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Executive Summary

Performance of the economy and financial markets both in China and internationally was complex and marked with volatility in 2010. The world economy continued to recover but performance across countries diverged. In China, the economic performance remained consistent with the macro-economic policies, reforms in the financial sector produced notable results as evidenced in the higher resilience systemwide, the financial markets developed in a steady and sound manner, the financial conditions of the government, corporate and household sectors was generally healthy, progress was made in financial infrastructure building, and the financial sector functioned soundly. Meanwhile, there were many uncertain and unstable factors in the global economy. The sovereign debt crisis in Europe continued to have negative impact. The international financial markets fluctuated. The commodities prices remained high, intensifying inflationary pressure at the domestic level. Potential risks in the financial sector were not resolved, posing new challenges to safeguarding financial stability.

The macro-economic performance in China was generally good. In 2010, with the pro-active fiscal policy and relatively easy monetary policy continued, the economy grew at a fairly stable and rapid rate, and its structure improved further. The domestic demand was driven by strong forces and external demand gradually improved. Growth of fiscal revenue was rapid, and fiscal expenditure on welfare, agriculture, rural areas and farmers was expanded by a large margin. The hike of price level led to stronger inflation expectations. The housing market austerity measures were intensified and housing price moderated. Growth of money and credit gradually normalized. The reform of RMB exchange rate regime was continued. At the moment, with the long-term and short-term problems intertwined and structural and institutional problems coexistent in the economy, difficulties in macro-economic management have increased. At the next stage, continued efforts should be made to combine a pro-active fiscal policy with a prudent monetary policy, measure the support of the financial sector to the real economy from the social financing aggregate perspective, accelerate the setting up of a counter-cyclical macro-prudential framework, and boost the endogenous growth drivers to speed up the transformation of growth pattern.

The banking sector improved credit structure and functioned soundly, while implementing macro-economic policies, Balance sheet of banking institutions further expanded, with asset quality continuously improved; provision coverage ratio was further increased at a high level, and capital adequacy ratio remained stable; the fee-based income increased, and loan to deposit ratio remained stable; the liquidity was adequate. The reform of banking institutions produced notable results, and cross-sector business and innovation made new progress. The size and structure of bank loans further improved, with the share of agro-lending and SME lending increased relatively. The soundness indicators and supervision quality further improved, and risk management and crisis response capability was bolstered. However, with a prominently increasing trend of the share of demand deposits in total deposits and the share of long-term loans in total lending, maturity mismatch risks were on the rise, and loan concentration remained a problem. It is necessary to strengthen risk management. Looking forward, efforts will be made to implement a prudent monetary policy, further deepen reforms, strengthen macro-prudential regulation and leverage ratio supervision, improve capital replenishment and constraint mechanism, and manage and dissolve potential risks in key areas to build a stronger and more resilient banking sector.

The securities and futures sector grew in a stable manner. Operation of securities firms was sound, and the stock market expanded in size and had a stronger financing function. The stock index futures trading was launched and the margin trading and short selling pilot program started. The reform of IPO system further deepened, and functions of the futures market improved. Compliance supervision was strengthened, and the supervision and regulation of market participants improved. The crack-down on insider trading produced initial results. However, with the launch of new business and products, it is necessary to pay attention to the high valuation of the GEB, the undiversified profit structure of securities firms and potential risks in the PE market. As the next step, measures will be taken to improve the market mechanisms, strengthen supervision and regulation and investors protection, expand direct financing, and promote capital market innovation so that the capital market can provide better services for economic and social development.

The insurance sector saw a good momentum of growth, as evidenced in asset expansion, strong growth of premium income, sounder operation system, larger coverage of risks, improved supervision and regulation, and progress in institutional building. Solvency of insurance companies was generally adequate, and structure of the insurance market optimized further. However, the investment of the insurance sector had a declining rate of return, capital replenishment channels remained limited for insurance companies, imbalance of product structure worsened, and the channels for bancassurance business were yet to be improved. Going forward, it is necessary to seize the opportunities in the rapid growth of the insurance sector, facilitate business structure adjustment and product innovation, establish a calamity insurance system, develop various channels for capital replenishment, strengthen solvency supervision, improve the quality of fund use by the sector, prevent investment risks, and regulate market order to enable the sector to play a better role in insuring against uncertainties and managing the risks for the entire society to support economic and social development.

The financial markets continued sound developments and fully played the role in improving financing structure and resources allocation. Money market trading was brisk and market interest rates hiked notably. Bond market expanded further, trading volume surged, and bond prices were generally up. Bill and paper market grew rapidly, the foreign exchange market fluctuated, and prices and trading volume were both up in the gold market. Financing structure diversified, and the government financing became more market-oriented. The fundamental institutional arrangements were improved. The inter-bank market real time yield curve was launched. RMB Bond issuance by international development institutions was better regulated. The pilot program of credit risks mitigation instruments started. Regulation of inter-bank loan transfer market and gold market improved.

The financial conditions of **the government**, **household and corporate sector** showed that the overall indebtedness of government was fairly sound with fiscal deficit and debt to GDP ratios at a low level. Performance of corporate sector improved, with higher profitability and debt service capability and improved liquidity. The size of financial assets and liabilities of household sector increased fast, and household debt as a share of GDP was slightly up. Attention should be paid to the implicit borrowing by government sector and financing pressure of some enterprises. The income distribution structure needs to be improved further so that household sector income will have a larger share in the GDP.

The financial infrastructure building advanced. The payment system was improved, as evidenced in innovation in non-cash payment instruments, improved regulation of payment services provided by non-financial institutions and better payment environment in rural areas. The system of laws and regulations for the financial sector was improved, and legal foundation for the financial sector performance was strengthened. The new accounting standards were implemented in the entire financial sector, and convergence with international accounting standards made important progress. Credit environment improved continuously, with the credit information system playing an increasingly important role and good results in the building of a credit information system for SMEs and rural areas. The nationwide money-laundering risk assessment was conducted for the first time, anti-money laundering supervision strengthened and international cooperation deepened. Going forward, it is necessary to improve institutional arrangements for payment and settlement, improve laws and regulations for the financial sector, build a better accounting standard system, improve society-wide credit environment and strengthen anti-money laundering efforts and effect.

A macro-prudential framework should be put into place for the financial sector. Important progress was made in building a counter-cyclical capital buffer and stronger supervision over SIFIs. The 12^{th} Five-Year Plan Program has pointed to the need to establish a counter-cyclical macro-prudential framework for the financial sector. To achieve this objective, it is necessary to strike a balance between financial stability and financial system efficiency, and handle the relationship among macro-prudential management, micro-prudential supervision and monetary policy as well as between macro-prudential management and accounting standards. Efforts should be made to establish a mechanism for counter-cyclical macro-economic management, reduce SIFIs risks, strengthen the building of a financial statistics and systemic risk monitoring as well as early-warning system, and improve the framework for crisis management and systemic risk resolution. Building a macro-prudential framework is of practical significance for ironing out cyclical fluctuations in economic performance, preventing systemic risks, preserving financial stability and promoting the sustainability of financial sector support to growth of the real economy.

Abbreviations and Acronyms

ABC	Agricultural Bank of China
ABS	The Centralized Accounting Book System
ADBC	Agricultural Development Bank of China
AML	Anti-money Laundering
AOSSG	Asian-Oceanian Standards Setters Group
BCBS	Basel Committee on Banking Supervision
BEPS	The Bulk Electronic Payment System
BOC	Bank of China
BOCOM	Bank of Communications
BIS	Bank for International Settlements
CAR	Capital Adequacy Ratio
CB	Covered Bond
CBRC	China Banking Regulatory Commission
CCAR	Core Capital Adequacy Ratio
CCB	China Construction Bank
CCP	Central Counterparty
CDB	China Development Bank
CDS	Credit Default Swap
CFETS	China Foreign Exchange Trading System
CFT	Cash Flow Testing
CGFS	Committee of Global Financial System
CIRC	China Insurance Regulatory Commission
CITIC	China International Trust and Investment Corporation
CMB	China Merchants Bank
CP	Commercial Paper
CPC	Communist Party of China
CPI	Consumer Price Index
CPSS	Committee on Payment and Settlement Systems
CSRC	China Securities Regulatory Commission

CTF	Counter Terrorist Financing
DBJ	Development Bank of Japan
DST	Dynamic Solvency Testing
ECAI	External Credit Assessment Institutions
ECB	European Central Bank
EFSF	European Financial Stabilizing Fund
EFSM	European Financial Stabilizing Mechanism
ETF	Exchanges Traded Fund
EXIM	Export-Import Bank of China
EU	European Union
EUR	Euro
FASB	Financial Accounting Standards Board
FATF	Financial Action Task Force on Money Laundering
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FSA	Financial Service Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FX	Foreign Exchange
G20	Group of Twenty
G30	Group of Thirty
GBP	Great Britain Pound
GDP	Gross Domestic Product
GEB	Growth Enterprise Board
G-SIFI	Global Systemically Important Financial Institution
HICP	Harmonized Index of Consumer Prices
HHI	The Herfindahl-Hirschman Index
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICBC	Industrial and Commercial Bank of China
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering

JPY	Japanese Yen
JSCB	Joint-Stock Commercial Bank
KDB	Korea Development Bank
LCR	Liquidity Coverage Ratio
LTV	Loan-to-Value
LVPS	Large Value Payment System
M&A	Merger and Acquisition
MBS	Mortgage Backed Securities
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NAFMII	The National Association of Financial Market Institutional Investors
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NPL	Non-Performing Loan
NPC	National People's Congress
NSFR	Net Stable Funding Ratio
OTC	Over the Counter
PBC	The People's Bank of China
P/E	Price-earnings
PPI	Producer Price Index
PSBC	Postal Savings Bank of China
QDII	Qualified Domestic Institutional Investor
QE2	The Second Round of Quantitative Easing
QFII	Qualified Foreign Institutional Investor
RCC	Rural Credit Cooperative
RCPMIS	RMB Cross-border Payment Management Information System
RMB	Renminbi
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
RRR	Reserve Requirement Ratio
SAFE	State Administration of Foreign Exchange
SAR	Special Administrative Region
SCP	Short-term Commercial Paper
SEC	Securities and Exchange Commission
SIB	Systemically Important Bank

SIFI	Systemically Important Financial Institution
SINOSURE	China Export& Credit Insurance Corporation
SME	Small and Medium-sized Enterprise
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
SPVs	Special Purpose Vehicles
TIC	Trust and Investment Company
UCC	Urban Credit Cooperative
UN	United Nations
USD	US Dollar
VAT	Value-Added Tax
WB	World Bank
XBRL	EXtensible Business Reporting Language
y-o-y	year-on-year

CONTENTS

Boxes

Chapter Ⅰ

Macroeconomic Environment

The year 2010 witnessed complex and volatile economic and financial situations at home and abroad. The global economy continued to recover but at various pace in different jurisdictions. Recovery of major economies was sluggish, and unemployment rates hovered at high levels. The emerging economies exhibited strong growth, but under increasing capital inflows and mounting inflationary pressures. China's economy continued to develop in the direction as intended by the macroeconomic policies, and performed generally well. However, inflationary pressures built up noticeably, and structural problems remained to be resolved.

In 2011, the world economy is expected to grow continuously. Due to multiple favorable domestic conditions for stable and relatively fast economic growth, the emerging economies will take the lead in the global recovery; however, many unstable and uncertain factors will still exist. High unemployment and slow growth of the advanced economies cannot be improved within a short period of time. In China, pressures for domestic economic structure adjustment will build up, resources and environment constraints will be strengthened, and it remains an arduous task to improve people's livelihood. Therefore, efforts will be made to make economic development better coordinated, more sustainable and more resilient.

Global Economic and Financial Developments in 2010

In 2010, the world economy continued to recover, and the annual growth rate posted 5.0 percent. However, economic performance varied from jurisdiction to jurisdiction, with the advanced economies and the emerging and developing economies growing at 3.0 percent and 7.3 percent respectively. The international financial markets continued to fluctuate, stock market performance was mixed, and commodity prices remained high.

Economic Performance of the Major Economies

There were positive signs in the US economy, but factors hindering economic recovery were not eradicated. In 2010, the GDP growth of the US registered 2.8 percent, in sharp contrast with –2.6 percent in 2009. Unemployment rate stood at 9.6 percent for the whole year, CPI gained 1.6 percent y-o-y, the lowest level in the past two years. However, there were some uncertainties amidst the gradual rebound. First, debt and trade deficits remained prominent problems. In the fiscal year of 2010, deficit of federal government approached USD 1.3 trillion, and many state governments were confronted with fiscal distress. In 2010, trade deficit stood at USD 497.8 billion, up 32.8 percent y-o-y. Second, the quantitative easing policy heightened concerns over dollar depreciation and inflation expectations in the medium and long run. Third, unemployment rate remained high, and the economy could not get rid of the problem of "jobless recovery". Fourth, with the ongoing deleveraging process in the banking and residential housing sectors, the real estate market remained weak, the forfeiture ratio stood at a high level, and the endogenous drivers for economic recovery were not adequate.

The Euro Zone member states exhibited diverging economic performance, and the sovereign debt crisis might continue to drag the overall economic recovery. In 2010, the GDP in the Euro Zone grew by 1.7 percent, an obvious rebound compared to 2009; however, economic performance diverged. Germany performed better than the other countries, and became the major driving force for the recovery in the area. In 2010, Germany's GDP posted a 3.5 percent growth, unemployment dropped to 6.9 percent, and both indicators hit the best levels since 1991. Other member countries recovered rather sluggishly. GDP of France and Italy grew slightly by 1.5 percent and 1.3 percent respectively, while Greece, Ireland, Spain and other countries slid into the negative zone as a result of the debt crisis. The HICP in the Euro Zone posted 1.6 percent, much higher than 0.3 percent in the previous year. The future economic recovery trend in the area will mainly be subject to two factors. First, though a series of fiscal consolidation and crisis rescue measures have helped to stabilize the financial market in Europe, deep-rooted problems that triggered the sovereign debt crisis are far from being addressed fundamentally. Market confidence is weak, and the evolution of the debt crisis remains unclear. Second, expectations for inflation and interest rate hike might influence the economic recovery outlook.

In Japan, deflation and poor employment were not improved, and growth momentum weakened. In 2010, Japan's GDP grew by 3.9 percent. Deflation still existed, with the core CPI declined by 1 percent y-o-y, representing the second negative growth in a row. Unemployment rate remained high, with the average of 5.1 percent, at a similar level to 2009. Government debt continued to increase. At the end of 2010, outstanding sovereign debt registered JPY 919 trillion, with over 190 percent of GDP and a new historical high. In addition, sluggish consumption growth, slowing export growth, local currency revaluation and other problems exerted pressures on the economic recovery.

The emerging economies generally rebounded strongly, but with increasing risks of capital inflows and mounting inflationary pressures. Since the beginning of 2010, due to growing domestic demand and rising commodity prices, emerging markets and developing economies in Asia, Latin America and other regions exhibited strong recovery, making them the major driving force of the world economic growth. In 2010, India, Brazil and Russia grew by 10.4 percent, 7.5 percent and 4.0 percent respectively. At the same time, as a result of sustained excess liquidity worldwide and weak economic recovery in the advanced economies, speculative capital swarmed into the emerging economies featuring strong economic growth and large interest spread, hence heightening the pressures on asset price hike including stocks and real estate, and pressures on local currency appreciation. Capital inflows also shored up pressures of imported inflation in the emerging economies. The CPI of India, Brazil and Russia gained 13.2 percent, 5.0 percent and 6.9 percent respectively. In order to prevent the economy from overheating and to rein in inflation, some emerging economies started to raise interest rates.

