing, promote the development of direct financing tools like bonds and securities, optimize social financing structure, reduce the over-reliance on bank loans, bring the market's fundamental role in resource allocation into full play, advance the reforms of interest rate liberalization and RMB exchange rate formation mechanism, positively expand the pilot credit asset securitization, guide long-term funding like insurance funds to pump into asset securitization, and fulfill the investment and financing demands of real economy.

Build a diversified and multi-layered financial system. Regulatory authorities should expand the financial market access, encourage private capital to establish small-sized community financial institutions, develop diversified and heterogeneous business models and products, solve such problems as under-service of rural finance and financing difficulties faced by small and micro enterprises, promote the establishment of deposit insurance system, cultivate medium and small-sized financial institutions, and forge a more competitive, diversified and open financial system.

Reinforce risk prevention and strengthen resolution. Regulatory authorities should be more stringent on management of LGFPs, real estate sector, and industries with high pollution, high energy consumption and excess capacity, wipe out the direct and indirect financing through shadow banking, make it crystal clear that local governments' duty should fall upon regional financial management and risk resolution, standardize and guide local financial market discipline, resolute more decisively and harshly towards illegal fund-raising, formulate contingency plans for regional financial risk resolution, and combat all kinds of risk events efficiently.

Special Topic V

The Resolution Regime for Financial Institutions

As both the theoretical research and events have shown, the effective regulation and supervision can not eliminate the possibility of failure. For failing or failed financial institutions, orderly resolution regime should be an option to restore its operating capacity or allow it exit the market in an orderly way, with an view of avoiding the disruption of the financial system, promote market efficiency and safeguard depositors and taxpayers' interests. Since the 2008 international financial crisis, great efforts have been taken by the national authorities and international communities, including Financial Stability Board (FSB), to develop a robust resolution regime for financial institutions. It is also important for China to further improve the legal system regarding resolution regime, introduce the deposit insurance system and strengthen the capacity to prevent and resolve systemic risks.

I. The need for the resolution regime and its framework

The financial failures have important implications on social and financial stability. The failure of individual financial institution will harm the interests of its creditors, depositors and investors, cause the risk contagion to other financial institutions through the asset and liability inter-correlation and probably lead to financial panic. Against the backdrop of financial globalization and deregulation, the failure of financial institutions with cross-border operations will exert influences for other countries and regions as well. The lack of a robust resolution regime will not only cause the disruption of critical services due to failure of financial institutions but also the rising cost of bailout, serious moral hazard and distorted the market competitive mechanism. The imperatives of building a robust resolution regime and authorizing the authority a wide range of resolution powers therefore lie in the need to reduce the destruction of financial failure to other financial institutions, financial markets, financial infrastructure and the real economy as well as protect depositors' interests to the maximum extent.

The events in the 2008 financial crisis highlighted the deficiencies of some countries' resolution regime for financial institutions. Firstly, the ordinary corporate bankruptcy procedures is not a good option for resolving the failed financial institutions, which takes long time and bring uncertain outcomes for stakeholders and do not take into account the systemic consequences. Secondly, bail-out of financial institutions heavily relies on the funds of the central bank and government, which increased the financial burden of taxpayers and moral hazard. Thirdly, a number of factors hampered the efficiency of crisis resolution, including ambiguous resolution authority, inadequate tools and mechanisms as well as the government's inability to limit shareholders' rights. Fourthly, the substantial difference in legal and institutional arrangements inevitably led to divergence in depositor protection and cross-border resolution cost-sharing among different countries.

The lessons from the recent international financial crisis highlighted the key elements of the resolution regime for financial institutions as follows:

Firstly, there should be designated resolution authorities. Jurisdictions should have one or more administrative resolution authorities, empowered with adequate resolution experiences, qualified human and resources as well as sound governance to avoid internal conflict of interests. Where there might be multiple resolution authorities in resolving financial groups, the leading authority should be designated and be responsible for coordinating the resolution actions of different authorities. The resolution authority can be the existing agency or the newly established agency, operating in line with the objectives including maintaining financial stability, ensuring the continuity of critical financial service, protecting the interests of depositors, investors and policy-holders, avoiding the destruction of value, minimizing the resolution costs and taking into account of negative impacts on other jurisdictions' financial stability.

Secondly, the resolution authority should be given a wide range of resolution powers and tools. The important resolution powers include being able to temporarily taking e over problem financial institutions, compulsory transfer of the asset and liability, set-up of the asset management vehicle for bad asset separation, setting up the "bridge bank", limiting the shareholders' rights and removing culpable senior management, requiring shareholders absorb losses and unsecured creditors take loss by the "bail-in", adjusting or terminating the financial contracts, reimburse depositors, investors, and policyholders in a timely and orderly way.

Thirdly, adequate funding should be in place for resolution. The deposit insurance fund or specialized resolution funds should be the first option. The public funds may be used as the last resort on the condition that shareholders and unsecured creditors have taken the losses. In case public funds were utilized, the loss recovery mechanism should be predetermined.

Fourthly, jurisdictions should have the well-designed and effective resolution procedures. Early intervention of the problem financial institutions should be allowed to prevent risks escalation. Liquidation of failed financial institutions should be avoided while resolution measures conductive to maintain the continuity of critical financial services should be encouraged and facilitated, including mergers and acquisitions, bridge institution mechanism, asset and liability transfer. The government should be authorized to temporarily place problem financial institutions into public ownership to maintain financial stability as well. The judicial review procedures should be in place to safeguard the interests of creditors.

Fifthly, cross-border cooperation and coordination in resolution should be further enhanced. The legal and institutional arrangements for cross-border resolution should be in place, making sure that the home authority should consult with host counterparty in case of resolution of financial institutions; the host authority should admit the effectiveness of resolution actions taken by home authority and treat domestic and foreign creditors fairly. The information sharing mechanism should be strengthened among various authorities, including central bank, regulatory authority, resolution authority, and ministry of finance both at domestic and cross-border level. The resolution arrangements for those Globally Systemically Important Financial Institutions (G-SIFIs) should be in place, including establishing the crisis management groups, making recovery and resolution plans, making periodic resolvability assessment.

II. Progresses by international organizations and major economies in strengthening the robust resolution regime for financial institutions

The Pittsburg Summit of G20 asked to develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future. The Toronto Summit of G20 called upon to incorporate effective resolution regime into the policy framework of systemically important financial institutions. Currently, achievements have been made by FSB and other major international organizations as well as major economies, like United States, United Kingdom and European Commission.

1. International Organizations

Key Attributes of Effective Resolution Regime for Financial Institutions. FSB's *Key Attributes of Effective Resolution Regime for Financial Institutions* was released in November 2011, as its implementation of G20's commitments, which set out the key elements that are considered to be included in developing an effective resolution regime for the first time. According to the *Key Attributes*, the resolution regime should be applied to any financial institution that could be systemically important. Each jurisdiction should designate one or more resolution authorities to exercise the resolution powers within the scope of the regime. Resolution authorities should have at their disposal a broad range of resolution powers, such as overriding the rights of shareholders of firm in resolution, removing culpable senior management, establishing a temporary bridge institution, transferring or selling assets or liabilities without pre-approval by shareholders, carrying out the "bail-in" with unsecured creditors. Jurisdictions should have the funding mechanism in place so that resolution authorities are not constrained to reply on public bailouts. When public funds used for resolution incurred losses, the recovery mechanism should be in place to make shareholders and creditors bear losses first and if necessary, require industry assessments as well. For the resolution of cross-border financial institutions, information sharing and coordination shall be enhanced among relevant authorities. For the resolution of G-SIFIs, specific resolution arrangements should be in place, including establishing the crisis management group, making recovery and resolution plan as well as carrying the resolvability assessment. According to the

Key Attributes, the recovery plan is made mainly for illustrating what measures would be taken by the financial institution itself when it get into difficulty. The resolution plan is made mainly for illustrating what actions would be opted by the resolution authority and supervisors to keep the continuation of the institution's core business to the maximum extent and minimize the resolution cost.

Peer Review of Resolution Regime. The first peer review of FSB member jurisdictions' resolution regime was completed in March of 2013. The review indicated that most jurisdictions have adopted the special resolution regime for banking institutions, but the effective resolution regime for securities and insurance companies still lag behind. Most jurisdictions push forward the legislation to reform and improve the existing resolution tools and measures, setting up the resolution funding arrangements. Most G-SIFIs have had the crisis management groups (CMGs) in place and have initiated the recovery and resolution planning , some of them have launched the resolvability assessments.

Core Principles for Effective Deposit Insurance System. Given its significant role in ensuring the problem financial institution exit the market orderly and protecting depositors' interests, the deposit insurance system have been developed as the resolution platform in many countries. In June, 2009, BCBS and IADI jointly issued *Core Principles for Effective Deposit Insurance System*, the main contents of are as follows. Firstly, an effective deposit insurance system should reduce moral hazard by proper design such as compulsory membership, limited coverage, protecting most depositors' interests and adequate funding. Secondly, the deposit insurer should be involved in the early detection, intervention and resolution of problem banks, mandated with full-scope access to information and on-site examination. Thirdly, public awareness of deposit insurance should be fostered and the cooperation among deposit insurer and other financial safety net participants should be strengthened.

2. Major jurisdictions

2.1 United States

In the United States, the Federal Deposit Insurance Corporation (FDIC) enjoys a broad range of resolution powers to deal with problem and failed banks with deposit insurance fund. The FDIC can effectively dispose of assets and liabilities of the bank in resolution by means of "purchase and assumption", "bridge bank" and "open bank assistance", where the resolution costs can be strictly controlled. During the 2008 international financial crisis, the FDIC lifted deposit insurance ceiling from USD 100 000 to USD 250 000, offered temporary guarantee for eligible senior unsecured debt of insured banks and other financial institutions, encouraged private equity to buy the failed banks through issuing *the Guidance on Acquisition of Failed Banks by Private Capital*. Though there were over 400 bank failures in the crisis, the timely and efficient resolution actions of the FDIC help to maintain public confidence and the stability of banking system.

In July 2010, the release of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* further expanded the FDIC's mandates and established the systemic risk mitigation and resolution regime c composed of Federal Reserve and the FDIC.

First of all, the resolution powers of the FDIC will be expanded to the non-bank institutions that are systemically important. Secondly, all the SIFIs are required to submit Resolution Plan (living will) to the FDIC and the Federal Reserve. If such plans were proved to be unqualified, the Federal Reserve and the FDIC would jointly issue strict regulatory requirements for the SIFI and limit its business expansion. Thirdly, the Treasury, the Federal Reserve and the FDIC jointly decide to initiate the Orderly Liquidation Authority, the FDIC would be authorized to take over and liquidate the SIFI , take assets and liabilities by establishing one or more bridge financial institutions. Fourthly, the loss recovery mechanism would be put in place where the public fund may be used temporarily. However, when losses occurred, the shareholders and unsecured creditors will absorb first and then, if it was insufficient, charges against the financial institutions with total consolidated assets over USD 50 billion would be required. Fifthly, the FDIC would be responsible for strengthening the cooperation and coordination with foreign authorities in the resolution of cross-border institutions.

As its important effort in implementing the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, the FDIC issued the paper of "The Resolution of Globally Systemically Important Financial Institutions" jointly with Bank of England in December 2012. It proposed the resolution strategy of applying resolution powers to the top of a group , assigning losses to shareholders and unsecured creditors rather than taxpayers, removing senior management and punishing culpable management. The resolution action will take place at the parent holding company level in the home country so that the operational continuity of domestic and foreign subsidiaries can be ensured.