Box 1 Development of Economic Stimulus Policies by Major Economies in 2010

Since the beginning of 2010, major economies diverged remarkably in economic stimulus policies. The US and Japan launched subsequently a new round of fiscal and monetary policies; European countries, while maintaining loose monetary policies, beefed up fiscal consolidation efforts; some countries sped up the exit of stimulus policies.

The US government launched new economic stimulus plans, and the Federal Reserve unveiled the second round of quantitative easing (QE2). In September 2010, in order to boost economic growth and job creation, the Obama administration announced a new round of economic incentives worth USD 350 billion, mainly aimed to increase infrastructure investment, and to cut personal income tax and tax burden on R&D companies. In December, the Congress passed the tax act with a total amount of USD 858 billion proposed by the Obama administration, thus once again making tax reduction as an economic growth driver. On November 3, the Federal Reserve decided to maintain the Federal Fund Rate at the lowest historical level of 0–0.25 percent. At the same time, it announced the plan to purchase another USD 600 billion long-term Treasury bonds, and indicated that it would reinvest principal payments from its securities holding.

The Japanese government reinforced economic stimulus, and re-launched the zero interest rate policy after a lapse of four years. In September and October 2010, the Japanese government launched economic stimulus plans twice in a row totaling nearly JPY 6 trillion, mainly to strengthen employment and cultivation of talents, to promote growth strategies, and to support green industries and small enterprises. In order to deal with deflation and a stronger yen, the Bank of Japan decided on October 5 to cut the uncollateralized overnight call rate from 0.1 percent to 0-0.1 percent, and announced an asset purchase plan amounting to JPY 5 trillion. The Bank of Japan also expanded the size of commercial banks' liquidity supply at fixed interest rate to JPY 30 trillion, and intervened massively on September 15 in the foreign exchange market to prevent the yen from substantial appreciation.

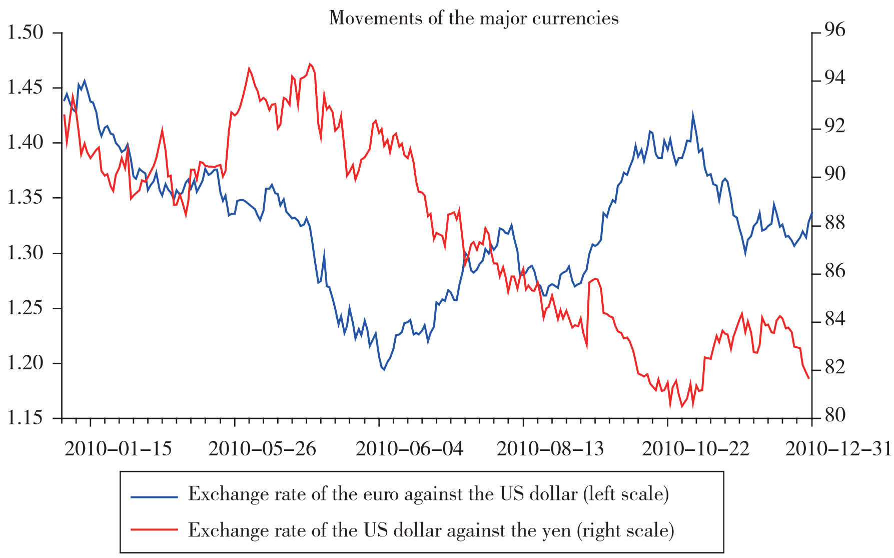
Europe postponed the exit of unconventional monetary policies and strengthened fiscal consolidation. In 2010, in response to the debt crisis, ECB maintained the main refinancing interest rate at the historical low level of 1 percent, and injected liquidity into the market through refinancing operations, the Securities Market Program and other measures. The Bank of England also maintained the Bank Rate unchanged at 0.5 percent and the stock of purchased assets at GBP 200 billion. In order to promote fiscal sustainability, the EU promoted the establishment of a punishment mechanism, requiring all member countries to strengthen fiscal consolidation, so as to meet the requirements of the *Stability and Growth Pact*. At the same time, in order to contain contagion of the debt crisis, the EU launched a EUR 750 billion rescue plan, and set up the European Financial Stabilizing Fund (EFSF), the European Financial Stabilizing Mechanism (EFSM), and the permanent European Stabilizing Mechanism (ESM). Major European countries announced large-scale fiscal consolidation plans subsequently, in order to bring down government debt and deficit levels. The EU, ECB and IMF reached an agreement of rescue with Greece and Ireland subsequently of EUR 110 billion and EUR 85 billion respectively, which, to some extent, stabilized the European financial markets.

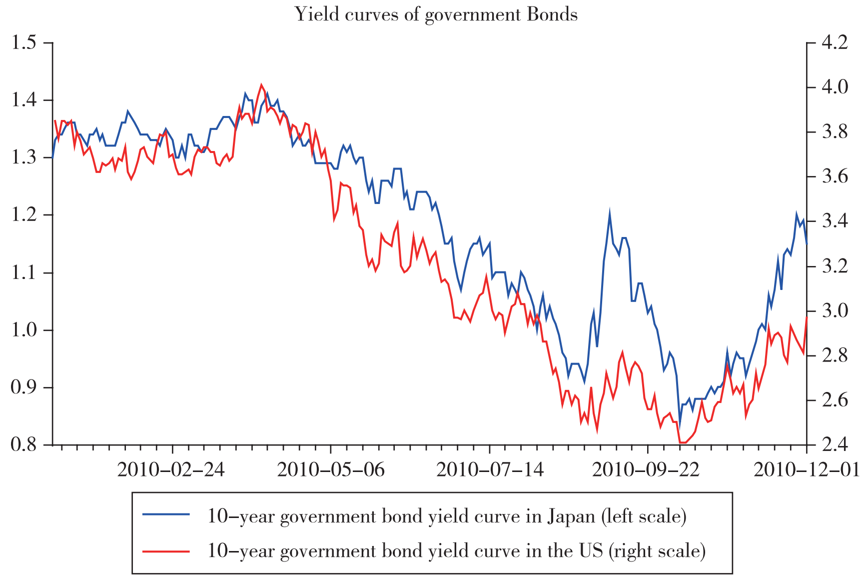
Some economies with strong economic recovery and high inflationary pressures accelerated policy exit. In 2010, some emerging economies and resources-abundant economies started to hike interest rates in order to contain inflation. For example, India, Brazil, South Korea, Canada and Australia increased benchmark interest rates on several occasions. India gradually exited from fiscal stimulus policies through increasing excise, resuming customs duty on refined oil products. Brazil, South Korea, Indonesia, Thailand and Malaysia strengthened controls over capital inflows and intervention on the foreign exchange markets. Singapore, Hong Kong and Australia tightened tax and credit policies targeting the real estate markets.

International Financial Markets

Foreign exchange and bond markets fluctuated noticeably. In 2010, affected by the European sovereign debt crisis, QE2 of the US, and other factors, exchange rates of major currencies fluctuated within a wide range. In 2010, the euro depreciated by 6.7 percent against the dollar, the yen appreciated by 14.5 percent against the dollar, and the broad-based trade weighted dollar index devalued by 2.4 percent cumulatively. In order to prevent their local currencies from rapid appreciation, some countries strengthened intervention operations on the foreign exchange market and control measures on capital inflows. At the same time, with the unfolding European sovereign debt crisis, the global economic recovery outlook gradually improved. Yields of major government bonds dropped first and then edged up, amidst substantial fluctuations. As of December 31, yields of 1-year Government bonds of the US, the Euro Zone and Japan posted 3.36 percent, 2.97 percent and 1.12 percent respectively, down by 0.43, 0.41 and 0.17 percentage points respectively from the end of 2009, but gained 0.85, 0.71 and 0.18 percentage points respectively from the end of the previous quarter (Figure 1.1).

Figure 1.1 Exchange Rate Movements of Major Currencies and Yield Curves of Government Bonds in 2010

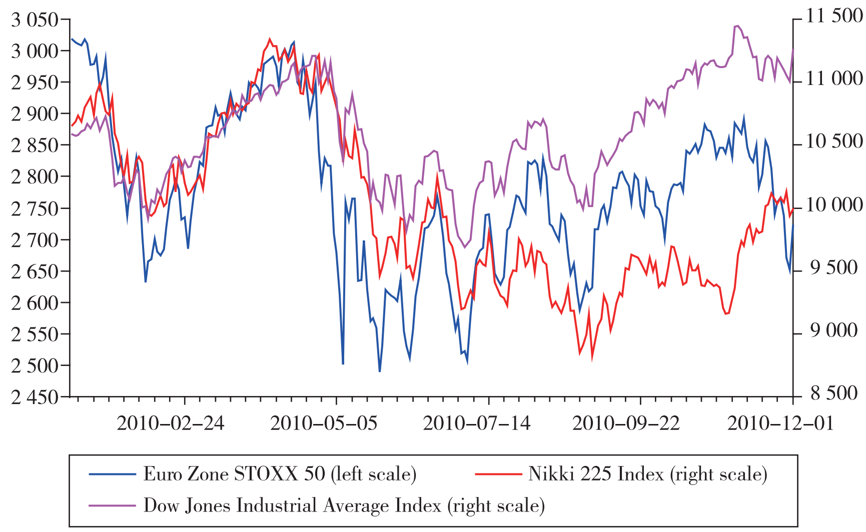




Source: CEIC.

Movements of major stock indices diverged. In 2010, driven by the QE2 policy, improved economic data and higher profitability of listed companies, the US stock market trended up amidst fluctuations. As of December 31, the Dow Jones Index closed at 11 578, up 10.9 percent from end-2009, and nearly back to the pre-crisis level (before the collapse of Lehman Brothers in September 2008). Affected by sluggish economic recovery, debt crisis, yen appreciation and other adverse factors, the European and Japanese stock markets performed poorly. The STOXX50 index closed at 2 601, up 0.85 percent from end-2009, while Nikki 225 index closed at 10 229, down 3.0 percent from the end of the previous year (Figure 1.2). Stock market performance of the emerging market economies diverged hugely. Russia's MICEX rose by 22 percent, Mumbai's BSE index increased by 17 percent, while Brazil's BOVESPA dropped by 1 percent, and China's Shanghai Composite Index declined by 14.3 percent.

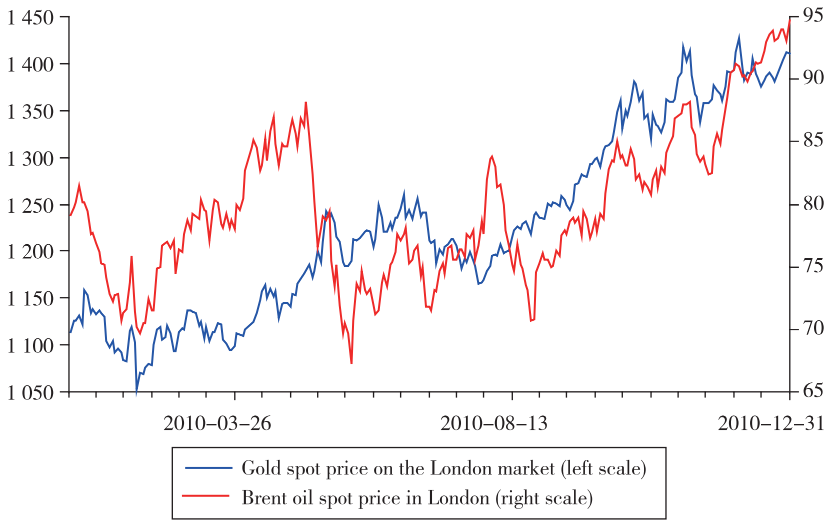
Figure 1.2 Major Stock Indices in 2010



Source: CEIC.

Commodity prices continued to increase. In 2010, due to rising demand driven by global economic recovery, liquidity glut, and strengthened inflationary expectations, prices of crude oil and precious metals grew substantially. On December 31, crude oil futures in the New York commodity market closed at USD 91.38 per barrel, up 15.1 percent from the end of 2009, and Brent spot oil price rose by 21.5 percent y-o-y to close at USD 94.63 per barrel. Spot gold price on the London Metals Exchange increased by 27.7 percent from end-2009 to close at USD 1 410.3 per ounce, the biggest increase since 2007 (Figure 1.3). Futures prices of copper, tin, nickel and other major metals increased substantially by 30–60 percent. Moreover, affected by increasing global demand and extreme weather in Russia, Brazil and Australia, prices of agricultural produce increased by a large margin, and prices of wheat, rice, corn and other crops reached the highest levels since the outbreak of the financial crisis.

Figure 1.3 Movements of Gold and Oil Price Indices



Source: CEIC.

Highlights of China's Economic and Financial Performance in 2010

Faced with complex and volatile situations at home and abroad, China continued to implement a proactive fiscal policy and a moderately loose monetary policy in 2010. PBC endeavored to make policies better targeted and more flexible, and promoted a gradual normalization of monetary conditions. In general, the Chinese economy developed in the direction as intended by macroeconomic policies, and the momentum of stable and relatively fast economic growth became more solidly based.

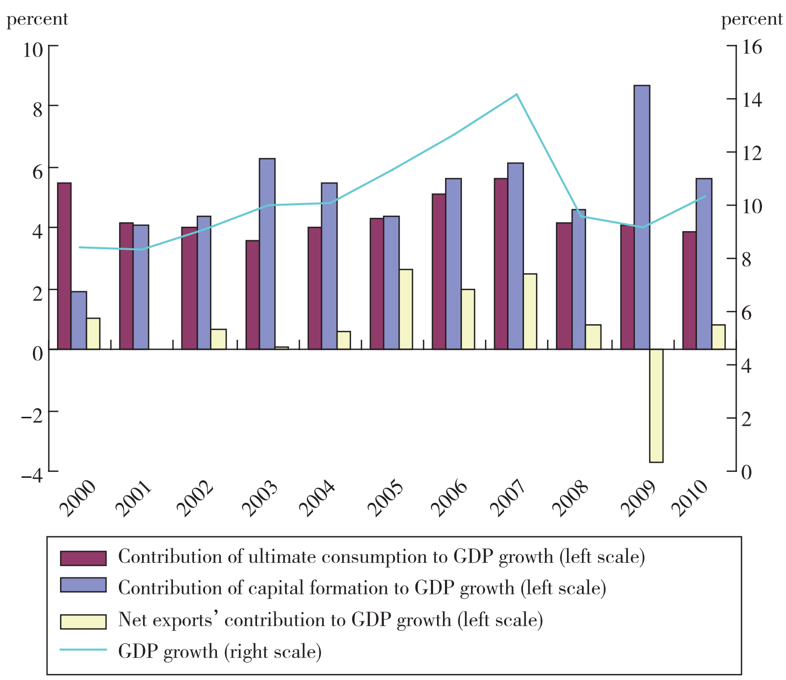
Economy Achieved Stable and Relatively Rapid Growth, and the Economic Structure Was Further Optimized

According to the preliminary data released by NBS, China's GDP posted RMB 39.8 trillion yuan in 2010, up 10.3 percent y-o-y, an acceleration of 1.1 percentage points from 2009. Broken down by quarters, the GDP grew 11.9 percent, 10.3 percent, 9.6 percent and 9.8 percent in the four quarters respectively. Broken down by industries, added value of the primary industry grew by 4.3 percent to RMB 4.05 trillion yuan, added value of the secondary industry posted RMB 18.65 trillion yuan, representing a y-o-y increase of 12.2 percent, and added value of the tertiary industry was up 9.5 percent to RMB 17.1 trillion yuan. In terms of share of added value of the three industries in the GDP, the economic structure was further improved. The primary industry accounted for 10.2 percent, down 0.4 percentage points from the previous year; the secondary industry rose marginally by 0.1 percentage point to 46.9 percent; the tertiary industry accounted for 43 percent, up 0.8 percentage points over the previous year.

Domestic Demand Became Stronger, and External Demand Improved Noticeably

In 2010, retail sales of consumer goods totaled RMB 15.5 trillion yuan, representing a y-o-y increase of 18.4 percent. Price adjusted real consumption growth was 14.8 percent. Broken down by urban and rural areas, retail sales in the urban areas registered RMB 13.4 trillion yuan, up 18.8 percent; whereas retail sales in the rural areas posted RMB 2.1 trillion yuan, up 16.1 percent. In 2010, fixed asset investments totaled RMB 27.8 trillion yuan, up 23.8 percent y-o-y. Total fixed asset investments in the urban areas totaled 24.1 trillion yuan, up 24.5 percent y-o-y; total fixed asset investments in the rural areas registered 3.67 trillion yuan, up 19.7 percent y-o-y. With the global economic recovery, the external demand also improved gradually. In 2010, imports and exports totaled USD 2.97 trillion, up 34.7 percent y-o-y. Specifically, exports posted USD 1.58 trillion, up 31.3 percent y-o-y; imports registered USD 1.4 trillion, up 38.7 percent y-o-y. Trade surplus dropped by 6.4 percent from 2009 to USD 183.1 billion (Figure 1.4). According to the preliminary measurement, internal demand (capital formation and ultimate consumption) drove the GDP growth by 9.5 percentage points in 2010, and net exports contributed to the GDP by 0.8 percentage points. Internal and external demand played an even more balanced role in driving economic growth.

Figure 1.4 Contribution of Consumption, Investments and Exports to GDP Growth



Source: CEIC.

Box 2 The Pilot Program for RMB Settlement of Cross-border Trade and the Pilot Program of RMB Cross-border Investment and Financing Were Conducted Steadily

Supported by other government agencies, PBC actively conducted the pilot program for RMB settlement of cross-border trade and the pilot program of RMB cross-border investment and financing by taking flexible and concrete measures, which greatly promoted trade and investment facilitation.

The pilot program for RMB settlement of cross-border trade made new breakthroughs. In June 2010, the *Notice on Issues Regarding Expanding the Pilot Program for RMB Settlement of Cross-border Trade Transactions* was issued, which expanded the pilot program to 20 provinces (autonomous regions, municipalities) including Beijing and Tianjin from the original list of 4 cities in Guangdong province and Shanghai. The move greatly advanced the RMB settlement of cross-border trade transactions. In 2010, the total amount of RMB settlement reached RMB 506.343 billion yuan, including RMB settlement of goods imports and exports of RMB 438 billion yuan, accounting for 2.2 percent of the total imports and exports volume in the whole year. Guangdong and Shanghai, namely the first batch of the pilot regions, accounted for over 50 percent of the total settlement volume, while the eight border provinces (autonomous regions) accounted for 7.84 percent. As of the end of 2010, about 92 countries and regions conducted RMB payment and receipt transactions for cross-border trade with domestic enterprises.

The pilot program of RMB cross-border investment and financing forged ahead steadily. In order to support the pilot program for RMB settlement of cross-border trade and large-size overseas investment projects, PBC launched the pilot program of RMB cross-border investment and financing. The program was aimed to serve the real economy, and it focused on examination of authenticity of transactions in order to strictly control risks. In 2010, various pilot regions conducted 386 transactions of RMB cross-border investment and financing, totaling RMB 70.17 billion yuan. In October 2010, Xinjiang Autonomous Region was the first to conduct the pilot program of direct cross-border investment with the RMB.

Supporting measures for cross-border use of RMB were introduced. In March 2010, PBC issued the *Tentative Measures on the RMB Cross-border Payment Management Information System*, in order to safeguard stable and effective operation of the RMB cross-border payment management information system (RCPMIS). In August, PBC issued the *Measures for the Administration of RMB Bank Settlement*

Accounts of Overseas Institutions, which made it possible to use non-residential accounts to settle cross-border RMB businesses permitted by various prevailing systems, thus creating a new channel for cross-border RMB settlement, and adding another instrument for indirectly regulating flows and prices of RMB funds in overseas markets. In the same month, PBC also announced *the Notice on Issues Related to the Pilot Program of Allowing Overseas RMB Clearing Banks and Other Two Types of Institutions to Make RMB Investments in the Inter-bank Bond Market*, providing a reasonable channel for value preservation of RMB assets held by overseas institutions; therefore, it can help increase the acceptability and recognition of RMB in overseas markets, and enlarge the role of RMB in cross-border trade and investment activities.

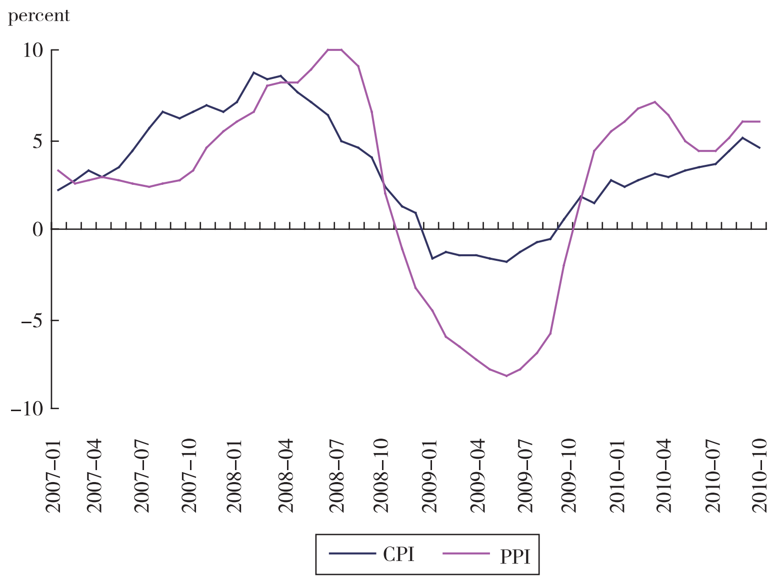
Fiscal Revenue Grew Rapidly and Growth of Fiscal Expenditure Decelerated

In 2010, due to stable economic growth, price increase and other factors, fiscal revenue grew rapidly. In the whole year, fiscal revenue surged by RMB 1.46 trillion yuan or 21.3 percent y-o-y to RMB 8.31 trillion yuan, representing an acceleration of 9.6 percentage points. The actual fiscal revenue exceeded the budget by RMB 915 billion yuan, mainly due to the fact that some related economic indicators for budget estimate outperformed the expectation. Fiscal expenditure registered RMB 8.96 trillion yuan, up 17.4 percent y-o-y, and a deceleration of 4.5 percentage points from 2009. However, expenditures on people' livelihood and agriculture, farmers and rural areas grew by a fairly large margin. Within the expenditure basket, spending on education, medical service, social security and employment, government-supported housing totaled RMB 889.854 billion yuan, up 19.9 percent, whereas spending on agriculture, farmers, and rural areas posted RMB 857.97 billion yuan, up 18.3 percent.

Price Indices Continued to Rise, and Inflationary Pressures Built up

In general, price increase in 2010 continued the upward trend, and in particular it sped up after the third quarter. The quarterly CPI was up 2.2 percent, 3.1 percent, 3.4 percent and 4.7 percent respectively, averaging 3.3 percent for the whole year. Food and housing prices were the major contributors to CPI increase, up 7.2 percent and 4.5 percent respectively, and non-food price growth accelerated after the fourth quarter. PPI gained 5.5 percent y-o-y, an acceleration of 10.9 percentage points over the previous year. The purchase prices of raw materials, fuel, and power increased by 9.6 percent y-o-y, representing an acceleration of 17.5 percentage points from 2009. The GDP deflator grew by 5.8 percent, representing an acceleration of 6.4 percentage points from the previous year (Figure 1.5). The continued hike of price indices was mainly due to generally loose monetary conditions in the world since the outbreak of the crisis. As expectation of major economies to maintain monetary easing to stimulate economy remains strong, emerging economies with strong growth performance are experiencing massive capital inflows. Against the backdrop of abundant liquidity supply, with growth stabilizing and pointing upward, sustained inflationary expectation is likely to emerge and the excess funds will inevitably look for various kinds of investment opportunities. Meanwhile, due to the Balassa-Samuelson effect[①] and the moderated growth of working-age population, labor cost is expected to rise. The prices of agricultural produce and service, with large labor cost content, face upward pressure. Reform of resource product is imminent. All of these will heighten inflationary pressures. According to PBC's Q4 urban depositor survey, household price sentiment index hit a low level never seen since Q4 1999, and the future price expectation index went up by 8.5 percentage points to 81.7 percent. The share of respondents expecting higher price in the next quarter was up 15.2 percentage points quarter on quarter, and the share of respondents expecting higher housing price in the next quarter went up again from the previous quarter by 6.8 percentage points.

Figure 1.5 Y-o-y Movements of Major Price Indices



Source: NBS.

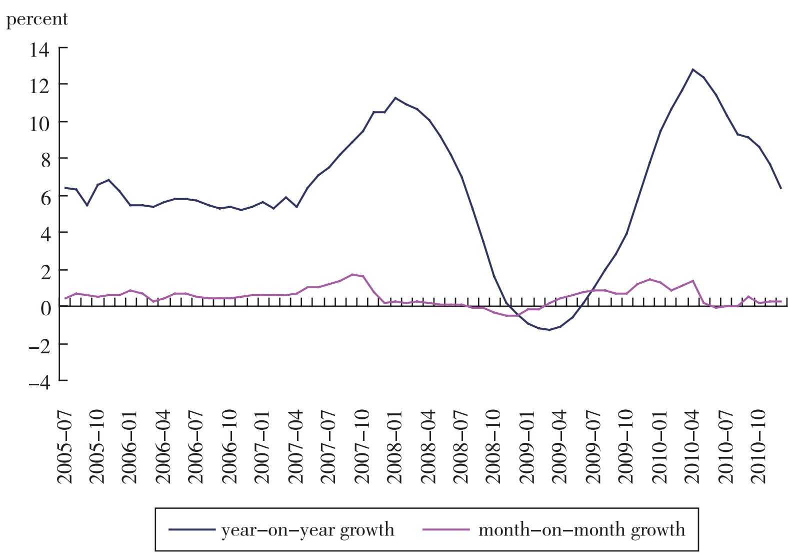
① The Balassa-Samuelson effect describes such a phenomenon: a country's economy is made up of the tradable sector (e.g., manufacturing of general industrial products and etc.) and the non-tradable sector (e.g., the real estate sector, the service sector and etc.). Productivity growth of the tradable sector is generally faster than that of the non-tradable sector, because its wage is normally higher than that of the non-tradable sector. However, as the labor force flows among the sectors, the wage level in the non-tradable sector will grow subsequently, which will exceed the growth of its productivity, hence pushing up prices of the non-tradable sector. Economists use this theory to explain why the prices of housing, food and drinks, and labor cost for services in the developed economies and fast-growing economies are higher than undeveloped countries.

Housing Price Growth Moderated As More Rigorous Measures Were Announced to Regulate the Real Estate Market

In 2010, in order to contain excessive housing price hike in some cities, the *Notice on Promoting Stable and Healthy Development of the Real Estate Market* was issued in January, which intended to inhibit house purchasing for investment and speculation purpose while encouraging and supporting rational consumption of households. In April, the *Notice of the State Council on Resolutely Curbing the Soaring of Housing Prices in Some Cities* was released, which required commercial banks to strictly follow the rules of no less than 50 percent down payment ratio and lending rate no lower than 1.1 times of the benchmark interest rate for second home buyers, and which allowed commercial banks to suspend mortgage loans to households purchasing the third home in regions featuring excessive and rising commercial residential housing prices and short supply of housing. In September, PBC and CBRC jointly issued the *Notice on Issues Concerning the Improvement of the Differentiated Housing Credit Policies*, requiring commercial banks to suspend the granting of housing loans for the third home. In December, the Central Economic Work Conference pointed out that efforts will be made to make the government more accountable for this issue, to promote the construction of more affordable housing projects, speed up the renovation of shantytowns and dilapidated rural houses, develop public rental housing, and create an affordable housing system and a commercial housing system in line with China's situation, for the purpose of improving people's livelihood.

The launch of the above measures helped to contain speculative demand and rapid surge of housing prices in some cities. In 2010, the sold floor area of commercial real estate was up 10.1 percent y-o-y, representing a deceleration of 32 percentage points from 2009. Sales of commercial real estate were up 18.3 percent y-o-y, representing a deceleration of 57.2 percentage points from 2009. In December, the housing prices in 70 large and medium-sized cities were up 6.4 percent y-o-y, representing a deceleration of 6.4 percentage points from April when the price hike was the highest (Figure 1.6), or up 0.3 percent month on month, representing a deceleration of 1.1 percentage points from April. In particular, the price of newly built homes was up 7.6 percent y-o-y, and 0.3 percent month on month, whereas the price of pre-owned homes was up 5.0 percent y-o-y and 0.5 percent month on month.

Figure 1.6 Monthly Growth of Sales Prices of houses in 70 Large- and Medium-sized Cities

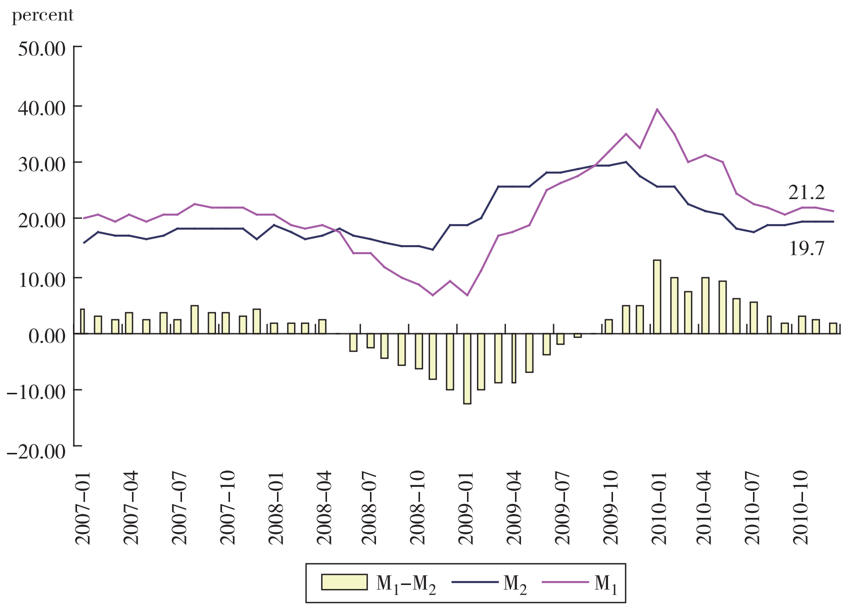


Source: NBS.

Monetary Conditions Returned to Normal, and the RMB Exchange Rate Flexibility Was Strengthened

According to the changing situation, PBC worked to make policies better targeted and more flexible, while maintaining policy consistency. In 2010, it raised the reserve requirement ratio on six occasions, raised the benchmark lending and deposit interest rates twice, furthered the reform of the exchange rate regime, strengthened exchange rate flexibility, reinforced risk warnings about credit lending, and promoted a gradual normalization of monetary conditions, all of which played an important role in managing inflation expectations and maintaining stable economic growth. At end-2010, outstanding M_2 registered RMB 72.6 trillion yuan, up 19.7 percent y-o-y, a deceleration of 8 percentage points over the end of 2009. Outstanding M_1 stood at RMB 26.7 trillion yuan, an increase of 21.2 percent y-o-y, and a deceleration of 11.2 percentage points (Figure 1.7). Outstanding RMB loans grew 19.9 percent y-o-y to RMB 47.9 trillion yuan, a deceleration of 11.8 percentage points from the same period of the last year. New loans posted RMB 7.95 trillion yuan, a deceleration of 1.65 trillion yuan y-o-y. Broken down by quarters, new loans stood at RMB 2.6 trillion yuan, RMB 2.03 trillion yuan, RMB 1.67 trillion yuan and RMB 1.64 trillion yuan respectively in the four quarters, accounting for 32.8 percent, 25.5 percent, 21 percent and 20.7 percent of the total respectively, more balanced compared to the last year.