2.2 United Kingdom

The banks in the U.K. were subject to the corporate insolvency regime before 2009. During the 2008 international financial crisis, the U.K. government had to bail out problem financial institutions. With the release of the Banking Law in 2009, a special resolution regime for banks was introduced. First, maintaining financial stability should become the prime objective and the key of banking resolution. Second, designate the Bank of England as the resolution authority, while the division of labor among the BOE, other regulatory authorities and ministry of finance is defined. Third, endow the Bank of England with a wide range of resolution powers, including selling part or whole business without the approval of shareholders and creditors, establishing the bridge institution to maintain the continuity of business and nationalizing institution if necessary. Fourth, the creditor protection mechanism should be established, the operating profits of bridge institutions and nationalized institution should be returned to the creditors, while following the creditor hierarchy stipulated by the Bankruptcy Law. Fifth, the depositor protection was further enhanced with lifting the insurance coverage to 850 000 pounds. The *Resolving the Globally Systemically Important Institutions* jointly issued by the Bank of England and the FDIC at the end of 2012 stated that the U.K. was considering further expanding the scope of the resolution regime, aiming to cover security firms, insurance firms, CCP (Central Counterparty) and non-CCP financial infrastructures.

2.3 European Union

The 2008 financial crisis suggested that the resolution regime in EU was lagging far behind international peers. Reforms of the existing resolution regime began in 2009. The draft directive of *Establishing a framework for the recovery and resolution of credit institutions and investment firms* was put forward by the European Commission in June 2012. First, the resolution regime for all credit institutions, investment firms, financial groups, mortgage loans or commercial loans non-bank institutions, and subsidiaries in EU of non-EU financial institutions should be set up. Second, member countries should designate one or more specific resolution authorities from central bank, regulatory authority, ministry of finance or deposit insurer. Third, financial institutions and regulators should make recovery and resolution plans, the resolution authority and regulators should conduct resolvability assessments. Fourth, early intervention and resolution powers are further enhanced, including transferring partial or all assets of the institution in resolution, establishing the bridge institution, divesting the bad assets to special asset management entity, introducing the "bail-in" mechanism, converting the debts into equities while making feasible restructuring plans. Fifth, member countries should have the adequate resolution funding in place, where the ex-ante funding from the industry is the recommended practice while ex-post funding and funds from the central bank should serve as the back-up. Issues concerning creditor safeguards, financial group resolution and cross-border resolution coordination are also addressed in the Directive.

III. China's Progress in establishing the effective resolution regime for financial institutions

Great achievements have been made in China's financial sector since the reform and opening up policy was carried out. However, some financial risk events emerged in the middle of 1990s, particularly after the Asian Financial Crisis. With the close cooperation among the People's Bank of China, other relevant authorities and the local governments, a number of measures, including the mergers and acquisitions, suspending business for rectification, charter revoking, closing and applying for bankruptcy, were employed to deal with financial institutions that engaged in illegal and unsafe operations to prevent the spread and contagion of financial risks.

1. Practices in the resolution of financial risks

In disposing the risks of financial institutions, China make great efforts to build the financial safety net consistent with socialism market economy, under which the costs of resolution should be compensated by developing the effective mechanisms and positive incentives. The focus of such efforts should be to prevent moral hazard, to continuously improve the risk compensation and market exit regime, to enhance the resolution regime, to introduce more effective resolution measures and to promote the financial stability in the long run.

Firstly, measures have been taken to implement the new compensation rules for individual investors. The release of *Guidance on Purchase of Individual Investor Claims and Customer Transaction Clearing Funds* jointly by the People's Bank of China, Ministry of Finance and China Banking Regulatory Commission in 2004, during the time of disposing risks arising from Delong Financial Group, changed the historic rule of full compensation for individual investors and made the 10 percent discount compensation for individual investors' claims over RMB 100 000 yuan. In the afterward, the release of *Supplementary Guidance on Purchase of Individual Investor Claims Issues*, set the accumulative compensation rule under which the discount will increase with the balance of claims until those over RMB 3 million yuan will not be compensated at all. The implementation of the new compensation rules get the government released from full protection of individual investors' claims, strengthen the market discipline, reduce the moral hazard, promote the investors' risk awareness and maintain the investors' confidence in the banking system and security markets in the long run.

Secondly, the investor protection programs in the securities, future and insurance sectors have been established. In the process of comprehensive restructuring of securities firms and resolving the risks of medium and small sized non-bank financial institutions, the People's Bank of China and relevant government agencies jointly pushed forward establishing investor protection programs in the securities, future and insurance sectors, with an aim to prevent moral hazard arising from the use of central bank funds in purchasing individual investors' claims and compensating gaps of such claim accounts, to develop the effective resolution regime for financial institutions and to better protect investors' interests. The Securities Investor Protection Fund and the Policyholder Protection Fund were established respectively in August 2005 and in September 2008, introducing the long-effect investor protection mechanism in these sectors.

Thirdly, the special asset management entity has been established. To better manage the central bank lending used for financial stability purpose and ensure the recovery of such funds, the Huida Asset Management and Trust Co., Ltd. was set up in August, 2005. The company employed various measures to ensure the recovery of central bank funds, including facilitating the debt repayment, asset restructuring, auction, substitution and risk subrogation. The company also played an important role in coordinating the asset management companies to participate the market-based disposition of bad assets arising from the shareholding reform of state-owned commercial banks and helped to facilitate the program of debt restructuring and debt conversion to equity for many state owned enterprises.

Fourthly, the innovative resolution measures have been carried out. The market-based measures like converting debt into equity have been adopted at the disposal of problem financial institutions' assets for the sake of safety of public funds. In April, 2011, with the close cooperation and coordination between the People's Bank of China and local governments and with the approval of State Council, a certain proportion of the central bank lending to Shantou City Commercial Bank were converted into equities, including both principal and interests. The name of the bank was then changed as Guangdong Huaxing Bank and the local financial risk was mitigated efficiently.

Fifthly, continuous efforts have been made to establish the deposit insurance system. The effort of the People's Bank of China promoting set-up of deposit insurance system can be dated back to 1997. Since 2004, the People's Bank of China, working together with the National Development and Reform Committee, the Ministry of Finance, the Legal Affair Office of State Council and the China Banking Regulatory Commission, reviewed the necessity and feasibility of setting up the deposit insurance system as well as the basic framework of the system in China. The National Finance Conference held in January, 2012 required the government further improve its proposal of deposit insurance system and consider the proper time for establishing the system. Currently, the People's Bank of China, working closely with related government agencies, are continuously improving the implementation plan of deposit insurance system, pushing forward to set up the system as early as possible.

2. Deficiencies in current resolution regime

Overall speaking, experiences have been accumulated in developing an effective resolution regime for financial institutions while some deficiencies still exist in current regime and need to be addressed. Firstly, it lacks the early intervention of problem institutions. Though it is stipulated by laws that authorities may take over and revoke the licenses of high-risk banks, securities and insurance firms, the legislation is too general for practice and there are not effective measures to urge problem institutions replenish capital positions and recover the operating capacity. Therefore, it was difficult to safeguard depositors' and creditors' interests in resolution actions, with little valuable property left. Secondly, most of the resolution measures are not market-based. The measure of business suspension and license revoking are the most common way to deal with high-risk financial institutions while the market-based mergers and acquisitions were seldom used, which can be flawed for its opaque resolution procedures and operations, low efficiency and time-consuming nature. Thirdly, the investor protection system need to be further improved. Due to lack of explicit deposit insurance system and market-based market exit regime, the government provided implicit full protection for depositors when banks fail, which can reduce market discipline and foster moral hazard. Fourthly, the considerable resolution costs increase the burden on public finance. Given the specific background of transformation of China's economy, the fiscal strength was weak and the financial safety net was still underdeveloped, the resolution costs have to be born by expanding the balance sheet of central bank. Fifthly, there is not a clear agency responsible for the resolutions. The resolution actions involve the duties of the central bank, ministry of finance, sectoral supervisors and local governments. The division of responsibility among different authorities should be further clarified, the coordination should be enhanced and the resolution efficiency should be further enhanced. Sixthly, current legal system needs to be strengthened. The legislation concerning bankruptcy regime and deposit insurance system should be proceeded. The laws and regulations, like Corporate Bankruptcy Law, are too general for practice and the laws of different levels should be better aligned.

IV. Advices for developing an effective resolution regime

Developing an effective resolution regime for financial institutions will help better implement macro-adjustment policy and financial supervision, play the fundamental role of market in resource allocation, and prevent and mitigate systemic risks. Drawing on international experiences and taking into account China's specific circumstances, further efforts need to be taken in the following aspects.

Firstly, there should be a specific resolution authority, working effectively with other agencies. In the resolution regime, the authority with financial stability mandate should play a leading role and work closely with other relevant agencies, strengthening the corporation and coordination of various policy tools. The resolution authority should be equipped with necessary resolution powers, including recapitalization, bad assets divesture, taking over problem institutions, facilitating the restructuring, restrictions on shareholders' rights and punishing culpable management.

Secondly, the market-based resolution regime should be improved. The fundamental role of market should be played fully in the resolution regime, with a view of resolving the financial institutions in an orderly and stable manner by transferring the critical services, maintaining the continuity of financial services and fostering the competitive market for financial asset management.

Thirdly, the deposit insurance system commensurate with China's circumstances should be established as early as possible. The explicit deposit insurance system should be set up as soon as possible, with specific coverage, reasonable compensation limits, clear premium collection criteria, effective deposit insurance fund management, sound governance and adequate mandates of deposit insurer. Give full play to the deposit insurer in the resolution regime, endow it with the early intervention of problem institutions, set out the standards, procedures and conditions for the use of deposit insurance fund , develop the asset purchase and liability compensation mechanisms.

Fourthly, the loss recovery and risk sharing mechanism should be in place to ensure the safety of public funding. First of all, the responsibilities of problem institutions, shareholders and creditors should be further reinforced; management, shareholders and creditors should bear the resolution cost, preventing moral hazard. After the shareholders absorb the losses, the residual losses should be further born by creditors, including bondholders, institutional creditors and uninsured depositors. In the second place, the lender-of-last-resort function of central bank should be improved while recovery mechanism of public funds should be in place. The central bank lending can be the back-up funding for deposit insurance system, which mainly are used as liquidity support to problem financial institutions. If there is a systemic risk, Central bank still needs to play the role of the lender of last resort to safeguard the stability of financial system. The losses of public funds incurred in the resolution should be made up firstly by the shareholders and creditors, or special charges from institutions if necessary.

Fifthly, the resolution regime for systemically important financial institutions should be established. For all the SIFIs, the crisis management groups consisting of delegates from the central bank, the ministry of finance, supervisor and resolution authority should be established and be responsible for making resolution strategies, recovery and resolution plans as well as resolvability assessments. The resolution authority should also strengthen the communication and coordination with foreign counterparties to facilitate the cross-border resolution.

Sixthly, the legal system and enforcement of law should be further enhanced. The deposit insurance legislation and the enactment of Deposit Insurance Regulations should be speed up, setting out the mandates and institutional arrangements of deposit insurance system. The other investor protection programs, namely the security investors' protection, the future investor guarantee fund and the policyholder protection fund, should be further improved. The legal system of financial institutions' bankruptcy should be developed in accordance with China's circumstances, regulating market-exiting procedures for financial institutions and improving alignment between the administrative measures and judicial procedures. Efforts should be made to further improve the law enforcement system, strengthen outreach and education on financial legislations, improve enforcement of financial laws, and enhance the efficacy of enforcement.

Appendix I

A Quantitative Analysis of the Soundness of Banking Sector: the Case of 17 Major Commercial Banks

In 2012, China's banking sector ran stably in general with assets size, capital position and risk management continued to improve, banking sector indicators remained favorable. In order to analyze the operational condition and evaluate the risk profile of the banking sector, we selected 17 major commercial banks① (hereafter referred to as major commercial banks) with aggregate assets accounting for 63% of total assets in all banking institutions②, and conducted a quantitative analysis in terms of profitability, assets, liabilities, capital and liquidity.③

I. Profitability Analysis

1. Breakdown Analysis of ROE

In 2012, the ROE of major commercial banks registered 20.72%, 0.56 percentage points lower than last year. Breakdown analysis showed that the decrease of ROE was primarily attributed to the reduction of profit margin and leverage ratio (Table B1.1), as well as slight increase of risk-adjusted return and operational risk. Risk-adjusted return of major commercial banks has increased for two consecutive years, indicating that the risk management kept improving. Increasing operational risks showed that banks held more risky assets, dropped profit margin suggested banks' profitability declined slightly, whereas leverage ratio has fell for three consecutive years, showed that soundness of the banking sector was strengthened.