Figure 1.7 M_1 and M_2 Growth



Source: PBC.

Since the furthering of the RMB exchange rate reform on June 19, 2010, the RMB exchange rate has moved in both directions and has appreciated slightly with more flexibility. At end-2010, the central parity of the RMB against the US dollar was 6.6227 yuan per US dollar, up 3.09 percent from June 18. BIS estimated that the RMB real effective exchange rate appreciated 4.2 percent in 2010, and that the RMB real effective exchange rate appreciated 24.97 percent from the exchange rate reform in 2005 to end-2010. Furthering the RMB exchange rate regime reform has positive effects on the real economy, and will play a positive role in promoting economic restructuring and more balanced and sustainable development, containing inflation and asset bubbles, and strengthening the preemptiveness and effectiveness of the macroeconomic management.

Box 3 Objectively Analyze Monetary Aggregates and Currency Excessive Issuing

Since the outbreak of the international financial crisis, in order to mitigate the impact of the crisis, China implemented the proactive fiscal policy and moderately loose monetary policy, and as a result, money and credit grew relatively fast, raising widespread attention. However, it is not a simple one to one relationship between money and an economy, so it is not accurate to arrive at the conclusion of currency excessive issuing just based on high absolute value of M_2 and M_2/GDP ratio.

Generally speaking, if a country's indirect financing ratio is high, of which bank financing accounts for a large share, the country's monetary aggregates are relatively abundant, because bank asset expansion (such as loan extension, purchase of bonds and foreign exchange and etc.) generates deposits, thus increasing money supply in society. Direct financing (such as issuing stocks and bonds and etc.) is only about transfer and exchange of currencies among different economic agents, and monetary aggregates do not change. Studies have shown that M_2/GDP ratio in countries where indirect financing dominates the financing structure is higher than that in countries mainly relying on direct financing. For example, direct financing is quite advanced in the US, and its M_2/GDP ratio was merely 0.6 in 2009. However, in Asian countries most of which reply on bank-intermediated financing, M_2/GDP ratio is relatively high, and this ratio was 1.6 in Japan in 2009, and 1.5 in Korea. For long, M_2 growth in China outpaced GDP growth. In addition, higher-than-GDP M_2 growth is related to a country's economic development stage, monetarization progress, savings rate, market structure, statistical coverage of M_2 and other factors.

China's M_2/GDP ratio has been declining in general since 2003, despite a modest rebound in the recent two years when China implemented the proactive fiscal policy and moderately loose monetary policy in response to the international financial crisis. In reality, the crisis response measures have played a crucial role in propping up confidence, expanding aggregate demand, and promoting stable and relatively fast economic growth. China's economy was among the first to stabilize and recover.

At the current juncture, China is faced with rising inflationary pressures. Causes of this problem are rather complicated, and cyclical and structural factors intertwine. First, the US and other major advanced economies carried out extremely loose monetary policies, which led to loose monetary conditions worldwide, exacerbating domestic inflation expectations on the one hand, and pushing up commodity prices on the other hand that further heightened pressures from imported inflation. Second, the lagged effects of fairly large monetary stock might emerge gradually. Third, disastrous climate and other factors have contributed to structural price increase of agricultural produce. Fourth, affected by changes in demographic bonus and other factors, labor cost, and prices of the service sector and non-tradable goods might climb further, and prices of resources products remain to be rationalized.

In view of the changes in the current economic and financial situation, China's monetary policy stance has changed from moderately loose to prudent. The change will help strengthen management of inflation expectations and prevent asset price bubbles while satisfying rational demand for capital supported by stable and relatively fast economic growth.

Global Economic Outlook for 2011

Looking forward in 2011, drastic turbulence caused by the international financial crisis will continue to wind down; the global economic recovery will go on, though not solidly based. According to IMF forecast, the world economy will grow by 4.5 percent in 2011, down 0.5 percentage points from 2010. The major advanced economies will face with such problems as mounting public debt, a weak property market and etc., unemployment will remain high, and economic growth will slow down. Emerging and developing economies will keep rapid growth; however, economic growth might slow down due to the effects of policy exit. According to IMF, advanced economies and emerging and developing economies will grow by 2.4 percent and 6.5 percent respectively in 2011, representing deceleration of 0.6 and 0.8 percentage points respectively. At the same time, inflation in emerging and developing economies will trend upward, which is expected to be 6.9 percent in 2011, up 0.7 percentage points from 2010. Inflation in the advanced economies will edge up slightly from 1.6 percent in 2010 to 2.2 percent in 2011.

However, the deep-rooted problems exposed by the crisis remain unsolved, and there are still some uncertainties blurring the world economic outlook. Some risk factors that may influence the global economic development include:

Deep-rooted and inherent problems of major advanced economies remain unsolved. The European sovereign debt crisis may exacerbate and expand further. If the Euro Zone countries fail to set up a reliable and long-term crisis response mechanism as soon as possible, the debt problem will become a big risk threatening the world economic recovery. In order to promote economic recovery, the US, Japan and other advanced economies announced a new round of fiscal stimulus packages, which, in the context of already high debt levels, will lead to further deterioration of fiscal conditions and increase public debt risks. IMF estimates that the US fiscal deficit will reach 10.75 percent in 2011, and gross government debt will account for 99.5 percent of the GDP, while the gross government debt and deficit in Japan will account for 229.1 percent and 8.9 percent of the GDP respectively in 2011. Failure to deliver effective fiscal consolidation in the advanced economies may lead to uncontrollable debt levels and shore up long- and medium-term interest rates, thus negatively impacting the global financial market and the world economic recovery. At the same time, very low savings in the US and other advanced economies are unlikely to change in the short run, and trade deficit will remain a prominent problem.

Quantitative easing policies of some economies will heighten inflationary pressures in the world. In the context of continued quantitative easing policies in the major advanced economies, the global monetary conditions remain loose, and voluminous excess liquidity will compete for limited investment opportunities. Due to strong economic recovery and large interest spread, some emerging economies have attracted a large amount of capital inflows, which has pushed up asset prices and inflation expectations, and this has made policy adjustment more difficult. If inflation, asset bubbles and other risk factors cannot be effectively controlled, more aggressive tightening policies of the emerging economies may lead to a hard landing and trigger a reversal of short-term capital flows, thus threatening the global economic recovery and stability of the financial markets. At the same time, affected by the turmoil in the Middle East, increasing global demand and abundant liquidity, prices of oil, minerals, crops, precious metals and other commodities have surged, which might further heighten the global inflationary pressures and financial market volatility, dampening confidence of consumers and investors, hence imposing adverse impact on the already fragile global economic recovery.

International cooperation and policy coordination have become more difficult. At present, economic cycles vary from country to country, and countries have different arguments for economic policies. Advanced economies continue to maintain interest rates at historical low levels and keep quantitative easing policies, while more and more emerging economies gradually tighten up macroeconomic policies. With trade protectionism continuing to flare up, competition in the international market will become fiercer. Divergent policy stance among different countries and less willingness to cooperate will make it more difficult to coordinate economic policies at international level, and will influence global economic recovery and stable operation of international financial markets.

Balance sheet repair of the financial sector progresses slowly. The global financial system is still vulnerable, toxic assets remain to be digested, banks are less willing to extend loans, and banking systems of some countries are exposed to the risks of deteriorating real estate loans. The banking systems in some Euro Zone countries may be influenced by downgrading of the sovereign debt. Financing pressures and risks facing the banking system render the financial system rather weak, vulnerable to deteriorating market sentiments, and the weak financial system will drag the recovery of the world economy.

China's Economic Outlook for 2011

The year 2011 is the first year of the 12th Five-year Plan, and there will be multiple favorable conditions for achieving stable and relatively fast economic growth. Existing measures, aimed to revitalize emerging industries of strategic importance, to speed up the construction of affordable housing and renovation of shantytowns, and to encourage and guide private investment, are playing their roles. The domestic market has tremendous potentials, household savings rate is relatively high, the consumption upgrading and urbanization are making steady progress, the reform of income distribution intensifies, and shift of the development pattern and economic restructuring are accelerating, so the drivers for sustained economic growth are adequate with great potentials. As the world economy is expected to continue to recover, external environment for China's economic growth is favorable. However, there are many challenges from home and abroad. The global economic recovery is not solidly based yet, with many unstable and uncertain factors. In terms of domestic economic performance, some long-term problems intertwine with short-term problems, institutional conflicts coexist with structural problems, and macroeconomic management is faced with such challenges as increasing asset price bubbles and inflationary pressures, and the challenge of speeding up economic restructuring.

Encountered with both opportunities and challenges, macroeconomic policies in 2011 will be proactive, prudent and flexible, in order to properly handle the relationship among maintaining stable and relatively fast economic development, economic restructuring, and managing inflationary pressures, to mitigate various types of potential risks, and to avoid big fluctuations of the economy. First, carry out the proactive fiscal policy and prudent monetary policy, and make the policies better targeted and more effective, to promote stable and healthy economic development. Efforts will be made to optimize the fiscal expenditure structure, with priority laid upon safeguarding and improving people's livelihood, and to improve fiscal transparency in order to maintain soundness and sustainability of public finance. Monetary policy shall follow the general principle of a prudent stance featuring proper measures of macro-economic management and supporting structural optimization, give greater priority to keeping the stability of overall price level, and preserve sound and safe performance of the financial system. Second, accelerate the strategic adjustment of the economic structure, shift the economic development pattern, continuously improve the industrial structure, build a long-term mechanism for expanding domestic demand, and promote balanced development among different regions. Third, attach more importance to the role of aggregate money supply in guiding expectations, and give more considerations to measuring the support of financial sector to real economy from the perspective of aggregate social financing. It is necessary to keep aggregate social financing at a proper level, and to strengthen the role of market in resource allocation. Fourth, create a counter-cyclical macro-prudential framework; combine it with management and adjustment of aggregate money, credit and liquidity, including changes of the differentiated reserve requirement ratio, so as to create a favorable monetary environment for stabilizing the general price level, managing inflation expectations and regulating the real estate market. Fifth, further strengthen coordination among various economic and financial policies, combine short-term regulatory policies with long-term development policies, with focus on promoting reform programs and structural adjustment, and enhance endogenous economic growth.

Chapter II

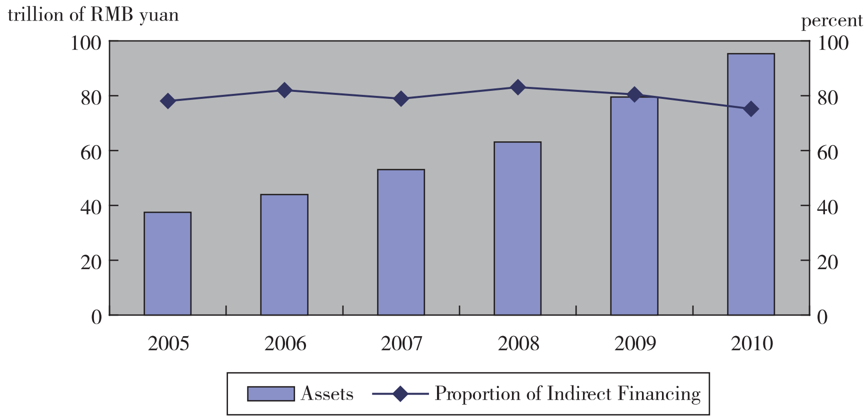
Banking Sector

In 2010, China's banking sector seriously implemented macroeconomic policies, continued to optimize credit structure to support transformation of the economic development pattern and economic restructuring, and continuously improved financial services. Great achievements were made in the reform of banking institutions. ABC was successfully listed which marked the completion of the shareholding reform of large commercial banks, and the reform of policy financial institutions and rural financial system steadily proceeded. These moves have further strengthened the foundation for sound performance of the banking sector.

Recent Developments

Total assets and liabilities continued to increase. As of end-2010, total assets of banking institutions increased by 19.9 percent y-o-y to RMB 95.3 trillion yuan, and total liabilities grew by 19.2 percent to RMB 89.5 trillion yuan. The outstanding deposits of banking institutions denominated in both domestic and foreign currencies grew by 19.8 percent y-o-y to RMB 73.3 trillion yuan, and the outstanding loans in both domestic and foreign currencies rose by 19.6 percent y-o-y to RMB 50.92 trillion yuan (Figure 2.1). Demand deposits account for a large part of bank deposits, with demand savings accounting for 56 percent of the new household savings in 2010, and demand deposits taking up 55 percent of the new deposits of non-financial enterprises.

Figure 2.1 Changes in Proportion of Indirect Financing① and Total Assets of the Banking Sector in Recent Years

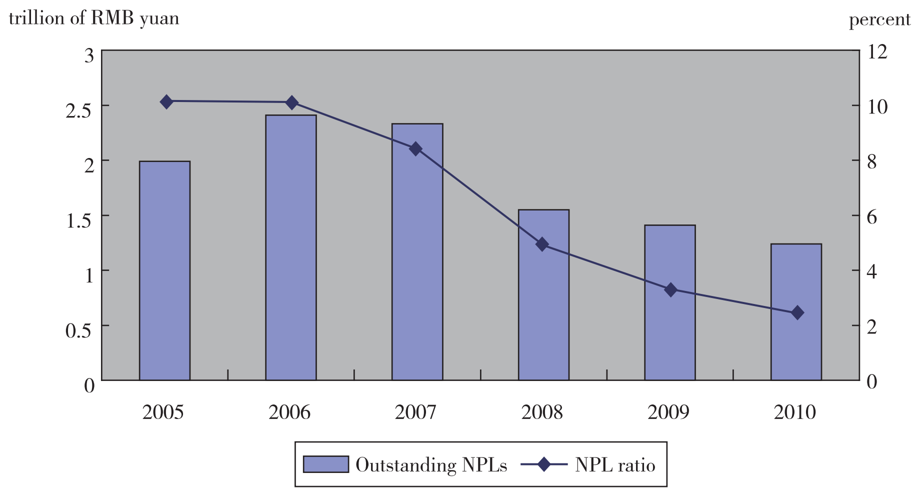


Source: PBC, CBRC.

① Proportion of Indirect Financing is the proportion of bank loans denominated in both domestic and foreign currencies in the total financing by domestic non-financial sectors.

Asset quality further improved. In 2010, banking institutions witnessed a further decline in both the outstanding NPLs and the NPL ratio (Figure 2.2). As of end- 2010, the outstanding NPLs of commercial banks registered RMB 433.6 billion yuan, a decrease of RMB 73.1 billion yuan from the beginning of the year; the NPL ratio recorded 1.13 percent, down 0.46 percentage points from the beginning of the year. Meanwhile, the provision coverage ratio rose at the high level, indicating strengthened risk absorption capability. At end-2010, the provision coverage ratio of commercial banks grew by 64.5 percentage points to 217.7 percent y-o-y; the loan loss provision adequacy ratio rose by 50.8 percentage points to 230.7 percent y-o-y.

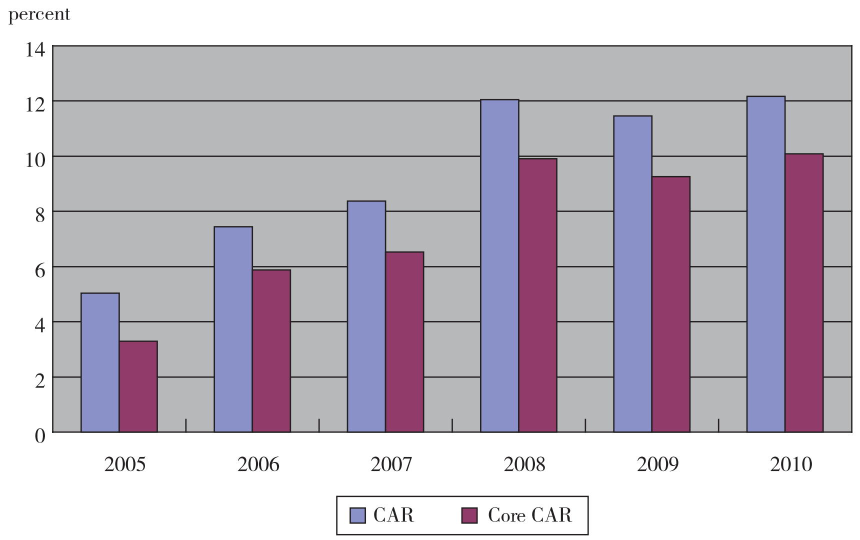
Figure 2.2 NPLs and NPL Ratio of Banking Institutions



Source: CBRC.

Capital adequacy level remained stable. In 2010, the capital base of commercial banks was replenished through shareholder capital injection and internal retained earnings, and meanwhile, commercial banks obtained refinancing in the stock and bond markets through various channels, including raising RMB 334.6 billion yuan by share allotment and raising RMB 92 billion yuan through issuance of hybrid capital bonds and subordinated bonds. As of end-2010, the CAR of commercial banks stood at 12.17 percent, with an increase of 0.71 percentage points y-o-y (Figure 2.3). In particular, the CAR of large commercial banks recorded 12.08 percent, up 0.95 percentage points y-o-y; CAR of JSCBs was 11.02 percent, up 0.76 percentage points y-o-y; CAR of city commercial banks was 12.84 percent, down 0.12 percentage points y-o-y.

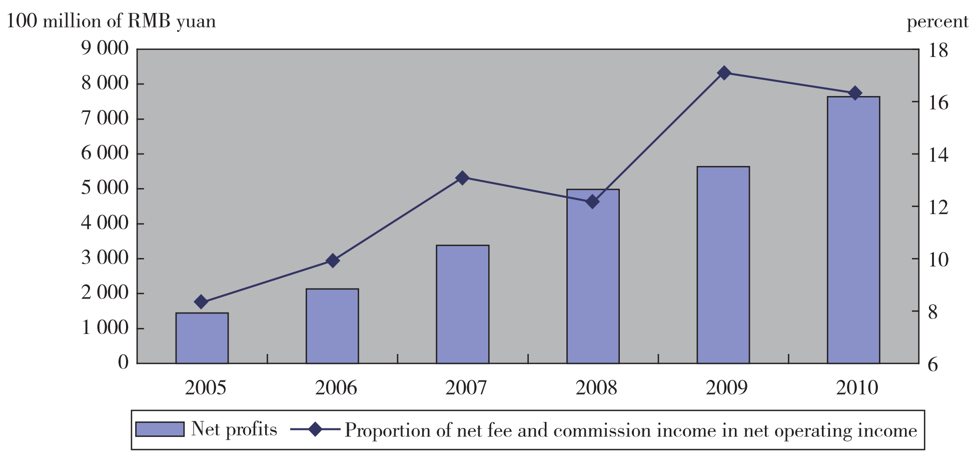
Figure 2.3 CAR of Commercial Banks



Source: CBRC.

Profits continued to increase rapidly. In 2010, banking institutions realized a net profit of RMB 899.09 billion yuan after tax, with a y-o-y growth of 34.5 percent, up 20 percentage points; the ROA and ROE increased by 0.09 and 1.26 percentage points y-o-y to 1.03 percent and 17.5 percent respectively; the net operating income registered RMB 2 548.24 billion yuan, among which the net interest income totaled RMB 1 688.66 billion yuan, a y-o-y increase of 36.3 percent, and the net fee and commission income was RMB 363.558 billion yuan, a y-o-y increase of 24.3 percent (Figure 2.4).

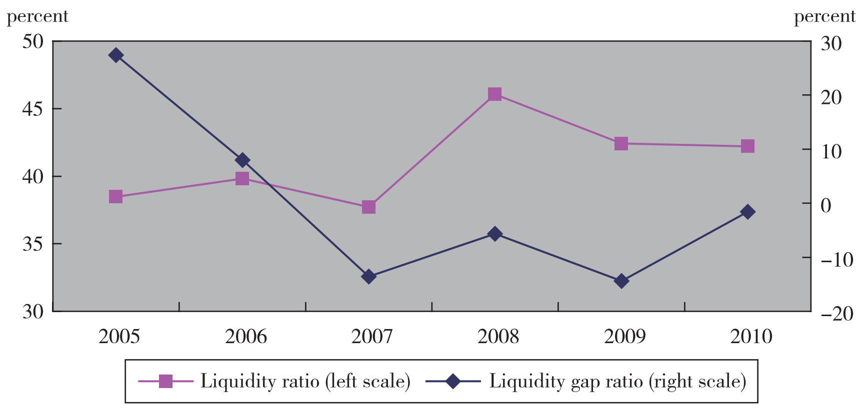
Figure 2.4 Changes in the Net Profits and Proportion of Net Fee and Commission Income in Net Operating Income of Banking Institutions



Source: CBRC.

Liquidity remained abundant. As of end-2010, the liquidity ratio of banking institutions fell by 2.1 percentage points y-o-y to 43.7 percent; liquidity gap ratio increased by 10 percentage points y-o-y to -2.7 percent (Figure 2.5); the loan to deposit ratio recorded 71.8 percent, down 0.07 percentage points y-o-y; the ratio of RMB excess reserve plus cash to total deposits fell by 0.73 percentage points to 3.51 percent. The overall liquidity of the banking sector was adequate, but the tendency of deposits biased towards demand deposits and loans towards long-term loans was becoming noticeable, pointing to rising maturity mismatch risks.

Figure 2.5　Changes in Liquidity Ratio and Liquidity Gap Ratio of Commercial Banks



Source: CBRC.

Soundness Assessment

Remarkable Progress Was Made in Reforms, and the Basis for Sound Performance of the Banking Sector Was Further Strengthened

Reform of large commercial banks was further deepened. In 2010, ICBC, BOC, CCB and BOCOM further advanced the reform, improved corporate governance, enhanced decision-making capability and efficiency, intensified risk management and internal control, and replenished capital through various channels, as reflected in continuous improvement of financial indicators and enhanced overall strength. As of end-2010, the CAR of the above four banks stood at 12.0 percent, 12.5 percent, 12.4 percent and 12.1 percent, respectively; the NPL ratio was 1.09, 1.20, 1.01 and 1.13 percent; the net profits after tax were RMB 156.4 billion yuan, RMB 99.5 billion yuan, RMB 133.3 billion yuan and RMB 41.8 billion yuan. CDB continued to improve corporate governance and organizational framework, actively explored the medium and long-term business model, enhanced the comprehensive risk management framework and steadily promoted the market-oriented reform.

ABC successfully went public, and its pilot reform of multi-divisional structure for financial services to agriculture, rural areas and farmers was further promoted. In 2010, ABC continued to improve corporate governance, step up internal reform and operation mechanism transformation, and steadily promoted preparatory arrangements for IPO. On July 15 and 16, 2010, ABC got listed on the Shanghai and Hong Kong stock exchanges respectively, raising USD 22.1 billion in total. Besides, ABC actively explored ways to effectively support agriculture, rural areas and farmers with commercial-based operation, and promoted its pilot reform of multi-divisional structure, so as to provide better financial services for agriculture, rural areas and farmers.

Box 4 Promoting ABC's Pilot Reform of Multi-divisional Structure for Financial Services to Agriculture, Rural Areas and Farmers

As the large commercial bank serving both the domestic urban and rural markets, ABC plays an important role in China's financial system. The National Financial Work Conference held at the beginning of 2007 defined the general principle for ABC reform as "supporting agriculture, rural areas and farmers, carrying out overall reform, adopting commercial-based operation and getting listed at a proper time". In order to improve ABC's financial support to agriculture, rural areas and farmers with its commercial-based operation, PBC took the lead in establishing the working group on ABC reform with other relevant agencies, to guide ABC to actively explore and innovate effective ways to support agriculture, rural areas and farmers, introduce specialized policies, business process and service model for this purpose, and promote the pilot reform of multi-divisional structure for rural financial services.

In March 2010, the State Council approved the program of deepening the shareholding reform of ABC, and decided to launch the pilot program of deepening reform of multi-divisional structure for financial services to agriculture, rural areas and farmers at ABC's 561 county-level branches in 8 provinces of Sichuan, Chongqing, Hubei, Guangxi, Gansu, Jilin, Fujian and Shandong. In the pilot reform, a 3-tier supervisory mechanism including the ABC headquarter, provincial branches and municipal branches is adopted, and the county-level branches are responsible for practical operation, with complete and independent systems for capital management, credit management, provisioning and write-off, fund balance and utilization, performance evaluation and incentivization, and accounting. County-level branches in the pilot program will be provided certain monetary, fiscal, taxation and regulatory support.

In May 2010, ABC started to launch the pilot program of deepening reform of multi-divisional structure for financial services to agriculture, rural areas and farmers in the 8 provinces, so as to further improve management structure and operation mechanism, and make the institutional arrangements for financial services to agriculture, rural areas and farmers.

The reform of policy financial institutions was progressively advanced. Focusing on issues including function orientation, scope of business, state capital injection, corporate governance, internal reform, external supervision and complementary measures to support the reform, PBC together with other relevant authorities, draw on international good practice and experience, and continued to study and discuss the reform plans and articles of association for EXIM and SINOSURE, so as to guide the two institutions to provide better services to foreign trade and enterprises investing overseas. At the same time, ADBC continued to step up research and internal reform to lay a solid foundation for the overall reform.

Box 5 International Experience on Reform of Policy Banks

Policy finance plays an important and special role in economic growth and social development across the world. International experience indicates that the function and business scope of policy banks are adjusting dynamically. In the period of Great Depression and after the World War II till 1960s, many countries established policy banks to deal with crisis and stimulate economic growth. Since 1990s till the eve of the recent financial crisis, along with the accelerated economic and financial globalization as well as rapid development of commercial finance and direct financing market, many countries deemed that policy finance had accomplished its mandate, and started to reform their policy banks successively. Some policy banks, which were formerly owned by governments, diversified their own shareholding structures, and some even went public. Some policy banks carried out market-oriented reform, and achieved commercial transformation and professional operation in terms of business and services.

After the recent financial crisis, the international community reconsidered the role of policy banks, and began to take active measures to reform policy financial institutions. Business scope of some policy banks was expanded, and many countries supported the development of policy financial institutions through direct capital injection. Some countries properly adjusted their objective and pace of policy bank reform. For example, Japan postponed the privatization process of DBJ, and Korea suspended the privatization of KDB. Many other countries are considering re-establishing or introducing export-import policy banks. However, some quasi-policy financial institutions may encounter risks due to blind and excessive asset expansion, which raised concerns over corporate governance, risk management and constraint mechanism of policy financial institutions.

The successful experience of reform and development of policy banks in the past centennial shows that most countries have set up self-contained policy financing system, and applied special regulations and independent supervision to policy banks. Policy banks usually enjoy explicit and implicit support, such as capital injection from the government, preferential taxation and risk sharing, and their business scope and model change along with the economic and financial environment. Policy banks are not profit-oriented, but they are financially sustainable on an overall basis thanks to state subsidy, and their development depends on long-term, stable and low-cost fund sources. Taking the governance pattern of commercial banks as reference, policy banks usually establish standard operation mechanism including board of directors and board of supervisors as well as internal constraint mechanism, and national governments always design long transitional periods for policy banks in the process of commercial-based transformation. Meanwhile, the recent international financial crisis revealed the deficiency in the development of policy banks, and this may serve as an essential enlightenment for the reform of China's policy banks. That is, the business expansion of policy banks should not be over accelerated, the function of policy banks should be strengthened and risk management of financial institutions depending on wholesale funding should be closely monitored.

Rural financial system further improved. In 2010, further progress was made in the reform of RCCs. By the end of 2010, there were 1 976 RCCs at the county (city) level, 84 rural commercial banks and 216 rural cooperative banks. In December 2010, Chong Qing Rural Commercial Bank got listed successfully at Hong Kong stock exchange, the first domestic rural commercial bank going public, marking a new breakthrough in the development of rural financial institutions. New-type rural financial institutions grew dramatically, with 172 institutions established by the end of the year, and access to financial services in rural areas was largely extended.

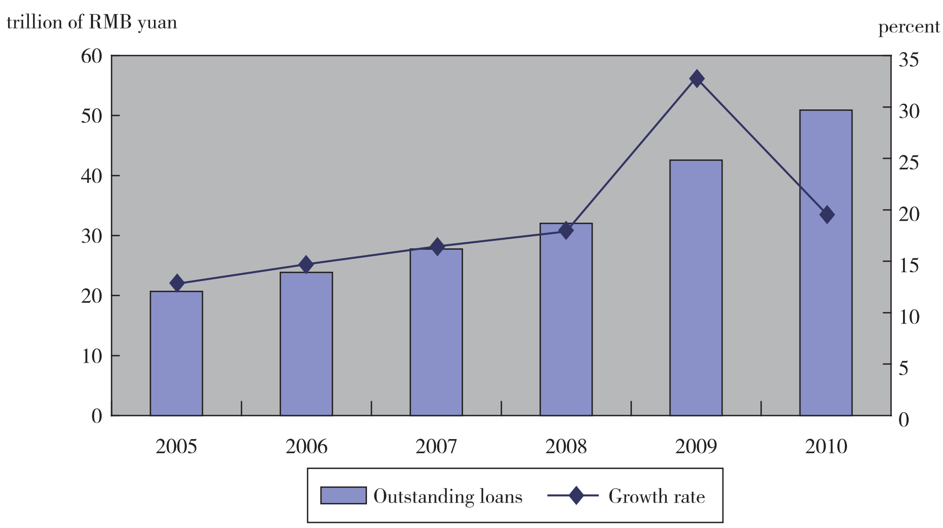
Reform of other institutions steadily progressed. Small and medium-sized commercial banks continued to improve corporate governance, and actively explored differentiated and specialized business. Foreign banks in China maintained stable performance. Reform and restructuring of Everbright Bank was further deepened, with financial indicators greatly improved. On August 18, 2010, Everbright Bank was listed at Shanghai Stock Exchange, raising a total of RMB 21.3 billion yuan. Relevant authorities worked actively on the plans of financial restructuring and shareholding reform of the four financial asset management companies to promote their commercial transformation, and launched pilot reform of Cinda Asset Management Company. On June 29, 2010, China Cinda Asset Management Co.Ltd. was officially inaugurated, forming the initial framework of modern corporate governance.

New achievements were made in integrated financial services and financial innovation. In 2010, integrated financial services of commercial banks made new progress, with 8 commercial banks establishing fund management companies, 4 investing in insurance companies, 7 establishing or investing in financial leasing companies, and 2 investing in trust companies. Financial innovation was steadily advanced, with new achievements in financial service innovation of small and micro enterprises. As of end-2010, 109 commercial banks had set up institutions specializing in financial services to small enterprises, and the rating and pricing mechanism on small and micro enterprises were further improved. Some banks introduced a series of innovative products, including joint-guaranteed loans, leasing right loans, emergency loans, order loans, patent right pledge loans and SME collective notes.