The comparison analysis suggested that LCBs'

Table B1.1 ROE Breakdown of 17 Major Commercial Banks

	Profit margin (In percent)		Risk-adjusted return (In percent)		Operational risk (In percent)		Leverage ratio (In percent)		ROE (In percent)	
	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012
17 Major Commercial Banks	26.86	26.65	8.51	8.53	56.57	56.94	16.46	16.01	21.28	20.72
5 Large Commercial Banks (LCBs)	31.28	29.22	7.68	8.15	55.04	55.77	16.12	15.52	21.32	20.60
12 Joint-stock Commercial Banks (JSCBs)	18.29	21.11	10.76	9.50	61.20	60.09	17.55	17.51	21.15	21.11

Note: ROE= Net Profits after Tax/Operating Income × Operating Income/Average Risk-weighted Assets × Average Risk-weighted Assets/Average Total Assets × Average Total Assets/Average Owner's Equity = Profit Margin × Risk-adjusted Return × Operational Risks × Leverage Ratio

Source: The CBRC.

① Including the 5 large commercial banks(ICBC, ABC, BOC CCB and BOCOM), and 12 JSCBs(China CITIC B ank, Everbright Bank ,Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Bank Corporation, Evergrowing Bank, China Zheshang Bank and Bohai Bank).

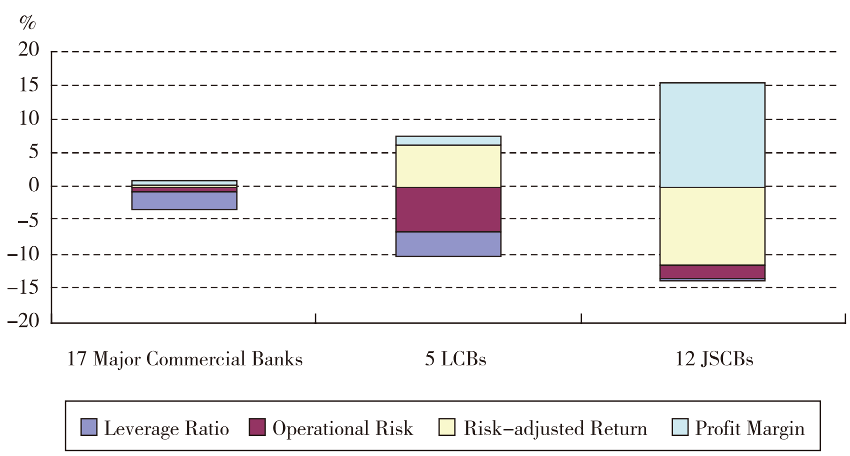
② Including policy banks, state-owned commercial banks, JSCBs, urban commercial banks, rural commercial banks, rural cooperative banks, foreign banks, UCCs, RCCs, non-banking institutions(TICs, finance companies, finance leasing companies, auto fiancé companies and money brokerage companies) and PSBC.

③ Data source: PBC, CBRC, calculated on the aggregated data of the legal entities.

ROE was lower than that of JSCBs. The results of ROE breakdown analysis showed that, the former had almost 8.11 percentage point higher profit margin than that of the latter, but lower risk-adjusted returns, operational risks and leverage ratio. In that case, the JSCBs should further enhance their operational efficiency, reduce operational risk and improve their soundness, while the LCBs should improve risk management.

In 2012, the risk-adjusted return and operational risk of major commercial banks increased by 0.27 and 0.64 percentage point on y-o-y basis, while the margin profits and leverage ratio went down by 0.78 and 2.73 percentage points respectively (Figure B1.1). Specifically, the risk-adjusted return and operational risk of LCBs wentby 6.08 and 1.32 percentage points respectively, while the margin profits and leverage ratio went down by 6.6 and 3.76 percentage points respectively. The risk-adjusted return of JSCBs increased by 15.4 percentage points, while the operational risk, margin profits and leverage ratio went down by 11.68, 1.81 and 0.27 percentage point respectively.

Figure B1.1 Fluctuations in ROE Breakdown of 17 Major Commercial Banks



Source: The CBRC.

2. Income Structure Analysis

In 2012, the major commercial banks' net operating income amounted to RMB 2.52 trillion yuan, up 16.07 percent y-o-y. In particular, the net income of LCBs increased by 12.9 percent to RMB 1.85 trillion yuan, while that of JSCBs increased by 25.93 percent to RMB 0.67 trillion yuan (TableB1.2).

The net interest income remained the major source of operating income. In 2012, the net interest income of the major commercial banks increased by 14.25 percent, accounting for 58.31 percent of the net operating income, down 0.93 percentage point y-o-y, in particular, the growth rate of net interest income of the

LCBs and JSCBs was 13.36 and 16.36 percent respectively.

The intermediate business income grew slowly in 2012.The net fee income of the major commercial banks increased by 14.29% y-o-y, down 28.9 percentage points, in particular, the growth rate of net fee income of the LCBs and JSCBs was 8.7 and 39.32 percent respectively. The proportion of net fee in net operating income of major commercial banks was 17.84 percent, down 0.28 percentage point y-o-y, in particular, the proportion of net fee in net operating income of the LCBs dropped by 0.73 percentage point while that of the JSBCs rose by 1.44 percentage points, increasing for the sixth consecutive year. Although it was still 3.81 percentage points lower than that of LCBs, the gap narrowed notably.

The proportion of investment income increased. In 2012, both domestic and foreign investment income rose slightly, investment income of the major commercial banks rose by 24.08%, up 9.18 percentage points y-o-y. Bond investment income increased by 18.3%, while equity and other investment income ballooned by 121.63%. Investment income of the LCBs and JSCBs increased by 16.71% and 63.7% respectively. The proportion of investment income in operating income reached 22.13%, up 1.43 percentage points. Specifically, the proportion of investment income in operating income of the LCBs and JSCBs increased by 0.78 percentage point and 4 percentage points respectively.

Table B1.2 Composition of Net Operating Income of the 17 Major Commercial Banks

Items		17 Major Commercial Banks		5 Large Commercial Banks		12 Joint-stock Commercial Banks	
		2011	2012	2011	2012	2011	2012
Balance (100 million of RMB yuan)	Net interest income	12 858.23	14 690.29	9 073.20	10 285.71	3 785.04	4 404.59
	Net fee and commission income	3 931.83	4 493.64	3 213.97	3 493.48	717.86	1 000.17
	Investment income	4 493.10	5 575.22	3 788.20	4 421.23	704.90	1 153.99
	Other business income	423.91	435.42	347.45	339.34	76.46	96.08
	Net operating income	21 707.07	25 194.58	16 422.83	18 539.75	5 284.25	6 654.82
Proportion (percent)	Net interest income	59.24	58.31	55.25	55.48	71.63	66.19
	Net fee and commission income	18.11	17.84	19.57	18.84	13.58	15.03
	Investment income	20.70	22.13	23.07	23.85	13.34	17.34
	Other business income	1.95	1.73	2.12	1.83	1.45	1.44
	Net operating income	100	100	100	100	100	100

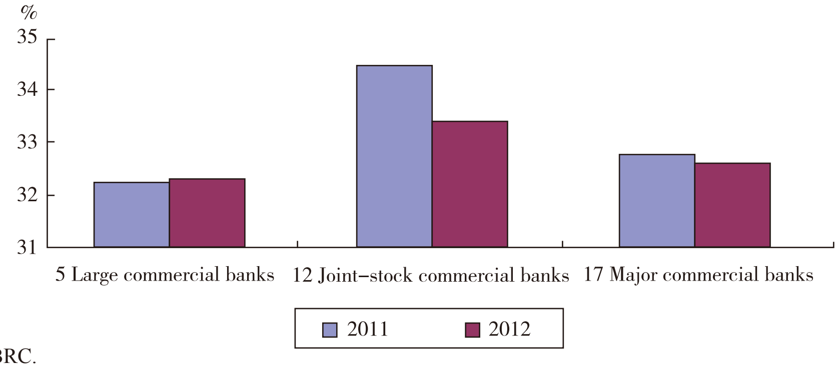
Source: The CBRC.

3. Cost Structure Analysis

In 2012, the operating cost[①] of the major commercial banks amounted to RMB 994.174 billion Yuan, with a y-o-y growth of 16.78%. In particular, the operating cost of the LCBs increased by 14.55% to RMB 722.527 billion yuan, and that of the JSCBs rose by 23.16% to RMB 271.647 billion yuan.

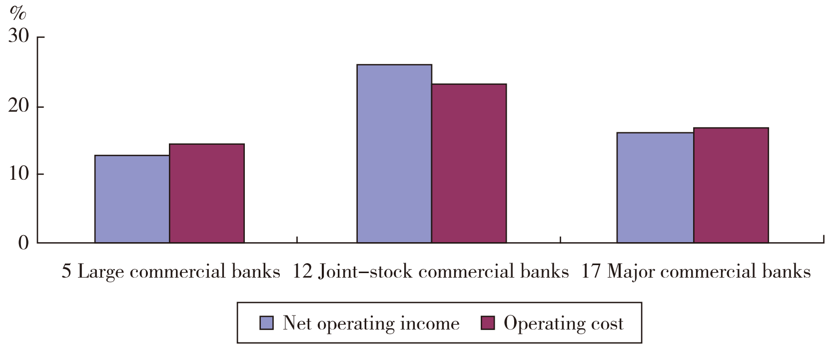
In 2012, the cost/income ratio[②] of the 17 major commercial banks was 32.62%, 0.19 percentage point lower than that of the previous year, declining for the sixth consecutive year, suggesting a continuous improvement in operational management (Figure B1.2). In particular, the cost/income ratio of the LCBs was 32.33%, keeping the same as the last year, while that of JSCBs decreased by 1.05 percentage points to 33.45%. The net operating income growth rate of major commercial banks was 0.72 percentage point lower than the operating cost, specifically, the growth rate of LCBs' net operating income was 1.66 percentage points lower than that of operating cost, while the growth rate of LCBs' net operating income was 2.78 percentage points higher than that of operating cost (Figure B1.3).

Figure B1.2 Cost/Income Ratio of the 17 Major Commercial Banks



Source: The CBRC.

Figure B1.3 Growth of Net Operating Income and Operating Cost of the 17 Major Commercial Banks



Source: The CBRC.

① Operating cost includes operating expense, business tax and additions, and other operating expenditures.

② Cost/ income ratio= (operating cost -business tax and additions) / (net interest income +net fee and commission income +other business income +investment income) × 100%.

II. Asset Analysis

1. The Scale and Structure of Total Assets

In 2012, the total assets of commercial banks maintained a stable growth. Total assets of the 17 major commercial banks amounted to RMB 83.57 trillion yuan, up 16.07% y-o-y and comprised 62.54% of the total assets of all banking institutions. In particular, assets of the LCBs totaled RMB 60.04 trillion yuan, up 14.32%; assets of the JSCBs totaled RMB 23.53 trillion yuan, up 28.58%.

In terms of the assets structure, loans and investment were still the main constituents, which accounted for 64.58% in total assets of major commercial banks. In 2012, the share of deposits in central bank to total assets decreased by 0.65 percentage point y-o-y, while the share of outstanding loans and trade finance declined by 1.86 and 2.14 percentage points respectively, the share of discount, interbank deposits and repurchase increased by 3.25, 0.54 and 1.45 percentage points respectively. The share of investment fell by 0.45 percentage point, declining for the fifth consecutive year (Table B1.3).