Credit Aggregate and Structure Gradually Improved, and Credit Risk Management in Key Areas Should Be Further Strengthened

Size and pace of credit expansion were appropriately managed, and credit structure was further optimized. In 2010, banking institutions actively implemented macroeconomic policies, and appropriately handled the size and pace of credit supply taking into account their own business needs as well as the changes in economic and financial environment. As a result, credit growth returned to normal from a high level (Figure 2.6). Banking institutions continued to implement differentiated credit policies, and enhanced credit support to the restructuring and revitalization of national key industries, weak links in the economy, employment, consumption, energy conservation, environmental protection, and emerging industries of strategic importance, especially laying stress on supporting agriculture, rural areas and farmers as well as SMEs. As of end-2010, outstanding agricultural loans of banking institutions amounted to RMB 14.6 trillion yuan, accounting for 28.6 percent of the total loans and up 7.1 percentage points from a year earlier. Outstanding SME loans totaled RMB 17.7 trillion yuan, accounting for 34.7 percent of the total loans and up 0.9 percentage point y-o-y.

Figure 2.6 Aggregate Credit Supply in China and Its Growth Rate in Recent Years



Source: PBC.

Asset quality continued to improve, while risk control still needs to be enhanced. In 2010, relevant authorities strengthened clean-up of the loans to local government financing platforms, implemented differentiated mortgage policies, undertook stress testing and severely cracked down on illegal activities including zero down payment and fake mortgage loans. Active measures were taken to adjust credit structure, and to cut back lending to high energy-consuming and heavy-polluting industries and industries with overcapacity. Efforts were also made to regulate the cooperation between banks and trust companies on wealth management products, transfer of credit assets and bancassurance business in terms of compliant operation and risk management. Both the outstanding NPLs and the NPL ratio of banking institutions dropped evidently. But from a medium and long-term point of view, adequate credit risk management and control are warranted. First, excessively rapid credit growth, especially high increase in local government loans and mortgage loans as well as increasing off balance sheet activities, may raise the risk of worsening asset quality along with economic cycles. Second, bank loans were increasingly issued with large amount, long maturity and excessive concentration. In terms of loan maturity, as of end-2010, medium and long-term loans grew by more than 30% y-o-y for the 19th consecutive month. Newly added medium and long-term loans for the whole year amounted to RMB 6.95 trillion yuan, accounting for 83.2 percent of total new loans, and up 15.7 percentage points on a y-o-y basis. In terms of loan targets, new loans issued to individuals, manufacturing industries, wholesale and retail as well as transportation accounted for 66.7 percent of the total new loans, up 7.2 percentage point y-o-y, indicating an aggravated concentration of loans. Third, fast expansion of some banks, especially some small and medium-sized commercial banks, and speedy extension of their business scope may pose potential risks.

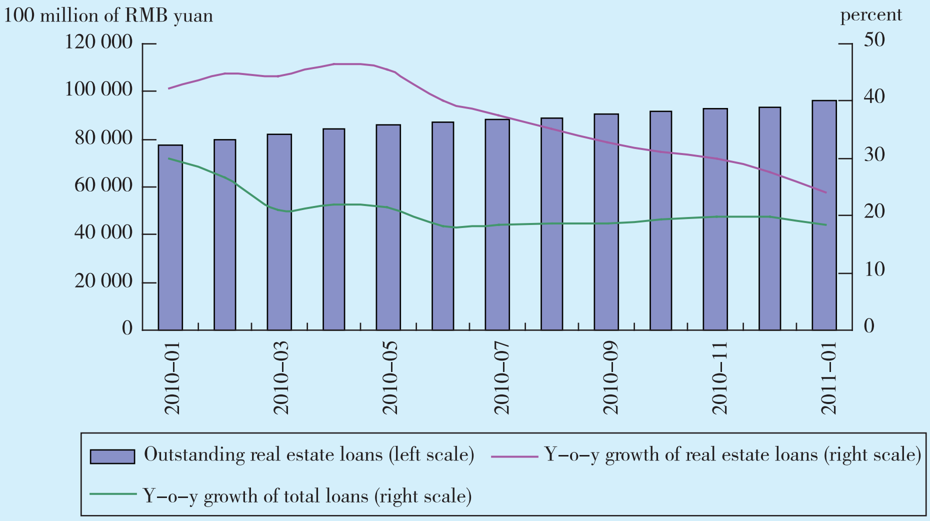
Box 6 Real Estate Loans in 2010

In 2010, the tightening measures targeting the real estate market were implemented steadily, and growth of real estate loans continuously slowed down since May. As of end-2010, outstanding real estate loans issued by major financial institutions① grew by 27.5 percent y-o-y to RMB 9.35 trillion yuan, down 18.9 and 10.6 percentage points from the end of April, 2010 and the end of 2009, respectively, and accounted for 20.5 percent of total outstanding loans②, up 1.3 percentage points from the previous year. Growth of outstanding real estate loans issued by major financial institutions exceeded the average loan growth rate by 7.6 percentage points (Figure 2.7). In 2010, new real estate loans posted RMB 2.02 trillion yuan, accounting for 27.4 percent in the total new loans, 5.5 percentage points higher than that in the previous year. Broken down by district, among the 31 provinces and cities, 23 witnessed a slowdown in the growth of real estate loans from the previous year.

① Major financial institutions include state-owned commercial banks, CDB, policy banks, JSCBs, city commercial banks, rural commercial banks, UCCs, rural cooperative banks, RCCs and PSBC.

② Total outstanding loans of major financial institutions.

Figure 2.7 Outstanding Amount and Growth of Real Estate Loans Issued by Domestic Major Financial Institutions



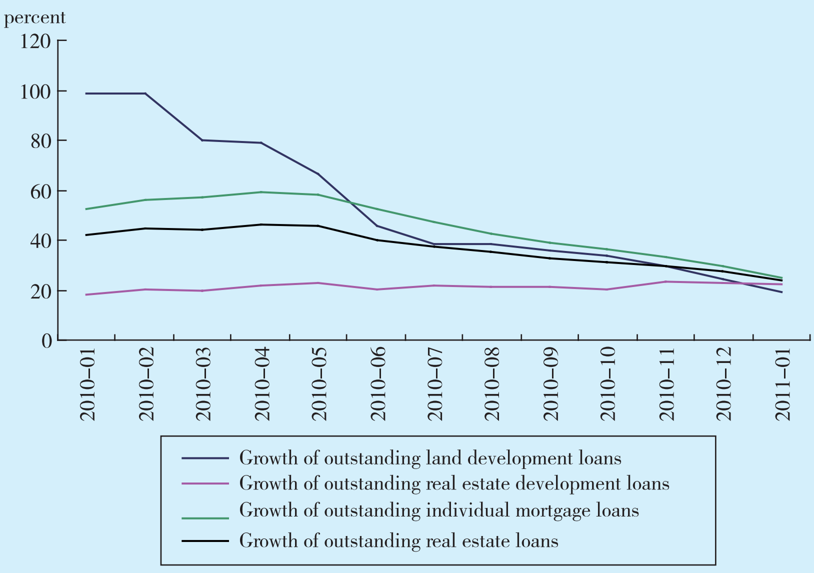
Source: PBC.

Growth of real estate development loans accelerated with fluctuations. At end-2010, outstanding real estate development loans increased by 23 percent y-o-y to RMB 2.28 trillion yuan, with an increase of 7.2 percentage points. In particular, outstanding housing development loans amounted to RMB 1.66 trillion yuan, a y-o-y increase of 28.2 percent, up 10.3 percentage points from a year earlier; outstanding affordable housing development loans grew by 32 percent on a y-o-y basis, 9 percentage points higher than the growth rate of real estate development loans. The growth of real estate development loans in 2010 did not slow down, mainly due to the rapid expansion of real estate investment, especially measures to construct more government-supported housing. New real estate development loans in 2010 totaled RMB 426.9 billion yuan, RMB 191 billion yuan more than the growth recorded a year earlier, and the increment for the first half of the year was RMB 318.7 billion yuan, accounting for 75 percent of that for the whole year.

Growth of individual mortgage loans increased slowly for the first four months, and declined continuously since May. As of the end of 2010, outstanding individual mortgage loans issued by major financial institutions increased by 29.8 percent y-o-y to RMB 5.73 trillion yuan, with a slowdown of 29.3 percentage points from the end of April. New individual mortgage loans in 2010 reached RMB 1.31 trillion yuan, RMB 81.8 billion yuan less than the previous year, and monthly increment decreased from RMB 176.7 billion yuan of April to RMB 63.3 billion yuan of December.

Growth of land development loans declined dramatically and continuously, and gradually returned to the normal path after the surge in 2009. At end-2010, outstanding land development loans issued by major financial institutions grew by 24.7 percent y-o-y to RMB 832.6 billion yuan, down 79.5 percentage points from the previous year. In particular, outstanding loans to government land reserve centers amounted to RMB 734.2 billion yuan, with a y-o-y increase of 27.5 percent and a slowdown of 95.2 percentage points. New land development loans in 2010 totaled RMB 164.7 billion yuan, RMB 175.9 billion yuan less than the previous year, and the growth rate became negative for both November and December on y-o-y basis (Figure 2.8).

Figure 2.8 Growth of Different Categories of Real Estate Loans Issued by Domestic Major Financial Institutions



Source: PBC.

Capital Quality Continued to Improve, While Capital Replenishment and Constraint Mechanism Need Further Improvement

Capital quality continued to improve. Capital of domestic commercial banks mainly consists of high-quality core capital, including common shares and reserves①. Compared with international peers, supplementary capital with weakness in loss absorbency, such as subordinated debts and preferred equity, accounts for a smaller part of the capital of domestic commercial banks, implying a relatively high level of capital quality. As of end-2010, core capital accounted for 85.83 percent of net capital of commercial banks, a growth of 20 percentage points from 2005 when the shareholding reform of commercial banks was launched, indicating high loss-absorbing capacity and improved capital quality.

Capital replenishment and constraint mechanism need further improvement. Currently, the capital replenishment options of domestic commercial banks are quite limited, mainly depending on external financing such as share offering and issuance of subordinated bonds and hybrid capital bonds, while slightly motivated by internal financing. Besides, although banking institutions became more and more concerned about capital constraint and explored to establish capital-based supervisory and management mechanism through advanced management like economic capital, economic value added and risk-adjusted return on capital, relevant policies and techniques still need to be improved and capital constraint mechanism should be strengthened. In particular, under the benign economic environment, the profits of the banking sector still heavily rely on interest income, and many banks tended to grow extensively with strong impulse of business expansion. As a result, capital constraint on business expansion was weakened, and pressure of capital replenishment increased.

Supervision Was Further Enhanced through Drawing on International Banking Supervisory Reform

Relevant authorities actively participated in the reform of international banking supervision and supervisory standards setting, and made prudential evaluation on Basel III's implications for China's banking sector. In 2010, remarkable progress was achieved in the reform of international banking supervision, and BCBS released a series of standards and codes in international banking supervision including Basel III. These reforms aimed to strengthen micro-prudential supervision and macro-prudential management, improve capital quality, raise minimum capital requirement, enhance risk coverage of capital framework, introduce internationally harmonized liquidity supervisory framework

① Reserves mainly include capital reserve, surplus reserve, general risk provision and unappropriated retained earnings.

and capital conservation buffers, build countercyclical buffers, apply capital surcharges and additional liquidity requirements to systemically important banks, and establish cross-border bank resolution regime. As BCBS members, PBC and CBRC actively participated in the discussions and formulation of new international supervisory standards including Basel III, and studies on Basel III's implications on China's banking sector. Basically, unlike some European and US banks, China's banking sector maintains relatively stable performance, and relies more on traditional loan business with simple product structure and relatively small share of international business. In addition, the capital base of China's banking sector is mainly composed of common shares of high quality, so the immediate and direct impact of Basel III on China's banking sector is deemed to be limited. But in the medium and long term, since the business model of China's banking sector is capital consuming, which mainly depends on credit expansion, raising regulatory standards may increase the pressure on banks in terms of capital replenishment.

Soundness standards for the banking sector were reinforced by drawing on achievements in international banking supervision reform. In 2010, in line with the macro-prudential requirements including reducing procyclicality and enhancing supervision over systemically important banks, China took active measures to formulate and improve regulatory standards on the banking sector, based on the regulatory framework and policies of Basel III. Efforts were made to guide commercial banks to establish dynamic capital replenishment and provisioning mechanism, and explore to build capital conservation buffers and countercyclical buffers on the basis of minimum CAR requirements. Core capital requirement was enhanced and liquidity supervisory framework was further improved with the new risk indicators including Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) in study. At the same time, researches were conducted to strengthen supervision over systemically important banks, including application of capital surcharges and additional liquidity requirements.

Box 7 Researches and Practice on Countercyclical Capital Buffer

The recent international financial crisis showed that there existed serious procyclicality in the financial system, which meant that financial institutions tended to expand assets and credit during economic booms while tighten assets and credit during recessions, and this would intensify cyclical fluctuations. After the crisis, BCBS introduced countercyclical buffer to strengthen countercyclical adjustment and reduce the procyclicality in the financial system.

The countercyclical capital buffer is built on the basis of capital conservation buffer, and the requirement could vary between zero and 2.5 percent to total risk-weighted assets above the common equity capital ratio. The countercyclical capital buffer regime aims to smooth credit cycle by imposing capital constraints on credit availability. BCBS suggests that authorities use the deviation of aggregate private sector credit to GDP ratio from its long-term trend as the reference guide when setting the buffer in their jurisdictions. When the credit/GDP ratio in a jurisdiction is close to or lower than its long-term trend, which means relatively low credit risk, the countercyclical capital buffer could be set to zero; when the ratio exceeds its long-term trend, which indicates that excess credit growth is associated with a build-up of systemic risk, countercyclical capital buffer should be built to limit credit expansion. According to this regime, authorities could apply judgment in the timing and size of the countercyclical capital buffer based on the credit circumstances and assessment result of systemic risk in their jurisdictions. When there is a downturn in credit cycle, authorities should release the buffer requirement to ensure that banks have sufficient capital to maintain credit availability.

Currently, the countercyclical capital buffer regime has been preliminarily established, except the policy design difficulties in striking a balance between international harmonization and national discretion. Different countercyclical capital buffer requirements in different jurisdictions may incur regulatory arbitrage, that is, international active banks may adjust their risk exposures in different jurisdictions to be subject to lower countercyclical capital buffers. Moreover, harmonized countercyclical capital buffer requirement may lead to adverse selection of banks, which tend to undertake risky but profitable credit businesses. Therefore, how to impose effective countercyclical capital buffer requirements on individual banks will remain a practical challenge to improvement of the countercyclical capital buffer regime.

The international community responded actively to the proposed countercyclical capital buffer regime, with some countries beginning to promote the establishment of their own countercyclical capital buffer mechanisms. For example, Switzerland has indicated that it will require Credit Suisse and UBS to build countercyclical capital buffers varying from zero to 2.5 percent to total risk-weighted assets. China is also exploring the way to set up the countercyclical capital buffer regime for the banking system using credit-to-GDP ratio as the reference guide, and encourage financial institutions to fulfill more prudential capital requirements by means of policies and instruments including differentiated reserve requirement.

Great efforts were made to establish the macro-prudential framework and to diversify regulatory instruments and methods. In 2010, to address the flaws in systemic risk management revealed in the recent international financial crisis, PBC, together with other agencies, explored to establish the macro-prudential framework, and to diversify management instruments and tools, such as to establish the dynamic adjustment mechanism of differentiated reserve requirement, guide commercial banks to conduct stress testing and further strengthen regulation to enhance systemic risk management, etc.. Regulatory agencies promulgated a series of guidelines and rules to improve banks' risk management and corporate governance, regulate external auditing and financing guarantee activities, and reinforce net capital-based management on trust companies, so as to promote sound performance of the banking sector.

Box 8 New Progress Was Made in Stress Testing of China's Banking Sector in 2010

In 2010, China Financial Sector Assessment Program (FSAP) progressed steadily, in line with the *Financial Sector Assessment Program (FSAP) Memorandum on the Scope of Work* signed by PBC, IMF and World Bank. As one of the key assessment contents, the stress testing exercise on banking sector aimed to make quantitative analysis on the soundness and risk profile of China's banking sector, so as to provide insights into the resilience and soundness of the banking system and to capture potential risks. In order to promote the FSAP stress testing in an orderly manner, PBC and CBRC jointly established the FSAP Stress Testing Working Group to organize the stress testing exercises of the 17 major commercial banks.