Table B1.3 Asset Structure of the 17 Major Commercial Banks

Items	Balance (RMB 100 million yuan)		As a percentage of total assets (percent)	
	2011	2012	2011	2012
Deposits in central bank	118 791.32	132 489.03	16.50%	15.85%
Inter-bank deposits	26 890.68	35 709.11	3.73%	4.27%
Loans	338 717.31	377 590.44	47.04%	45.18%
Discount	7 115.46	9 567.38	0.99%	4.24%
Trade finance	23 737.05	35 450.75	3.30%	1.14%
Inter-bank lending	17 852.76	20 130.81	2.48%	2.41%
Investment	142 957.27	162 110.34	19.85%	19.40%
Repurchase of assets	32 265.11	49 560.37	4.48%	5.93%
Others	11 802.41	13 063.69	1.64%	1.56%
Total assets	720 129.37	835 671.93	100.00%	100.00%

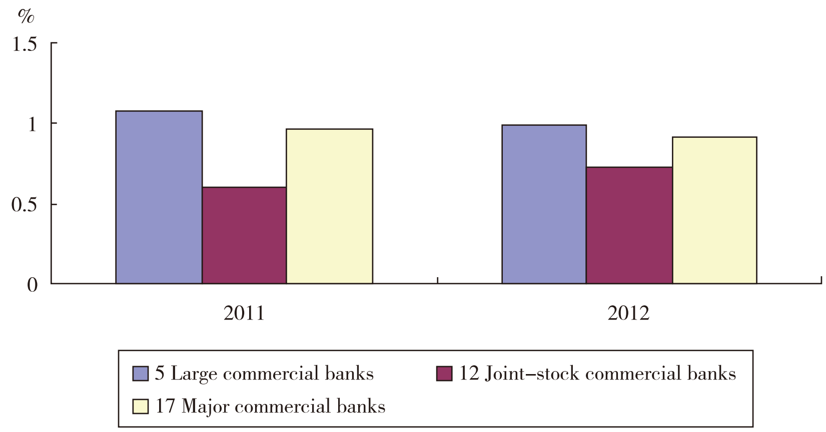
Source: The CBRC.

2. The Scale and Quality of Loans

By the end of 2012, outstanding loans of the major commercial banks totaled RMB 42.26 trillion yuan, increasing RMB 6.39 trillion yuan compared with the early of the year. In particular, the outstanding loans of the LCBs and JSCBs rose by 17.4% and 21.39%, reaching RMB 15.40 and 4.88 trillion yuan respectively.

As of the end of 2012, outstanding NPLs of the major commercial banks totaled RMB 389.214 billion yuan, increasing RMB 33.314 billion yuan y-o-y, NPL ratio registered 0.92%, down 0.04 percentage point y-o-y. In particular, NPL ratio of the LCBs and JSCBs was 0.99% and 0.72%, down 0.09 percentage point and up 0.12 percentage point respectively (Figure B1.3).

Figure B1.4 NPL Ratio of the 17 Major Commercial Banks

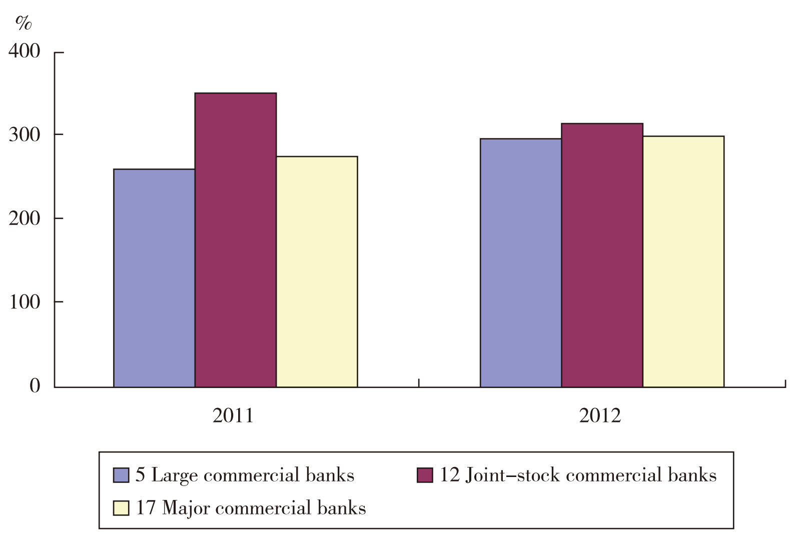


Source: The CBRC.

*3. Provision Coverage Ratio*①

In 2012, the provision coverage ratio of the major commercial banks kept growing while maintaining high level. At end-2012, the overall provision coverage ratio was 299.61%, up 24.11 percentage points y-o-y. In particular, provision coverage ratio of the LCBs was 295.73%, up 34.23 percentage points, while the ratio of the JSCBs was 314.68%, down 35.62 percentage points (Figure B1.5).

Figure B1.5 Provision Coverage Ratio of the 17 Major Commercial Banks



Source: The CBRC.

① Provision coverage ratio = loan loss provision / outstanding NPLs × 100%.

III. Liabilities, Capital and Liquidity

1. The Scale and Structure of Liabilities

As of end-2012, liabilities of major commercial banks totaled RMB 78.3 trillion yuan, with a y-o-y growth of 15.9% and accounting for 62.66% of the total liabilities of all banking institutions. In particular, the share of liabilities of the LCBs and JSCBs in the total was 44.88% and 17.78%, down 2.51 percentage points and up by 1.48 percentage points respectively.

By the end of 2012, the outstanding deposits of the 17 major commercial banks reached RMB 64.16 trillion yuan, growing by 13.35% y-o-y. In particular, the growth rate of corporate deposits increased by 5.32 percentage points to 14.46%, while the household savings rose by 15.13%, with an increase of 2.66 percentage points in the growth rate. The proportion of corporate deposits and household savings to total liabilities of the major commercial banks was 81.94%, down 1.88 percentage points y-o-y.

2. Capital and CAR

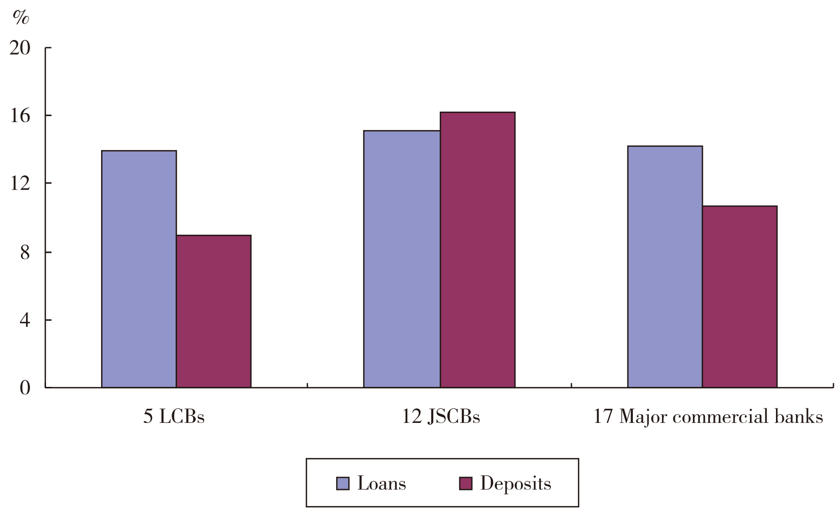
As of end-2012, all the 17 major commercial banks had met the CAR requirement set by CBRC. CCAR and CAR of the major commercial banks was 10.13% and 12.92%, increasing by 0.4 and 0.6 percentage point respectively. Due to the increase of retained earnings and bond issuance, the net capital saw a substantial growth. At end-2012, the net capital of the major commercial banks reached RMB 6.1 trillion yuan , increasing by 19.6% or RMB 1 trillion yuan y-o-y.

3. Liquidity

In 2012, deposits of the LCBs grew faster than their loans, but the JSCBs saw the opposite trend (Figure B1.6). By the end of 2012, the loan/deposit ratio of the major commercial banks recorded 65.87%, up 0.61 percentage point y-o-y. Liquidity ratio[①] increased by 3.05 percentage points to 44.85%, Liquidity coverage ratio rose by 4.78 percentage points to 124.08%, indicating overall sufficient liquidity in banking sector.

① Liquidity ratio = liquidity assets/ liquidity liabilities × 100%.

Figure B1.6 Growth of Loans and Deposits of the 17 Major Commercial Banks



Source: The CBRC.

Appendix II

Statistics

TableB2.1 Selected Economic Indicators

(Year-end Balance)

Items	2008	2009	2010	2011	2012
Gross Domestic Product(RMB 100 million yuan)	314 045	340 903	401 513	473 104	519 322
Industrial Value Added	129 112	134 625	160 030	188 572	199 860
Fixed Asset Investment(RMB 100 million yuan)	172 828	224 599	278 122	311 485	374 676
Retail Sales of Consumer Goods(RMB 100 million yuan)	114 830	132 678	156 998	183 919	210 307
Export & Import (USD 100 million)	25 616	22 072	29 728	36 421	38 668
Export	14 285	12 017	15 779	18 986	20 489
Import	11 331	10 056	13 948	17 435	18 178
Balance	2 955	1 961	1 831	1 551	2 311
Foreign Direct Investment (USD 100 million)	924	900	1 057	1 160	1 117
Foreign Exchange Reserve (USD 100 million)	19 460.3	23 991.5	28 473.4	31 811.0	33 116.0
Consumer Price Index (previous year = 100)	105.9	99.3	103.3	105.4	102.6
Fiscal Revenue(RMB 100 million yuan)	61 316.9	68 476.9	83 080.3	103 740.0	117 209.8
Fiscal Expenditure(RMB 100 million yuan)	62 427.0	75 873.6	89 575.4	108 929.7	125 712.3
Per Capita Urban Residents Dispensable Income (RMB)	15 781	17 175	19 109	21 810	24 565
Per Capita Rural Residents Net Income (RMB)	4 761	5153	5 919	6 977	7 917
Number of Employed Persons in Urban Area (million)	302.1	311.2	—	359.1	371.0
Registered Unemployment Rate in Urban Area (%)	4.2	4.3	4.1	4.1	4.1
Total Population (million)	1 328.0	1 334.7	1 339.7	1 347.4	1 354.0

Notes: 1. GDP in 2012 is preliminary.

2. Since 2011, the cut-off size of fixed assets investment projects rose from a total planned investment above 500 thousand yuan to 5 million yuan.

Source：Calculated on the basis of data from *China Statistical Year Book* and *Statistical Communique of The People's Republic of China on the National Economic and Social Development*.

TableB2.2 Selected Financial Indicators (1)

(Year-end)

(RMB 100 million yuan)

Items	2008	2009	2010	2011	2012
Money & Quasi-money (M_2)	475 166.6	606 225.0	725 851.8	851 590.9	974 148.8
Money (M_1)	166 217.1	220 001.5	266 621.5	289 847.7	308 673.0
Currency in Circulation (M_0)	34 219.0	38 246.0	44 628.2	50 748.5	54 659.8
Total Deposits with Financial Institutions	466 203.3	597 741.1	718 237.9	809 368.3	917 368.1
Household Deposits	217 885.4	260 771.7	303 302.5	343 635.9	399 546.9
Non-financial Enterprise Deposits	157 632.2	217 110.0	244 495.6	303 504.3	327 444.9
Total Lending by Financial Institutions	303 394.6	399 684.8	479 195.6	547 946.7	629 906.6

Source: The PBC.

TableB2.3 Selected Financial Indicators (2)

(Percentage Point)

(Growth Rate)

Items	2008	2009	2010	2011	2012
Money & Quasi-money (M_2)	17.82	27.68	19.73	13.61	13.80
Money (M_1)	9.06	32.35	21.19	7.85	6.49
Currency in Circulation (M_0)	12.65	11.77	16.69	13.76	7.71
Total Deposits with Financial Institutions	19.73	28.21	20.16	13.54	13.34
Urban & Rural Household Deposits	26.29	19.68	16.31	13.78	16.27
Enterprise Deposits	13.67	37.73	12.61	9.23	7.89
Total Lending by Financial Institutions	18.73	31.74	19.89	15.83	14.96

Note: Growth rate has been adjusted to reflect recent changes in statistical coverage.

Source: The PBC.

TableB2.4 International Liquidity

(USD million)

Items	2008	2009	2010	2011	2012
Total Reserves (minus gold)	1 949 260	2 414 131	2 862 276	3 197 107	3 325 440
Special Drawing Rights (SDRs)	1 199	12 510	12 345	11 855	11 366
Reserve Positions in IMF	2 031	2 469	2 593	4 104	2 485
Foreign Exchange	1 946 030	2 399 152	2 847 338	3 181 148	3 311 589
Gold (1 million ounces)	19.29	33.89	33.89	33.89	33.89
Gold (national valuation)	4 074	9 815	9 815	9 815	9 815
Foreign Liabilities of Other Depository Companies	75 255	88 146	108 406	123 250	157 509

Note: Data of “Foreign Liabilities of Other Depository Companies” for 2009 has been adjusted to reflect changes in statistical coverage.

Source: The PBC.

TableB2.5 Gold and Foreign Exchange Reserves

Year	Gold Reserves (10 thousand ounces)	Foreign Exchange Reserves (USD 100 million)	Change in Foreign Exchange Reserves (percentage point)
1995	1 267	736.0	42.6
1996	1 267	1 050.3	42.7
1997	1 267	1 398.9	33.2
1998	1 267	1 449.6	3.6
1999	1 267	1 546.8	6.7
2000	1 267	1 655.7	7.0
2001	1 608	2 121.7	28.1
2002	1 929	2 864.1	35.0
2003	1 929	4 032.5	40.8
2004	1 929	6 099.3	51.3
2005	1 929	8 188.7	34.3
2006	1 929	10 663.4	30.2
2007	1 929	15 282.5	43.3
2008	1 929	19 460.3	27.3
2009	3 389	23 991.5	23.3
2010	3 389	28 473.4	18.7
2011	3 389	31 811.5	11.7
2012	3 389	33 115.9	4.1

Note: The PBC made adjustments to statistical coverage of gold reserves in December 2001, December 2002 and April 2009.
Source: The PBC.

TableB2.6 Assets of China's Financial Sector

(Including foreign currencies)
(December 31, 2012)

(RMB trillion yuan)

Type of Financial Institution	Assets
Financial Sector	171.53
Central Bank	29.45
Banking Financial Institutions	133.62
Securities Financial Institutions (Assets of clients excluded)	1.11
Insurance Financial Institutions	7.35

Source: Calculated by the Financial Stability Analysis Group of PBC.

TableB2.7 Depository Corporations Survey in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter4
Net Foreign Assets	258 068.1	261 277.2	261 919.2	258 850.9
Domestic Credit	722 026.2	746 505.2	772 580.9	805 593.8
Claims on Governments (net)	42 117.1	38 943.2	42 051.4	50 683.7
Claims on Non-financial Sectors	629 015.1	653 562.3	675 061.9	694 351.5
Claims on other Financial Sectors	50 894.0	53 999.8	55 467.7	60 558.5
Money & Quasi-money	895 565.5	924 991.2	943 688.8	974 148.8
Money	277 998.1	287 526.2	286 788.2	308 664.2
Currency in Circulation	49 595.7	49 284.6	53 433.5	54 659.8
Demand Deposits	228 402.4	238 241.5	233 354.7	254 004.5
Quasi-money	617 567.4	637 465.0	656 900.6	665 484.6
Time Deposits	177 916.5	186 605.6	200 657.5	195 940.1
Savings Deposits	385 443.5	396 299.6	403 174.6	411 362.6
Other Deposits	54 207.4	54 559.8	53 068.5	58 181.9
Deposits not Included in Broad Money	20 468.7	24 465.4	25 097.6	24 454.1
Bonds	80 404.8	85 314.0	88 415.5	92 318.3
Paid-in Capital	29 248.4	29 823.5	30 291.9	30 945.0
Other Items (net)	–45 593.2	–56 811.6	–52 993.6	–57 421.5

Source: The PBC.

TableB2.8 Balance Sheet of Monetary Authority in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	240 694.6	239 978.3	240 190.5	241 416.9
Foreign Exchange	235 799.5	235 189.8	235 297.0	236 669.9
Money Gold	669.8	669.8	669.8	669.8
Other Foreign Assets	4 225.3	4 118.6	4 223.7	4 077.1
Claims on Governments	15 349.1	15 349.1	15 313.7	15 313.7
Of Which: Central Government	15 349.1	15 349.1	15 313.7	15 313.7
Claims on Other Depository Corporations	10 551.5	13 303.7	17 901.8	16 701.1
Claims on Other Financial Corporations	10 635.1	10 625.3	10 234.0	10 038.6
Claims on Non-financial Corporations	25.0	25.0	25.0	25.0
Other Assets	6 767.1	6 789.7	5 992.8	11 041.9
Total Assets	**284 022.4**	**286 071.1**	**289 657.8**	**294 537.2**
Reserve Money	226 684.3	228 050.9	236 032.6	252 345.2
Currency Issuance	54 378.6	54 294.3	59 177.8	60 646.0
Other Depository Corporations	172 305.7	173 756.5	176 854.8	191 699.2
Deposits of Financial Corporations not included in Reserve Money	1 106.9	1 182.3	1 297.1	1 348.9
Bond Issuance	21 440.0	18 690.9	17 464.2	13 880.0
Foreign Liabilities	1 846.6	1 097.1	1 241.5	1 464.2
Deposits of Government	23 085.2	27 550.3	28 149.1	20 753.3
Own Capital	219.8	219.8	219.8	219.8
Other Liabilities	9 639.7	9 280.0	5 253.6	4 525.9
Total Liabilities	**284 022.4**	**286 071.1**	**289 657.8**	**294 537.2**

Source: The PBC.

TableB2.9 Balance Sheet of Other Depository Corporations in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	27 857.3	32 057.3	31 760.7	28 798.5
Reserve Assets	176 422.0	178 259.3	182 267.8	197 132.5
Deposits with Central Bank	171 639.1	173 249.7	176 523.5	191 146.3
Cash in Vault	4 782.8	5 009.7	5 744.3	5 986.2
Claims on Governments	49 853.2	51 144.4	54 886.8	56 123.3
Of Which: Central Government	49 853.2	51 144.4	54 886.8	56 123.3
Claims on Central Bank	22 898.7	19 392.5	15 461.5	12 709.0
Claims on Other Depository Corporations	209 443.7	233 288.4	222 477.8	237 024.6
Claims on Other Financial Corporations	40 258.9	43 374.5	45 233.7	50 519.9
Claims on Non-financial Corporations	488 787.6	507 098.1	520 718.0	534 132.7
Claims on Other Resident Sectors	140 202.5	146 439.2	154 318.9	160 193.8
Other Assets	53 184.8	57 630.2	58 580.9	60 228.6
Total Assets	**1 208 908.7**	**1 268 684.0**	**1 285 706.0**	**1 336 862.8**
Liabilities to Non-financial Institutions and Households	816 395.4	850 305.5	867 498.4	891 427.9
Deposits Included in Broad Money	791 762.4	821 146.7	837 186.7	861 307.2
Enterprise Demand Deposits	228 402.4	238 241.5	233 354.7	254 004.5
Enterprise Time Deposits	177 916.5	186 605.6	200 657.5	195 940.1
Household Savings Deposits	385 443.5	396 299.6	403 174.6	411 362.6
Deposits not Included in Broad Money	20 468.7	24 465.4	25 097.6	24 454.1
Transferable Deposits	7 032.7	7 541.8	7 463.6	8 036.1
Other Deposits	13 436.0	16 923.5	17 634.0	16 418.0
Other Liabilities	4 164.3	4 693.4	5 214.0	5 666.6
Liabilities to Central Bank	7 619.6	10 239.5	14 714.1	13 903.1
Liabilities to Other Depository Corporations	99 761.6	108 076.0	98 311.8	108 636.2
Liabilities to Other Financial Corporations	60 329.0	60 753.5	58 809.9	62 999.2
Of Which: Deposits Included in Broad Money	54 207.4	54 559.8	53 068.5	58 181.9
Foreign Liabilities	8 637.3	9 661.4	8 790.4	9 900.3
Bond Issuance	80 404.8	85 314.0	88 415.5	92 318.3
Paid-in Capital	29 028.6	29 603.7	30 072.1	30 725.3
Other Liabilities	106 732.3	114 730.4	119 093.8	126 952.6
Total Liabilities	**1 208 908.7**	**1 268 684.0**	**1 285 706.0**	**1 336 862.8**

Source: The PBC.

TableB2.10 Balance Sheet of Chinese-funded Large Banks in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	20 822.17	24 421.02	23 873.47	20 196.27
Reserve Assets	108 535.41	107 861.80	108 784.64	111 464.93
Deposits with Central Bank	105 862.50	105 114.03	105 463.06	108 019.02
Cash in Vault	2 672.91	2 747.77	3 321.58	3 445.91
Claims on Governments	33 560.01	34 620.85	37 737.09	38 753.51
Of Which: Central Government	33 560.01	34 620.85	37 737.09	38 753.51
Claims on Central Bank	20 535.10	17 186.15	13 530.50	11 466.81
Claims on Other Depository Corporations	95 425.30	102 779.83	97 778.95	102 248.20
Claims on Other Financial Corporations	22 733.66	23 844.62	23 636.04	24 668.65
Claims on Non-financial Corporations	278 972.19	286 210.42	291 755.84	297 056.46
Claims on Other Resident Sectors	76 067.53	79 054.12	83 408.78	86 878.75
Other Assets	33 845.64	36 365.62	37 806.78	39 975.15
Total Assets	**690 497.00**	**712 344.44**	**718 312.10**	**732 708.72**
Liabilities to Non-financial Institutions and Households	484 574.02	498 794.55	504 604.92	508 789.57
Deposits Included in Broad Money	469 257.79	480 646.09	486 132.86	491 047.69
Enterprise Demand Deposits	129 832.83	134 296.49	130 754.39	139 932.96
Enterprise Time Deposits	82 129.59	83 849.50	89 723.76	84 401.16
Household Savings Deposits	257 295.37	262 500.09	265 654.71	266 713.57
Deposits not Included in Broad Money	12 142.68	14 502.03	14 458.98	13 487.50
Transferable Deposits	3 716.84	4 002.73	3 861.97	4 070.77
Other Deposits	8 425.84	10 499.29	10 597.01	9 416.74
Other Liabilities	3 173.55	3 646.43	4 013.08	4 254.38
Liabilities to Central Bank	2 827.98	3 102.10	5 872.57	4 071.30
Liabilities to Other Depository Corporations	34 446.15	33 143.53	28 312.11	30 249.56
Liabilities to Other Financial Corporations	34 157.21	34 718.84	32 073.48	33 285.55
Of Which: Deposits Included in Broad Money	31 226.31	31 934.77	29 800.05	31 754.02
Foreign Liabilities	3 027.52	3 642.44	3 475.61	4 203.26
Bond Issuance	53 140.55	56 091.48	57 901.52	60 293.27
Paid-in Capital	15 945.64	15 952.25	16 079.49	16 070.57
Other Liabilities	62 377.94	66 899.25	69 992.38	75 745.64
Total Liabilities	**690 497.00**	**712 344.44**	**718 312.10**	**732 708.72**

Source: The PBC.