China FSAP stress testing used both top-down and bottom-up approaches, with focus on credit risk, market risk, liquidity risk and contagion risk of the 17 major commercial banks. In specific, credit risk exercise examined the adverse impact of changes in quality of aggregate credit assets and structural credit assets including real estate loans on banks; market risk exercise analyzed how banks could be negatively affected by changes in benchmark deposit and lending rates, parallel shifts of yield curves for various bonds as well as movements in the RMB exchange rate; liquidity risk exercise studied the negative impact of several shocks materializing simultaneously, including deposit drawdown, rising required reserve ratio, declining asset price and shrinking inter-bank deposits and lending; contagion risk exercise discussed the interconnectedness risk and contagion among large commercial banks.

Results of the stress testing indicated that thanks to the shareholding reform, China's banks have continuously improved internal control and asset quality, with adequate capital and sufficient liquidity. They managed risk prudently and could be relatively resilient to varied shocks, which helps to maintain stable performance of the whole banking system.

Outlook and Reform Measures

In 2011, the banking sector will still operate in an environment with great uncertainty, and the task of the financial sector to support the transformation of economic development pattern and economic restructuring according to the general requirement of the 12th Five-year Plan remains arduous. Therefore, the banking sector should take active measures to implement prudent monetary policy, further strengthen macro-prudential management, fend off and mitigate potential risks in key areas, transform development pattern, heighten soundness standards, enhance internal disciplines and deepen reform, so as to improve the comprehensive strength and resilience to shocks.

Implement prudent monetary policy to support economic restructuring and transformation of economic development pattern. The banking sector should appropriately handle the size and pace of credit supply, carefully carry out the dynamic adjustment policy of differentiated reserve requirement, and maintain proper and reasonable liquidity in the banking system and the total amount of social funding. Banks would continue to implement differentiated credit policies, and optimize credit structure to give full play to credit policies in facilitating economic structure adjustment. They would enhance financial support to emerging industries of strategic importance, energy conservation and environmental protection sector, modern service sector as well as high-tech and innovative industries, and strictly restrain lending to high energy-consuming, heavily-polluting industries and industries with over-capacity. More credit support should be directed to SMEs as well as agriculture, rural areas and farmers, so as to bolster the transformation of economic development pattern and economic restructuring.

Strengthen credit risk management in key areas to improve security of the credit assets. Banking institutions should pay close attention to changes in external environment and strengthen credit risk management in key areas to guard against deterioration of credit assets. Measures should be taken to enhance risk management of loans to local government financing platforms and the following clean-ups, and strictly control, prudently issue and scientifically manage any new loans to such platforms. Banking institutions would carefully implement the national adjustment policies on the real estate sector, strictly implement differentiated mortgage policies, strengthen real estate credit management, crack down on fake mortgage loans and subprime mortgage loans, and take rigorous measures to prevent credit fund from entering the real estate sector illegally for purpose of investment and speculation. Meanwhile, efforts should be made to properly adjust credit targets and maturity structure to mitigate risks associated with high loan concentration and maturity mismatch.

Shift business growth pattern and reinforce capital constraint mechanism. In the coming future, banking institutions should alter the business growth pattern at a faster pace from the current extensive growth model depending heavily on expansion, and step up innovations in financial services and products in accordance with their own advantages and regional characteristics to avoid unduly homogeneous and low-level competition. The development of fee-based business should be fostered so as to optimize income structure and enhance the overall profitability. Meanwhile, measures should be taken to reinforce capital constraint mechanism, improve capital quality, properly expand business based on the risk absorption capability of capital, increase internal accumulation and enhance constraint effect of capital.

Strengthen macro-prudential management to heighten soundness standards of the banking sector. China will draw on the latest reform results in international banking supervision, and explore to establish the countercyclical macro-prudential framework and bolster soundness standards of the banking sector based on practical condition. Efforts should be made to raise both the quality and quantity of regulatory capital base, enhance risk coverage, build capital conservation buffers and countercyclical buffers, and introduce leverage ratio requirement; the internationally harmonized liquidity supervisory framework should be explored; supervision of systemically important banks should be strengthened with researches on higher and more prudential standards, and comprehensive implementation of Basel II and Basel III should be promoted; international supervision and resolution regime on cross-border banks should be reinforced. Scope of the stress testing should be extended and relevant database and techniques improved, so as to promote gradual incorporation of stress testing into overall risk management framework of banking institutions. Supervision and management over non-depository financial institutions including trust investment companies, financial leasing companies and finance companies should be strengthened, and active measures should be taken to fend off and mitigate the interconnectedness risks among non-depository financial institutions, financing guaranty companies, pawn houses and informal finance in order to further strengthen the basis for sound performance of the banking sector.

Deepen the reform to improve the diversified banking organizational system. Continued efforts should be made to encourage large commercial banks to improve their modern financial enterprise system, with focus on promoting ABC's pilot reform of multi-divisional structure for financial services to agriculture, rural areas and farmers. Steps should also be taken to accelerate the pace of CDB's market-oriented reform and improve its corporate governance. The reform of EXIM should be promoted to provide better services to international trade and enterprises investing overseas. Research on ADBC reform would also be pushed forward. Reform of small and medium-sized commercial banks and pilot reform of financial asset management companies should be steadily promoted. The RCCs reform should be bolstered to improve services to agriculture, rural areas and farmers as well as SMEs, and rural financial policy support system should be strengthened. Development of new-type rural financial institutions would be regulated on the basis of scientific planning, which may help to improve the diversified banking organizational system.

Chapter III

Securities and Futures Sector

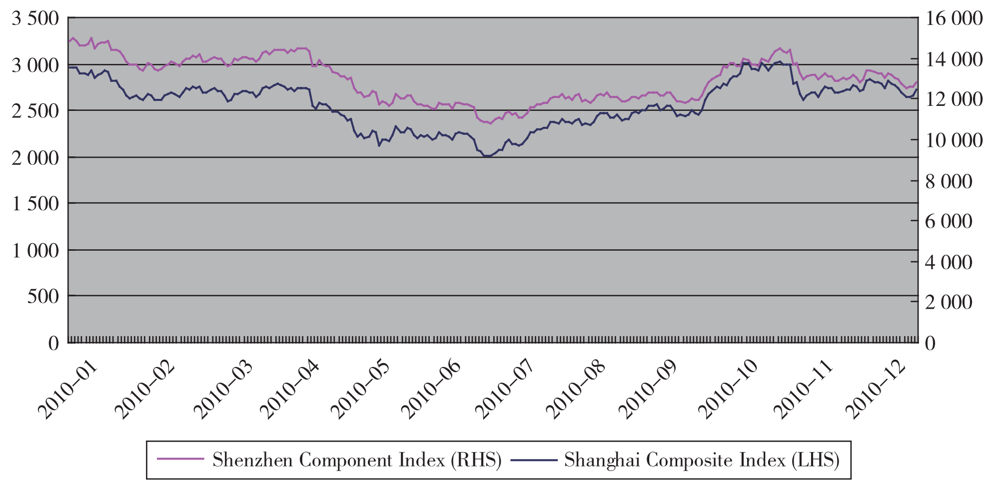
In 2010, the securities and futures firms in China performed and developed soundly with compliance to regulations. The capital market was basically stable, with the launch of stock index futures, the market realized breakthroughs and its capacity to support the economic development further enhanced.

Recent Developments

The Market Continued to Expand and the Dominant Position of Institutional Investors has been Further Strengthened

Size of the stock market continued to expand. At end-2010, there were 2 063 listed companies on the stock markets in Shenzhen and Shanghai, up 345 y-o-y. Capitalization of A-share market totaled RMB 26.54 trillion yuan, up 8.81 percent y-o-y, while the market capitalization of the tradable shares registered RMB 19.31 trillion yuan, up 27.67 percent compared with end-2009. The Shanghai Composite Index closed at 2 808.08 points, down 14.31 percent compared with end-2009. The Shenzhen Component Index closed at 12 458.55 points, a decline of 9.06 percent y-o-y (figure 3.1). Through 2010, the average daily trading value of the Shanghai and Shenzhen stock markets stood at RMB 225.4 billion yuan, up 2.64 percent y-o-y. A total of 531 companies raised RMB 1.027521 trillion yuan through equities and debts on the A-share market, up 122.91 percent y-o-y. The total financing value and the number of companies financing on the A-share market both hit records high in 2010.

Figure 3.1 Shanghai Composite Index and Shenzhen Component Index in 2010 (closing price)



Source: Shanghai Stock Exchange, Shenzhen Stock Exchange.

Trading volume of the futures transactions increased significantly. In 2010, 1.567 billion transactions were made on the futures market with a total value of RMB 154.56 trillion yuan, up 42.25 percent and 136.8 percent respectively. Among which, 1.521 billion commodity futures transactions were made with a total value of RMB 113.49 trillion yuan, up 40.9 percent and 73.9 percent respectively; 46 million stock index futures transactions were made with a total value of RMB 41.07 trillion yuan.

The number of investors increased stably. At end-2010, there were 152.041 million A-share accounts, 2.5 million B-share accounts and 34.042 million fund accounts on the Shanghai and Shenzhen Stock Exchanges, up 10.32, 1.57 and 9.05 percent y-o-y respectively. The market capitalization of tradable A-shares held by institutional investors registered RMB 13.74 trillion yuan, accounting for 70.85 percent of all listed tradable A-shares, up 2.17 percentage points over end-2009. The dominant role of institutional investors has been further established.

Market Infrastructure Building Progressed Steadily and Market Operation was Improved

Stock index futures market performed soundly after the launch of Shanghai and Shenzhen 300 stock index futures on China Financial Futures Exchange on April 16, 2010. The launch of stock index futures and the introduction of short selling to A-share market could help build an internal operation mechanism that facilitates stable market performance, and indicated an important step for improving the infrastructure of the capital market. Since its launch, the stock index futures operated stably with smooth delivery and sound relationship with the Shanghai and Shenzhen 300 spot index. Market players demonstrated rationality in transaction and risk was basically under control.

Box 9 Function of the Stock Index Futures and Issues Worth Attention

Stock index futures is one of the fundamental institutional arrangements on the capital market, and its launch is of great significance in the history of China's Capital Market. First, as a financial instrument for risk hedging, it helps improve self-stabilization mechanism of the capital market. The short selling of stock index futures helps curb irrationality when bubbles loom large on the market during the upward movement, and selling of stock index futures may hedge the systemic risk of overall decline of the spot stock market during the downward movement, easing panic selling of stocks and preventing excessive market adjustment. Second, stock index futures could enrich products on the market and facilitate diversification of investment strategies and profiting models. As a basic financing instrument, stock index futures could equip investors, especially institutional investors with more means of asset allocation and investment, and thus facilitate the diversification of options and strategies of investment, meeting the needs of investors with various risk appetites and promoting diversified and differentiated development of profiting models of markets and institutions.

Despite of the sound performance of China's stock index futures market since April 2010, the following issues still warrant attention. First, the trading volume/ open interest ratio① is high and the participation of institutional investors is inadequate. At end-2010, more than 90 percent of market participants on China's stock index futures market were individuals, with a trading volume/ open interest ratio as high as 9.43, which far exceeded the average level of 10 percent of dominant contracts on mature stock index futures markets. A wide range of professional institutional investors have been active on mature stock index futures market, while in China, only securities firms are actively engaged, with inadequate participation by insurance companies and other institutional investors. This is an imbalanced structure of market participants and is yet to improve. Second, potential risk of information-based market manipulation is a concern, and improvement of prevention mechanism is needed. Stock index futures market is very sensitive to macro policy moves. In the context of wide usage of internet, there lie potential risks for the dissemination of false information and rumors by some market participants, which would have impact on market trend and constitute information-based market manipulation. Inter-ministerial communication and coordination should be strengthened to further regulate government information release mechanism, and to prevent illegal operation on the stock market inflicted by the intentional abuse of information. Third, the spread basis remains high and the spread basis arbitrage mechanism needs improvement. Since the launch of the stock index futures market, the spread basis (namely cash price deducted from futures price) of some forward month contracts have been higher than that of the mature markets, reflecting the necessity of further enhancing the efficiency of the

① Futures market participants could be classified into hedging traders and speculative traders according to their trading purposes. Generally speaking, hedging traders would hold their positions for a certain period of time, and barely participate in daily trading. Therefore, a low trading volume/open interest ratio indicates that the market is dominated by hedging traders.

pricing function of China's stock futures index market. Fourth, along with the launch of the stock index futures market, new international transaction approaches such as high-frequency trading[①] emerged and their potential cross-market risks need to be considered. High-frequency trading may undermine the stability of trading platform of exchanges, aggravate market volatility, make transmit channel between futures market and spot market more complex, and enhance co-movement between specific markets. The risk related to high-frequency trading warrants attention.

The pilot program of margin trading and short selling was launched. Following the principle of "pilot program first, then launch and implement gradually", in March 2010, margin trading and short selling launched on a pilot basis in securities firms. By the end of 2010, 25 securities firms were licensed to run the business, with 42 thousand accounts and RMB 119.77 billion yuan of transaction value. Within which, transaction value of margin trading stood at RMB 117.324 billion yuan, accounting for 98 percent, while that of short selling registered RMB 2.445 billion yuan, accounting for 2 percent of the total. At present, the pilot program of margin trading and short selling is in sound shape, and the credit-based trading mechanism in the securities market has been preliminarily established.

The reform of IPO system deepened. Based on the principle of "enhance market discipline and improve the integrity of market participants", the IPO reform entered its second phase starting from October 2010, drawing on the experiences and foundation in the first phase. Several measures were taken, such as improving the disciplinary mechanism on quotation and allotment during price inquiry, increasing the stocks allotted to individual institutions, broadening scope of inquiry objects for determining issuance price, inviting more institutional investors, improving transparency of pricing information and strengthening claw-back and suspension mechanisms. Such measures have imposed stronger discipline over market participants during the IPO process. As well acknowledged, this market-based reform is producing positive results.

Functioning of the futures market was improved. The guideline on strengthening self-disciplinary management of exchanges was launched, covering market access, supervision, revision of rules and other relevant items. Market monitoring and supervision have been improved to handle the risk of drastic price fluctuations of some futures products.

① High-frequency trading is the execution of computerized trading strategies. High-frequency traders use computer programs to analyze market data to capture trading opportunities that may open up for only of fraction of a second and do very frequent buying and selling accordingly.

Successful and best practices in the futures product and service industry have been disseminated, in order to promote enterprises to make a good use of the futures market in their operation, pricing of products and risk management. Assessments were carried out to evaluate the functions of futures products, in a bid to improve product contracts and business rules. Efforts were made to guide futures companies to attract more industrial customers and provide them with customized services.

Relevant Legal System was Improved, and Efforts in Preventing and Cracking Down on Insider Trading have Produced Some Results

In 2010, efforts were made to revise *The Law on Securities Investment Funds* and *Regulations on the Administration of Futures Trading*, and to refine the drafts of *Administrative Regulations on the Supervision of Listed Companies* and *Regulations on Protecting Securities Investment Funds*. Standards were set to identify insider trading and market manipulation, and studies were conducted on formulating procedural regulations concerning the transfer and centralized management of criminal cases related to the securities and futures sector. Meanwhile, the State Council released the *Opinions on Combating, Preventing and Controlling Insider Trading* jointly formulated by the five ministries and/or commissions, making an overall arrangement concerning insider trading, and further defining the duties and responsibilities of relevant agencies of the State Council, local governments and regulators. Therefore, a comprehensive system of preventing and controlling insider trading jointly implemented by all relevant government agencies and regulators has taken form. The securities regulator studied how to improve the information disclosure and trading suspension and resumption system in order to detect and control abnormal movements of stock prices. The principle of "inspection upon abnormal movements, suspension in case of suspicion, and termination against irregularity" has been followed. Efforts were made to establish the insider registration system governing listed companies and to launch dedicated campaigns to combat insider trading, facilitating the successful investigation into major insider trading cases such as that of Zhong Shan Public Utilities Group.