TableB2.11 Balance Sheet of Chinese-funded Medium-sized Banks in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	5 490.13	5 969.81	6 140.68	6 665.84
Reserve Assets	28 777.86	30 085.64	31 658.96	34 937.31
Deposits with Central Bank	28 356.43	29 610.57	31 149.15	34 343.77
Cash in Vault	421.43	475.06	509.81	593.54
Claims on Governments	7 654.29	7 743.84	8 315.99	8 648.84
Of Which: Central Government	7 654.29	7 743.84	8 315.99	8 648.84
Claims on Central Bank	1 653.84	1 570.86	1 336.36	790.10
Claims on Other Depository Corporations	48 143.51	60 444.70	59 152.10	63 346.59
Claims on Other Financial Corporations	8 638.57	9 427.72	10 350.39	12 867.18
Claims on Non-financial Corporations	110 749.24	115 480.78	120 369.45	124 944.11
Claims on Other Resident Sectors	24 573.03	25 752.24	28 169.69	30 199.31
Other Assets	7 757.67	8 380.44	8 435.81	7 534.33
Total Assets	**243 438.13**	**264 856.03**	**273 929.44**	**289 933.61**
Liabilities to Non-financial Institutions and Households	134 432.06	144 211.51	150 405.76	156 491.92
Deposits Included in Broad Money	128 819.28	136 898.43	142 385.54	148 246.59
Enterprise Demand Deposits	44 792.06	47 493.58	46 602.42	51 219.53
Enterprise Time Deposits	54 308.98	57 692.98	63 315.05	62 392.48
Household Savings Deposits	29 718.25	31 711.87	32 468.07	34 634.58
Deposits not Included in Broad Money	4 989.45	6 668.41	7 282.71	7 469.27
Transferable Deposits	1 584.39	1 867.79	1 906.04	2 173.99
Other Deposits	3 405.06	4 800.62	5 376.67	5 295.29
Other Liabilities	623.32	644.67	737.51	776.05
Liabilities to Central Bank	3 195.53	4 829.51	5 891.65	7 112.35
Liabilities to Other Depository Corporations	30 648.41	37 103.24	36 448.29	40 961.30
Liabilities to Other Financial Corporations	22 631.11	22 267.31	23 197.68	25 625.21
Of Which: Deposits Included in Broad Money	20 853.02	20 332.30	21 171.26	23 798.67
Foreign Liabilities	1 047.36	1 156.26	1 013.35	1 302.89
Bond Issuance	26 007.81	27 959.36	29 132.23	30 544.57
Paid-in Capital	2 362.62	2 379.39	2 394.39	2 413.02
Other Liabilities	23 113.23	24 949.44	25 446.07	25 482.34
Total Liabilities	**243 438.13**	**264 856.03**	**273 929.44**	**289 933.61**

Source: The PBC.

TableB2.12 Balance Sheet of Chinese-funded Small Banks in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	336.87	377.71	186.84	219.84
Reserve Assets	23 704.98	24 977.54	26 092.00	32 034.03
Deposits with Central Bank	22 924.89	24 140.73	25 173.04	30 950.76
Cash in Vault	780.08	836.81	918.95	1 083.27
Claims on Governments	6 394.08	6 468.99	6 730.83	6 785.12
Of Which: Central Government	6 394.08	6 468.99	6 730.83	6 785.12
Claims on Central Bank	571.39	540.04	493.54	392.73
Claims on Other Depository Corporations	39 782.94	43 852.54	39 803.94	45 553.80
Claims on Other Financial Corporations	6 127.04	7 119.20	8 327.73	9 916.74
Claims on Non-financial Corporations	62 315.93	66 998.85	69 058.43	72 244.65
Claims on Other Resident Sectors	17 886.93	19 125.42	19 863.15	21 384.09
Other Assets	6 638.71	7 534.83	7 258.72	7 250.93
Total Assets	**163 758.87**	**176 995.14**	**177 815.17**	**195 781.93**
Liabilities to Non-financial Institutions and Households	113 155.54	121 359.01	125 481.25	137 712.63
Deposits Included in Broad Money	112 308.20	120 422.76	124 432.90	136 460.70
Enterprise Demand Deposits	34 210.21	36 350.81	35 938.19	41 319.32
Enterprise Time Deposits	28 003.72	31 015.08	32 698.02	33 892.26
Household Savings Deposits	50 094.27	53 056.87	55 796.69	61 249.11
Deposits not Included in Broad Money	592.84	645.26	708.94	784.94
Transferable Deposits	251.12	246.88	255.92	344.94
Other Deposits	341.72	398.37	453.02	440.00
Other Liabilities	254.50	290.99	339.41	467.00
Liabilities to Central Bank	446.59	918.19	1 565.82	1 401.16
Liabilities to Other Depository Corporations	29 155.89	32 085.55	27 160.28	30 553.07
Liabilities to Other Financial Corporations	2 171.68	2 351.98	2 294.96	2 742.96
Of Which: Deposits Included in Broad Money	1 844.85	2 006.12	1 998.26	2 516.83
Foreign Liabilities	206.02	230.16	255.23	311.60
Bond Issuance	873.02	948.42	1 117.68	1 320.42
Paid-in Capital	5 132.23	5 409.06	5 572.72	5 980.86
Other Liabilities	12 617.90	13 692.76	14 367.24	15 759.24
Total Liabilities	**163 758.87**	**176 995.14**	**177 815.17**	**195 781.93**

Source: The PBC.

TableB2.13 Balance Sheet of Foreign-funded Banks in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	1 114.52	1 188.32	1 450.27	1 612.53
Reserve Assets	2 640.37	2 623.91	2 755.08	3 228.47
Deposits with Central Bank	2 630.20	2 614.25	2 744.55	3 218.43
Cash in Vault	10.17	9.66	10.52	10.04
Claims on Governments	1 480.21	1 636.84	1 427.01	1 294.89
Of Which: Central Government	1 480.21	1 636.84	1 427.01	1 294.89
Claims on Central Bank	0.00	0.00	0.00	0.00
Claims on Other Depository Corporations	5 497.23	5 721.92	5 057.58	5 361.33
Claims on Other Financial Corporations	518.78	590.06	622.06	752.17
Claims on Non-financial Corporations	9 043.56	9 375.58	9 977.72	10 510.18
Claims on Other Resident Sectors	477.70	508.96	548.75	603.22
Other Assets	1 488.71	1 662.90	1 447.77	1 219.58
Total Assets	**22 261.09**	**23 308.50**	**23 286.24**	**24 582.36**
Liabilities to Non-financial Institutions and Households	11 750.21	12 081.25	12 126.75	13 072.20
Deposits Included in Broad Money	9 485.93	9 804.61	9 833.13	10 670.72
Enterprise Demand Deposits	2 147.72	2 495.98	2 244.05	2 912.56
Enterprise Time Deposits	5 473.68	5 377.90	5 668.26	5 822.96
Household Savings Deposits	1 864.53	1 930.72	1 920.83	1 935.19
Deposits not Included in Broad Money	2 264.28	2 276.64	2 293.62	2 401.49
Transferable Deposits	1 082.63	1 115.32	1 167.62	1 209.48
Other Deposits	1 181.66	1 161.33	1 126.00	1 192.01
Other Liabilities	0.00	0.00	0.00	0.00
Liabilities to Central Bank	3.51	9.27	14.51	8.57
Liabilities to Other Depository Corporations	1 829.95	1 966.61	2 510.58	2 571.04
Liabilities to Other Financial Corporations	618.85	618.47	654.81	817.44
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	4 356.39	4 632.26	4 046.04	4 082.49
Bond Issuance	57.92	72.78	22.42	7.19
Paid-in Capital	1 659.85	1 757.14	1 826.18	1 941.31
Other Liabilities	1 984.41	2 170.72	2 084.95	2 082.14
Total Liabilities	**22 261.09**	**23 308.50**	**23 286.24**	**24 582.36**

Source: The PBC.

TableB2.14 Balance Sheet of Rural Credit Cooperatives in 2012

(Quarter-end Balance)

(RMB 100 million yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	5.69	5.40	5.33	5.14
Reserve Assets	10 695.30	10 549.03	10 706.38	13 245.10
Deposits with Central Bank	9 797.74	9 609.12	9 723.35	12 391.73
Cash in Vault	897.56	939.91	983.03	853.37
Claims on Governments	634.68	573.76	577.02	537.27
Of Which: Central Government	634.68	573.76	577.02	537.27
Claims on Central Bank	137.41	94.49	100.09	58.31
Claims on Other Depository Corporations	14 589.52	14 604.79	14 337.62	13 677.02
Claims on Other Financial Corporations	1 829.14	1 940.13	1 824.13	1 803.93
Claims on Non-financial Corporations	19 225.56	20 120.40	20 556.74	19 629.49
Claims on Other Resident Sectors	20 941.37	21 751.66	22 079.17	20 887.80
Other Assets	2 973.56	3 253.67	3 336.67	4 004.08
Total Assets	**71 032.24**	**72 893.34**	**73 523.15**	**73 848.14**
Liabilities to Non-financial Institutions and Households	59 113.76	60 029.06	60 446.47	59 910.56
Deposits Included in Broad Money	58 997.93	59 914.69	60 318.68	59 740.53
Enterprise Demand Deposits	10 590.02	10 708.79	10 811.58	10 893.98
Enterprise Time Deposits	1 972.74	2 135.22	2 202.28	2 016.65
Household Savings Deposits	46 435.18	47 070.67	47 304.82	46 829.90
Deposits not Included in Broad Money	9.21	9.66	10.59	8.36
Transferable Deposits	0.73	0.78	0.94	0.82
Other Deposits	8.47	8.89	9.64	7.54
Other Liabilities	106.62	104.71	117.20	161.67
Liabilities to Central Bank	1 079.68	1 314.72	1 306.08	1 212.45
Liabilities to Other Depository Corporations	2 892.86	3 103.61	3 216.87	3 492.15
Liabilities to Other Financial Corporations	556.11	602.45	443.35	462.84
Of Which: Deposits Included in Broad Money	253.63	255.12	67.75	56.87
Foreign Liabilities	0.02	0.21	0.21	0.02
Bond Issuance	3.75			
Paid-in Capital	2 266.66	2 357.77	2 374.43	2 428.41
Other Liabilities	5 119.39	5 485.52	5 735.74	6 341.72
Total Liabilities	**71 032.24**	**72 893.34**	**73 523.15**	**73 848.14**

Source: The PBC.

TableB2.15 Statistics of Securities Market

Year	2006	2007	2008	2009	2010	2011	2012
Number of Domestic Listed Companies (A share, B share)	1 434	1 550	1 625	1 718	2 063	2 342	2 494
Number of Domestic Listed Foreign Companies (B share)	109	109	109	108	108	108	107
Number of Overseas Listed Companies (H share)	143	148	153	159	165	171	179
Number of Shares Issued (100 million shares)	14 926.35	22 416.85	24 522.85	26 162.85	33 184.35	36 095.52	38 395.00
Of Which: Negotiable Shares (100 million shares)	5 637.79	10 331.52	12 578.91	19 759.53	25 642.03	28 850.26	31 339.60
Total Market Value of Shares (RMB 100 million yuan)	89 403.90	327 140.89	121 366.44	243 939.12	265 422.59	214 758.10	230 357.62
Of Which:Negotiable Shares (RMB 100 million yuan)	25 003.64	93 064.35	45 213.90	151 258.65	193 110.41	164 921.30	181 658.26
Trade Volume of Shares(100 million shares)	16 145.22	36 403.76	24 131.38	51 106.99	42 151.99	33 957.55	32 881.06
Turnover of Shares(RMB 100 million yuan)	90 468.91	460 556.20	267 112.64	535 986.74	545 633.54	421 646.74	314 667.41
Shanghai Composite Index (close)	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08	2 199.42	2 269.13
Shenzhen Composite Index (close)	550.59	1 447.02	553.30	1 201.34	1 290.87	866.65	881.17
Number of Investor Accounts (10 thousand)	7 854.00	13 887.02	10 449.09	12 037.69	13 391.04	14 050.37	17 064.46
Average P/E							
Shanghai	33.30	59.24	14.86	28.73	21.61	13.40	12.30
Shenzhen	32.72	69.74	16.72	46.01	44.69	23.11	22.01
Average Turnover Rate (%)							
Shanghai	541.12	927.19	392.52	499.41	197.61	124.80	101.59
Shenzhen	609.38	987.42	469.11	793.27	557.46	340.49	297.85
Treasury Bonds Issue (RMB 100 million yuan)	8 883.00	23 139.10	8 558.20	17 927.24	19 778.30	17 100.10	16 154.20
Corporate Bonds Issue (RMB 100 million yuan)	3 938.00	5 181.00	8 723.40	16 599.30	16 094.45	21 395.32	37 365.46
Trade Volume of Bonds (10 thousand units)							
Turnover of Bonds (RMB 100 million yuan)							
Turnover of Outright Treasury Bonds Purchase (RMB 100 million yuan)	12 568.77	21 446.79	38 422.29	42 291.52	78 391.44	87 629.52	92 221.85
Turnover of Treasury Bonds Repo (RMB 100 million yuan)	9 092.77	18 345.08	24 268.65	35 475.87	65 877.79	199 581.50	443 655.31
Number of Securities Investment Funds	307	346	439	557	704	914	1173
Total Net Asset Value of Securities Investment Funds (RMB 100 million yuan)	6 020.09	22 339.84	25 741.79	26 767.05	24 228.35	26 510.37	28 661.81
Turnover of Securities Investment Funds (RMB 100 million yuan)	2 002.65	8 620.10	5 831.06	10 249.58	8 996.43	6 365.80	8 667.36
Trading Volume of Futures (10 thousand lots)	44 950.82	72 846.08	136 396.00	215 751.76	156 684.42	105 413.75	145 052.57
Turnover of Futures(RMB 100 million yuan)	210 063.37	409 740.77	719 173.35	1 305 142.92	1 540 296.21	1 375 162.44	1 711 269.35

Source: The CSRC, China Government Securities Depository Trust&.Clearing Co..

TableB2.16 Ratio of Stock Market Capitalization to GDP

(Percentage Point)

(RMB 100 million yuan)

Year	GDP	Market Capitalization	Ratio of market captialization to GDP	GDP	Negotiable Market Capitalization	Ratio of negotiable market captialization to GDP
1996	71 177	9 842	13.83	71 177	2 867	4.03
1997	78 973	17 529	22.20	78 973	5 204	6.59
1998	84 402	19 506	23.11	84 402	5 746	6.81
1999	89 677	26 471	29.52	89 677	8 214	9.16
2000	99 215	48 091	48.47	99 215	16 088	16.21
2001	109 655	43 522	39.69	109 655	14 463	13.19
2002	120 333	38 329	31.85	120 333	12 485	10.38
2003	135 823	42 458	31.26	135 823	12 485	9.70
2004	159 878	37 056	23.18	159 878	11 689	7.31
2005	183 868	32 430	17.64	183 868	10 631	5.78
2006	211 923	89 404	42.19	211 923	25 004	11.80
2007	249 530	327 141	131.10	249 530	93 064	37.30
2008	300 670	121 366	40.36	300 670	45 214	15.04
2009	335 353	243 939	72.74	335 353	151 259	45.10
2010	397 983	265 422	66.69	397 983	193 110	48.52
2011	471 564	214 758	45.54	471 564	164 921	34.97
2012	519 322	230 358	44.36	519 322	181 658	34.98

Source: Calculated on the basis of data from CSRC and NBS.

TableB2.17 Ratio of Domestic Stock Financing to Bank Loan Increment

(Percentage Point)

(RMB 100 million yuan)

Year	Domestic Stock Financing	Loan Increment	Ratio of deomestic stock financing to loan increment
1996	341.52	10 683.33	3.20
1997	933.82	10 712.47	8.72
1998	803.57	11 490.94	6.99
1999	897.39	10 846.36	8.27
2000	1 541.02	13 346.61	11.55
2001	1 182.13	12 439.41	9.50
2002	779.75	18 979.20	4.11
2003	823.10	27 702.30	2.97
2004	862.67	19 201.60	4.49
2005	338.13	16 492.60	2.05
2006	2 463.70	30 594.89	8.05
2007	7 722.99	36 405.60	21.21
2008	2 619.71	41 703.76	6.28
2009	3 894.53	96 290.18	4.04
2010	8 954.99	79 510.73	11.26
2011	5 073.07	68 751.14	7.38
2012	3 127.54	81 962.95	3.82

Note: Since 2008,the Statistic of stock refinancing were divided into two items: asset injection and cash injection, the former was not included in “Domestic Stock Financing”.

Source: The CSRC.

TableB2.18 Statistics of Stock Market

Year		2006	2007	2008	2009	2010	2011	2012
Number of Domestic Listed Companies (A share, B share)		1 434	1 550	1 625	1 718	2 063	2 342	2 494
Of Which: ST Companies				140	142	153	137	96
Medium/ Small-sized Companies		102	202	273	327	531	646	701
Growth Enterprises Board					36	153	281	355
Number of Domestic Listed Foreign Companies (B share)		109	109	109	108	108	108	107
Of Which: ST Companies				20				12.00
Number of Shares Issued (100 million shares)		14 897.57	22 416.85	24 522.85	26 162.85	33 184.35	36 095.52	38 395.00
Of Which: Medium/ Small-sized Companies		143.21	339.64	591.60	794.13	1 366.74	1 943.50	2 410.25
Growth Enterprises Board					34.60	175.06	399.53	600.89
Total Market Capitalization of Shares(RMB 100 million yuan)		89 403.90	327 140.89	121 366.44	243 939.12	265 422.59	214 758.10	230 357.62
Of Which: Medium/ Small-sized Companies		2 015.30	10 646.84	6 269.68	16 872.55	35 364.61	27 429.32	28 804.03
Growth Enterprises Board					1 610.08	7 365.22	7 433.79	8 731.20
Market Capitalization of Negotiable Shares(RMB 100 million yuan)		25 003.64	93 064.35	45 213.90	151 258.65	193 110.41	164 921.30	181 658.26
Of Which: Medium/ Small-sized Companies		723.63	3 823.66	2 672.68	7 503.57	16 150.32	14 343.52	16 244.15
Growth Enterprises Board					298.97	2 005.64	2 504.08	3 335.29
Volume (100 million shares)	Total	16 145.22	36 403.76	24 131.38	51 106.99	42 151.99	33 957.55	32 881.06
	Daily Average	66.99	150.43	98.10	209.45	174.18	139.17	135.31
	Medium/ Small-sized	296.78	815.56	1 189.26	3 283.65	4 055.35	3 729.74	5 075.85
	Growth Enterprises Board	—	—	—	38.55	400.53	761.69	1 478.14
Turnover (RMB 100 million yuan)	Total	90 468.91	460 556.22	267 112.64	535 986.74	545 633.54	421 649.72	314 667.41
	Daily Average	375.39	1 903.12	1 085.82	2 196.67	2 254.68	1 728.07	1 294.93
	Medium/ Small-sized	3 071.55	16 173.66	16 637.28	48 273.52	85 832.42	69 026.48	61 891.45
	Growth Enterprises Board	—	—	—	1 828.11	15 717.88	18 879.15	23 304.64

(concluded)

Year		2006	2007	2008	2009	2010	2011	2012
Average Turnover Rate (%)	Shanghai	541.12	927.19	392.52	499.41	197.61	124.80	101.59
	Shenzhen	609.38	987.42	469.11	793.27	557.46	340.49	297.85
Average P/E	Shanghai	33.30	59.24	14.86	28.73	21.61	13.40	12.30
	Shenzhen	32.72	69.74	17.13	46.01	44.69	23.11	22.01
	Medium/ Small-sized	42.03	85.07	24.96	51.01	56.93	28.26	25.42
	Growth Enterprises Board				105.38	78.53	37.62	32.01
Shanghai Composite Index	Open	1 163.88	2 728.19	5 265.00	1 849.02	3 289.75	2 825.33	2 212.00
	Highest	2 698.90	6 124.04	5 522.78	3 478.01	3 306.75	3 067.46	2 478.37
	Date	2006-12-29	2007-10-16	2008-1-14	2009-8-4	2010-1-11	2011-4-18	2012-2-27
	Lowest	1 161.91	2 617.02	1 664.92	1 844.09	2 319.74	2 134.02	1 949.46
	Date	2006-1-4	2007-1-5	2008-10-28	2009-1-5	2010-7-2	2011-12-28	2012-12-4
	Close	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08	2 199.42	2 269.13
Shenzhen Composite Index	Open	278.99	555.26	1 450.33	560.10	1 207.33	1 298.60	871.93
	Highest	552.93	1 567.74	1 584.40	1 240.64	1 414.64	1 316.19	1 020.29
	Date	2006-12-29	2007-10-8	2008-1-15	2009-12-4	2010-11-11	2011-1-6	2012-3-14
	Lowest	278.99	547.89	452.33	557.69	890.24	828.83	724.97
	Date	2006-1-4	2007-1-5	2008-11-4	2009-1-5	2010-7-2	2011-12-28	2012-12-4
	Close	550.59	1447.02	553.30	1 201.34	1 290.87	866.65	881.17

Source: The CBRC,Shanghai Stock Exchange and Shenzhen Stock Exchange.

TableB2.19 Summary of China's Bond Issuance

(RMB 100 million yuan)

Year	Treasury Bonds			Policy Financial Bonds			Subordinated Bonds			Corporate Credit Bonds		
	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance
1993	381.31	123.29	1 540.74	—	34.29	108.83	—	—	—	235.84	255.48	802.40
1994	1 137.55	391.89	2 286.40	—	13.54	95.29	—	—	—	161.75	282.04	682.11
1995	1 510.86	496.96	3 300.30	—		1 708.49	—	—	—	300.80	336.30	646.61
1996	1 847.77	786.64	4 361.43	1 055.60	254.50	2 509.59	—	—	—	268.92	317.80	597.73
1997	2 411.79	1 264.29	5 508.93	1 431.50	312.30	3 628.80	—	—	—	255.23	219.81	521.02
1998	3 808.77	2 060.86	7 765.70	1 950.23	320.40	5 121.13	—	—	—	147.89	105.25	676.93
1999	4 015.00	1 238.70	10 542.00	1 800.89	473.20	6 447.48	—	—	—	158.20	56.50	778.63
2000	4 657.00	2 179.00	13 020.00	1 645.00	709.20	7 383.28	—	—	—	83.00	—	861.63
2001	4 884.00	2 286.00	15 618.00	2 590.00	1 438.80	8 534.48	—	—	—	147.00	—	—
2002	5 934.30	2 216.20	19 336.10	3 075.00	1 555.70	10 054.10	—	—	—	325.00	—	—
2003	6 280.10	2 755.80	22 603.60	4 561.40	2 505.30	11 650.00	—	—	—	358.00	—	—
2004	6 923.90	3 749.90	25 777.60	4 148.00	1 778.70	14 019.30	918.80	—	918.80	327.00	—	—
2005	7 042.00	4 045.50	28 774.00	5 851.70	2 053.00	17 818.00	966.30	—	1 885.10	2 046.50	37.00	—
2006	8 883.30	6 208.61	31 448.69	8 980.00	3 790.00	23 008.00	215.00	—	2 100.10	3 938.30	1 672.40	—
2007	23 139.10	5 846.80	48 741.00	11 090.20	4 133.60	29 926.80	376.50	—	2 348.50	5 181.00	2 880.90	7 683.30
2008	8 558.20	7 531.40	49 767.80	10 823.00	4 063.80	36 686.00	724.00		3 072.50	8 723.40	3 277.84	13 250.62
2009	17 927.24	9 745.06	57 949.98	11 678.10	3 745.33	44 818.83	2746.00	958.20	4 860.30	16 599.30	4 309.12	25 540.80
2010	19 778.30	10 043.38	67 684.90	13 192.70	5 648.37	52 363.16	919.50	469.30	5 310.50	16 094.45	5 099.23	36 318.15
2011	17 100.10	10 958.50	73 826.50	19 972.70	7 317.04	65 018.82	3168.50	112.00	8 367.00	23 103.21	10 266.67	49 299.69
2012	16 154.20	17 987.10	71 993.60	21 414.80	7 522.80	78 910.80	2253.70	176.50	10 342.70	37 365.46	14 746.20	74 623.00

Notes: ① Since 2006, data of Subordinated Bonds included Capital-mixed Bonds issued after Sep. 2006.

② Due to statistic method adjustment, since 2012, the item "Enterprise bonds" is replaced by "Corporate credit bonds", including Enterprise bonds, Corporate bonds, Short-term commercial paper, Ultra short-term commercial paper, Medium-term Notes, Collective Notes of SMEs, Private Placement Notes, Asset-backed Securities, Convertible Bonds, bonds with detachable warrants, SME private-funded bonds.

Source: The PBC.

TableB2.20 Statistics of China's Insurance Sector

(Percentage Point)

(RMB 100 million yuan)

Items	2006	Growth (y-o-y)	2007	Growth (y-o-y)	2008	Growth (y-o-y)	2009	Growth (y-o-y)	2010	Growth (y-o-y)	2011	Growth (y-o-y)	2012	Growth (y-o-y)
Premium Income	5 641.44	14.49	7 035.76	24.72	9 784.10	39.06	11 137.30	13.83	14 527.97	30.44	14 339.25	—	15 487.93	8.01
1.Property Insurance	1 509.43	22.73	1 997.74	32.35	2 336.71	16.97	2 875.83	23.07	3 895.64	35.46	4 617.82	18.54	5 330.93	15.44
2.Personal Accident Insurance	162.47	15.31	190.11	17.01	203.56	7.08	230.05	13.02	275.35	19.69	334.12	—	386.18	15.58
3.Health Insurance	376.90	20.69	384.17	1.93	585.46	52.40	573.98	-1.96	677.47	18.03	691.72	—	862.76	24.73
4.Life Insurance	3 592.64	10.74	4 463.75	24.25	6 658.37	49.17	7 457.44	12.00	9 679.51	29.80	8 695.59	—	8 908.06	2.44
Claim Payment	1 438.46	27.33	2 265.21	57.47	2 971.17	31.16	3 125.48	5.19	3 200.43	2.40	3 929.37	22.78	4 716.32	20.03
1.Property Insurance	796.29	18.54	1 020.47	28.15	1 418.33	38.99	1 575.78	11.10	1 756.03	11.44	2 186.93	24.54	2 816.33	28.78
2.Personal Accident Insurance	51.67	18.75	63.43	22.76	62.57	-1.35	63.92	2.15	71.39	11.69	81.84	14.64	96.80	18.28
3.Health Insurance	125.10	15.92	116.86	-6.58	175.28	49.99	217.03	23.82	264.02	21.65	359.67	36.23	298.17	-17.10
4.Life Insurance	465.41	51.85	1 064.45	128.71	1 314.98	23.54	1 268.74	-3.52	1 108.99	-12.59	1 300.93	17.31	1 505.01	15.69
Operating Expenses	667.06	26.83	947.62	42.06	1 079.52	13.92	1 234.06	14.32	1 538.35	24.66	1 882.38	22.36	2 171.46	15.36
Bank Deposits	5 989.10	14.26	6 516.26	8.80	8 087.55	24.11	10 519.68	30.07	13 909.97	32.23	17 737.17	27.51	23 446.00	32.19
Investment	11 796.29	32.63	20 205.69	71.29	22 465.22	11.18	26 897.43	19.73	32 136.65	19.48	37 736.67	17.43	45 096.58	19.50
Of Which: Treasury Bonds	3 647.01	1.64	3 961.12	8.61	4 208.26	6.24	4 053.82	-3.67	4 815.78	18.80	4 742.40	-1.52	4 795.02	1.11
Securities Investment Funds	912.08	-17.02	2 530.46	177.44	1 646.46	-34.93	2 758.78	67.56	2 620.73	-5.00	2 915.86	11.26	3 625.58	24.34
Total Assets	19 731.32	29.59	29 003.92	46.99	33 418.44	15.22	40 634.75	21.59	50 481.61	24.23	60 138.10	19.13	73 545.73	22.29

Notes: ① Since 2011, the calculation of premium income has been adjusted according to *Accounting Standards for Enterprises No.2* circulated by the Ministry of Finance. As a result, data of premium income in 2011 is incomparable with those in previous years.

② Data of premium income, claim payment and operating expenses are data for the year.

③ Data of bank deposits, investment and total assets are data of year-end balance.

Source: Calculated based on data from CIRC Website.

TableB2.21 The Structure of Non-life Insurance Premium Income

(Percentage Point)

(RMB 100 million yuan)

Insurance Lines	2009	proportion	2010	proportion	2011	proportion	2012	proportion
Automobile Insurance	2 155.61	72.02	3 004.15	74.60	3 504.56	73.33	4 005.17	72.43
Enterprise Property Insurance	221.43	7.40	271.61	6.74	329.81	6.90	360.36	6.52
Cargo Transportation Insurance	61.27	2.05	78.74	1.96	97.83	2.05	101.71	1.84
Accident Insurance	73.92	2.47	85.53	2.12	105.12	2.20	126.54	2.29
Liability Insurance	92.21	3.08	115.88	2.88	148.01	3.10	183.77	3.32
Others	388.46	12.98	470.98	11.70	593.73	12.42	752.33	13.60
Total	2 992.9	100.00	4 026.89	100.00	4 779.06	100.00	5 529.88	100.00

Source: The CIRC.

TableB2.22 The Structure of Life Insurance Premium Income

(Percentage Point)

(RMB 100 million yuan)

Insurance Lines	2009	proportion	2010	proportion	2011	proportion	2012	proportion
Life Insurance	7 457.22	91.57	9 679.31	92.18	8 695.40	90.96	8 907.90	89.46
Of Which: Common Life Insurance	961.56	11.81	948.17	9.03	951.20	9.95	969.65	9.74
Participating Insurance	5 292.56	64.99	7454.77	70.99	7 662.54	80.15	7 854.29	78.88
Unit-linked Insurance	147.90	1.82	152.82	1.46	4.55	0.05	4.35	0.04
Accident Insurance	156.13	1.92	189.83	1.81	229.00	2.40	259.64	2.61
Health Insurance	530.83	6.52	631.74	6.02	635.61	6.65	790.35	7.94
Total	8 144.18	100.00	10 500.88	100.00	9 560.00	100.00	9 957.89	100.00

Source: The CIRC.

TableB2.23 Insurance Premium Income of China's Different Regions in 2012

(RMB 100 million yuan)

Regions	Insurance Premium Income	Property Insurance	Life Insurance	Accident Insurance	Health Insurance
Total	15 487.93	5 330.93	8 908.06	386.18	862.76
Guangdong	1 301.28	440.92	765.87	35.20	59.29
Jiangsu	1 290.86	416.80	759.51	33.18	81.37
Henan	967.75	317.62	572.48	22.39	55.26
Shandong	923.09	267.02	554.27	21.74	80.06
Beijing	841.13	195.77	595.49	12.78	37.10
Sichuan	820.64	256.38	482.45	24.33	57.48
Hebei	819.88	358.22	401.25	23.12	37.29
Shanghai	819.53	271.51	483.07	23.05	41.90
Zhejiang	766.16	258.65	459.02	14.30	34.19
Hubei	533.31	135.25	357.29	13.07	27.70
Hunan	465.11	144.96	283.56	12.05	24.55
Anhui	453.61	169.06	257.89	7.26	19.40
Shanxi	402.42	143.24	227.76	8.25	23.16
Shaanxi	401.27	154.51	211.24	10.71	24.81
Liaoning	384.78	133.77	211.45	11.27	28.28
Heilongjiang	384.65	127.79	234.11	6.55	16.20
Chongqing	365.33	115.78	223.59	8.88	17.08
Fujian	344.15	99.25	219.60	7.01	18.29
Shenzhen	331.03	95.20	207.00	11.63	17.19
Jiangxi	271.72	97.49	155.24	6.46	12.52
Jilin	271.30	123.54	116.24	10.84	20.67
Tianjin	247.74	119.84	109.45	5.86	12.60
Guangxi	238.26	92.25	124.25	8.22	13.54
Yunnan	238.16	90.79	126.98	5.58	14.81
Xinjiang	235.56	93.68	113.68	9.02	19.19
Inner Mongolia	232.54	78.11	138.23	3.97	12.22
Dalian	164.71	86.23	69.25	4.02	5.21
Gansu	160.62	57.66	90.05	3.61	9.31
Qingdao	160.29	64.93	81.46	3.68	10.22
Ningbo	158.77	55.94	90.84	3.73	8.26
Guizhou	150.22	70.39	68.35	5.45	6.02
Xiamen	92.92	41.50	43.32	2.63	5.47
Hainan	62.69	26.47	28.71	1.68	5.83
Ningxia	60.27	25.15	30.76	1.61	2.76
Qinghai	32.40	16.15	13.20	1.06	1.99
Tibet	9.54	6.52	0.98	1.27	0.78
Group and Head Office Level	84.29	82.56	0.17	0.76	0.79

Note: Data of "Group and Head Office Level" refers to the premium income earned by the group and head office, which is not reflected in any regions' data.

Source: The CIRC.

TableB2.24 Transactions of Payment Systems

(100 million transactions/RMB 100 million yuan)

Items	2008		2009		2010		2011		2012	
	Number	Value	Number	Value	Number	Value	Number	Value	Number	Value
HVPS	21 406.52	6 402 310.77	24 801.90	8 039 463.72	29 121.66	11 043 680.19	37 211.44	13 552 814.97	47 035.96	17 719 972.13
BEPS	14 070.65	51 181.80	22 580.53	114 617.04	38 672.84	162 124.36	56 304.92	183 614.11	75 393.50	185 477.54
IBPS									26 580.35	35 630.14
ACH	42 820.71	719 388.05	43 043.30	694 061.69	44 957.39	731 904.25	41 803.08	709 484.72	39 135.21	665 182.46
CDFCPS			28.29	3 445.88	54.48	9 506.38	76.24	17 103.76	111.05	33 614.79
Intra-bank payment systems of banking institutions	288 229.93	4 085 541.43	3 387.83	3 147 552.55	524 460.31	4 580 717.89	729 076.77	5 305 821.12	895 492.15	6 245 593.61
UnionPay Bankcard Interbank Clearing System	359 743.51	45 509.46	4 528.07	76 636.31	557 666.09	111 847.33	687 797.63	150 146.80	827 295.72	197 436.63
Total	726 271.32	11 303 931.51	98 369.92	12 075 777.19	1 194 932.77	16 639 780.40	1 552 270.08	19 918 985.48	1 911 043.94	25 082 907.30

Note: HVPS(High-value payment system), BEPS(Bulk electronic payment system), IBPS(Internet banking payment system), ACH(Automated clearing houses), CDFCPS(China domestic foreign currency payment system).

Source: The PBC.

责任编辑：董　飞
责任校对：张志文
责任印制：程　颖

图书在版编目（CIP）数据

中国金融稳定报告. 2013：China Financial Stability Report. 2013：英文/中国人民银行金融稳定分析小组编. —北京：中国金融出版社，2013. 7
ISBN 978－7－5049－7068－8

Ⅰ.①中…　Ⅱ.①中…　Ⅲ.①金融市场—研究报告—中国—2013—英文　Ⅳ.①F832.5

中国版本图书馆CIP数据核字（2013）第166871号

出版
发行　中国金融出版社
社址　北京市丰台区益泽路2号
市场开发部　（010）63266347，63805472，63439533（传真）
网 上 书 店　http://www.chinafph.com
　（010）63286832，63365686（传真）
读者服务部　（010）66070833，62568380
邮编　100071
经销　新华书店
印刷　天津银博印刷技术发展有限公司
尺寸　210毫米×285毫米
印张　16.75
版次　2013年7月第1版
印次　2013年7月第1次印刷
定价　228.00元
ISBN 978－7－5049－7068－8/F.6628