The Supervision of Creditworthiness and Compliance was Strengthened, and Market Participants Operated in a Well-regulated Manner

The supervision over listed companies was reinforced. The securities regulator conducted an ad hoc campaign to address peer competition and lessen related-party transactions. The *Measures Concerning On-site Inspection of Listed Companies* was issued, including controlling shareholders and actual controllers into the inspection scope in order to improve financial information disclosure of listed companies and to strengthen supervision over fund-raising and fund use by companies listed on the growth enterprise market as well as share-selling of their senior management.

Securities and futures institutions were more effectively regulated. The compliance management and classified supervision over securities firms have been strengthened, and firms were asked to set up information firewalls, put in place stress testing systems and improve dynamic adjustment mechanism of risk control indicators. Efforts were made to support qualified companies to get listed, and establishment of subsidiaries engaged in direct investment and asset management was encouraged. Measures were taken to encourage innovation of the fund management sector, conduct classified inspection of fund products, and steadily promote development of asset management for specific clients as well as specialized development of fund sales institutions. The pilot programs allowing third-party payment institutions to participate in online sales settlement was launched. Efforts were also made to promote the pilot program allowing fund management companies and securities firms' Hong Kong-based subsidiaries to invest the funds raised overseas into domestic securities market. The practice of securities service providers was better regulated by formulating the *Provisional Rules on Securities Investment Advisory Business,* and the *Provisional Rules on Releasing Securities Research Reports*, as well as releasing the implementation rules on law firms' engagement in conducting securities-related legal businesses. Supervision over net capital and margin of futures firms was promoted. Classified supervision over futures companies was put into practice, and classified assessment has been completed. Efforts were made to raise the protection fund for futures investors. Studies were conducted on the plan of innovation business pilot program for futures companies.

Breakthroughs were made on the supervision over the creditworthiness of securities and futures companies. The system of creditworthiness and discipline supervision was put in place, mainly by setting up a nation-wide creditworthiness database for participants in the securities and futures market, recording the irregularities and misconducts of market participants, promoting inter-ministerial information sharing, connecting the creditworthiness database with the PBC credit information system, formulating specialized administrative measures, and depending the market access threshold and intensity of regulation and law enforcement on credit information, in order to enhance punishment and discipline over behaviors undermining creditworthiness.

With Opening More to the Outside World, Domestic Capital Market has been More Influential on the International Arena

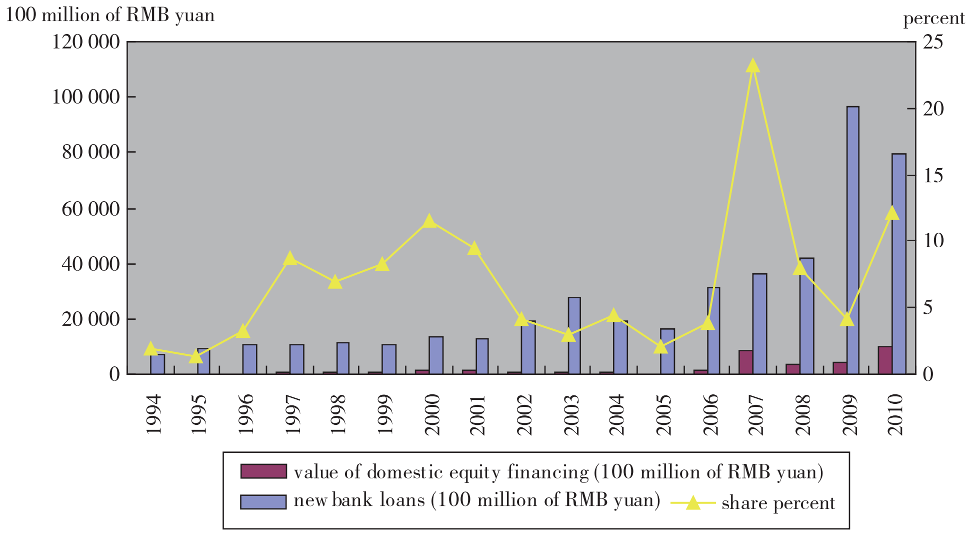
In 2010, 2 new joint venture fund management companies were approved, adding up to 37 such companies, accounting for 58.7 percent of the total 63 fund management companies. 3 new joint venture securities firms were approved, adding up to a total of 12. Meanwhile, 13 new QFIIs were approved to operate, expanding the engagement of foreign medium- and long-term investment institutions in domestic capital market. Active efforts were made to support enterprises to finance on foreign capital markets. In 2010, a total of USD35.38 billion was raised on overseas market by domestic institutions, ranking second to the record high. Researches were underway on the overall plan and institutional arrangements of the international board.

Soundness Assessment

The Stock Market Played a More Important Role and the Financing Structure was Further Optimized

In 2010, the stock market has played a more important role in financing. A total of RMB 967.22 billion yuan was raised on the A-share market, hitting a record high. Among which, the value of IPO reached RMB 488.263 billion yuan, secondary public offering registered RMB 37.715 billion yuan, private placement stood at RMB 217.268 billion yuan, rights issue posted RMB 143.825 billion yuan, the exercise of warrants amounted to RMB 8.428 billion yuan and the financing through convertible bonds totaled RMB 71.73 billion yuan. The strengthened role played by the stock market contributed positively to the increase of the share of direct financing, with the social financing structure more balanced (Figure 3.2).

Figure 3.2　The Value and Share of Equity Financing and Bank Loans in China 1994 through 2010

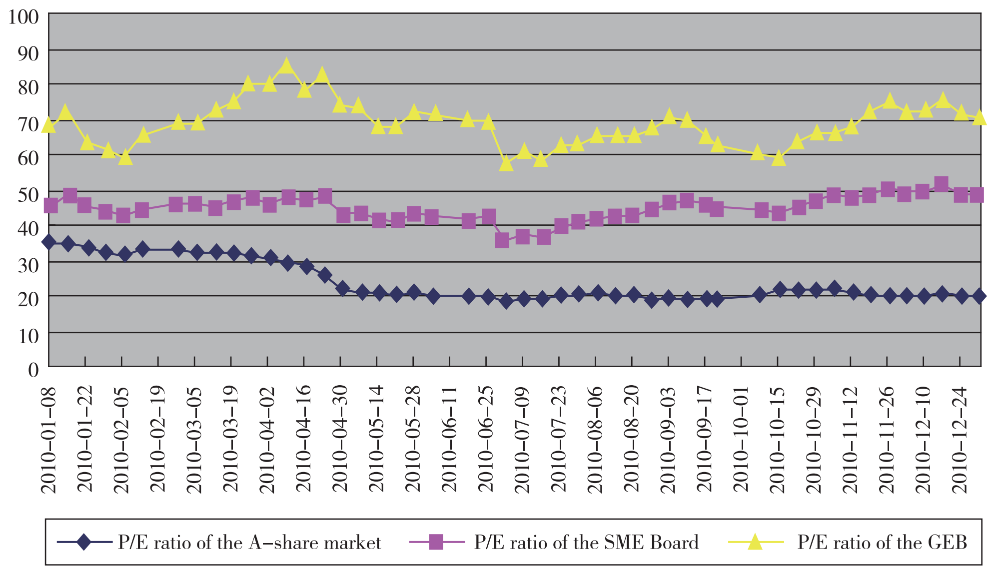


Source: PBC, CBRC.

Valuation of the A-share Market was Generally Reasonable while the over-valuation of the GEB Worth Attention

In 2010, the valuation of the A-share market was generally stable. By end-2010, the static P/E ratio of the A-share market was 20.09, down 41.63 percent from 34.42 at the beginning of 2010. Broken down by market, companies listed on the GEB were significantly overvalued. By the end of 2010, the static P/E ratios of the Small and Medium-size Enterprise Board and the GEB stood at 49.12 and 70.75 respectively (figure 3.3).

Figure 3.3 P/E Ratio of the A-share Market in 2010



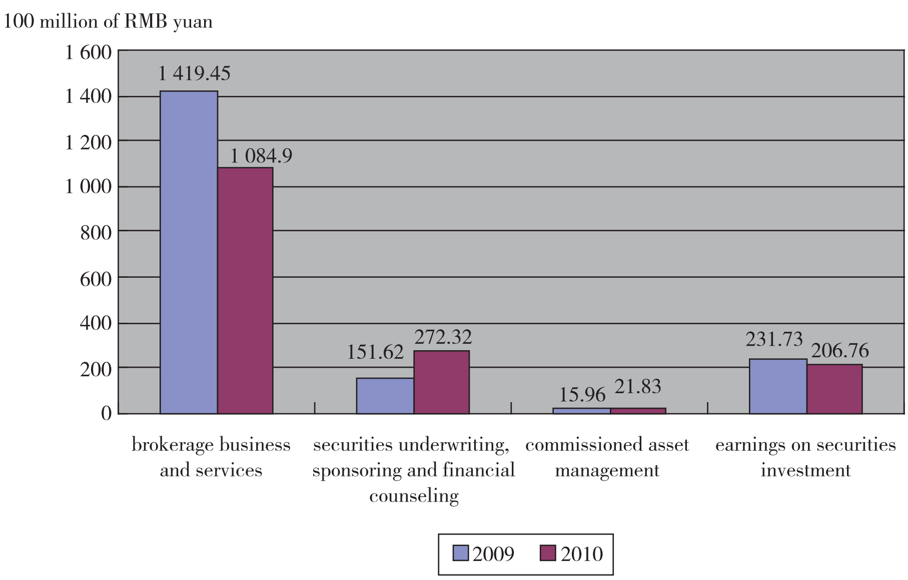
Source: Wind Info.

High P/E ratios of the GEB can usually be attributed to high growth of listed enterprises, while their financial statements in the first half of 2010 failed to support the valuation. In the first half of 2010, net profits of the 117 companies listed on the GEB registered RMB 3.435 billion yuan, among which, excluding 12 incomparable companies, the net profits of the rest 105 companies grew by 25.75 percent y-o-y, marking a significant drop from the 47.04 percent in 2009, and also lower than the average 46.48 percent of all companies listed on the A-share market.61 companies listed on the GEB saw a net profit growth of less than 30 percent, accounting for as high as 58.1 percent of the total. Though such underperformance can be assumed as a result of the volatility in the business of growth enterprises, their overvaluation is still worth concerns.

Securities Firms Strengthened Resilience and Diversified the Profit-Making Models

By the end of 2010, net assets of 106 securities firms reached RMB 566.4 billion yuan, up 17 percent y-o-y, while their net capital stood at RMB 431.9 billion yuan, up 13 percent y-o-y. The whole industry had an average net capital of RMB 4.07 billion yuan, net capital/risk-based capital provision of 3.9, net capital/net assets of 76 percent, net capital/liabilities of 2.5, net assets/liabilities of 3.3, and liabilities/assets ratio of 23 percent after deducting assets and liabilities of the clients. All risk control indicators of the securities firms showed full compliance with regulatory provisions, and the securities sector had adequate liquidity, relatively low liabilities and strong resilience against market risks. Revenue of the securities sector registered RMB 191.102 billion yuan, down 6.8 percent y-o-y. Broken down, net turnover of the securities brokerage, sales commission of financial products and investment and advisory services reached RMB 108.49 billion yuan, turnover of securities underwriting, sponsoring and financial advisory business registered RMB 27.232 billion yuan, turnover of client asset management posted RMB 2.183 billion yuan and earnings on securities investment (change of fair value included) stood at RMB 20.676 billlion yuan (figure 3.4). The accumulated actual profits totaled RMB 77.557 billion yuan, down 16.85 percent y-o-y. Compared with the previous year, net revenue of securities underwriting, sponsoring, financial counseling and commissioned asset management went up slightly, while that of proprietary business and brokerage services declined. The drop of brokerage revenue was mainly attributed to a lower commission rate. As of the structure of revenue, brokerage remained the major source of revenue, accounting for 56.77 percent of the total, down 12 percentage points compared with the previous year, showing that securities companies became less reliant on brokerage business.

Figure 3.4 Comparison of Revenue of Securities Firms in 2009 and 2010



Source: CSRC.

Private Equities Grew Rapidly but Posing Potential Risks

In recent years, private equities in various forms have been developed rapidly in China, falling into two major categories of "underground" private equities and "sunshine" private equities. Currently, there are no specific regulations on "Underground" private equities, and they are not included in the regulatory framework which may brew illegal fund-raising and other irregularities or breaches of law. Moreover, the rights and interests of investors more easily fall victim to disputes with managers. By contrast, "sunshine" private equities are more formal and transparent, but their size is comparatively limited. The significant presence of "underground" private equities outside of the regulatory framwork may render the financial system to larger risk exposure. The "sunshine" private equities, such as asset management for specific clients by fund management companies, collective wealth management by securities firms, individual wealth management by commercial banks and collective fund trust by trust companies, recently have developed rapidly. Since these products lack a consistent legal base for regulation, their greatly divergent regulatory requirements have resulted in overlapping or vacuum of regulation.

Outlook and Reform Measures

China's capital market generally is not yet fully developed and needs further consolidation of market infrastructure and improvement of the markets system and structure. Competitiveness and innovation of securities and futures firms are still weak. In 2011, efforts should be made to promote sustained, stable and healthy development of the capital market in line with the 12th five year plan, in order to better serve social and economic development.

Continue to Improve the Market Institutional Arrangements and Efficiency

Continued efforts should be made to deepen the reform of the IPO system, implement the second phase measure of the IPO reform, and launch follow-up measures based on experiences and studies, so that the IPO price would be market-based choice and market participants would be more prudent and self-disciplined. Market-based merger and acquisition should be promoted. Measures should be taken to improve institutional arrangements for mergers and acquisitions, support qualified listed companies in asset restructuring and financing at the same time, and regulate and guide backdoor listing. The delisting process will be improved. Prioritized efforts will be made to promote the reform of the delisting process of listed companies on the main board and SME board, establish delisting mechanism for the GEB and improve the delisting accountability. Infrastructure on the futures market will be strengthened. Efforts should be made to set up an investor appropriateness system in the commodities futures market, improve the investor structure on the stock index futures market, revise the futures trading and clearing rules and improve relevant mechanism and models to facilitate agricultural produce futures for the interests of agriculture, farmers and rural areas.

Strengthen Regulation to Ensure Fairness, Equitability and Openness of the Capital Market

In the new market environment, effective measures should be taken to strengthen the protection of investors' interests, ensure the fairness, even-handedness and openness of the capital market and enhance investors' confidence. Insider trading should be cracked down, and the insider registration system will be put in place for listed companies. Efforts should be made to strengthen information disclosure in order to detect abnormal stock price movements more effectively, and stricter administrative and criminal punishment should be imposed. Regulation over listed companies should be strengthened by cracking down on related-party trading and misconducts of listed companies such as tunneling and price manipulation in favor of their related parties. Regulation over securities institutions should be reinforced by implementing the rules of Chinese wall, strengthening supervision of sponsoring and financial advisory business, and including direct investment under routine supervision. Measures should be taken to clamp down on rat trading, unfair trading and all kinds of tunneling. Well-regulated development of futures companies should be promoted by refining risk monitoring and supervision indicators of futures companies and the calculation standard of net capital, improving dynamic monitoring and control of net capital, delivering classified supervision and assessment of futures companies and supporting futures companies in developing and expanding via merger and acquisition as well as raising capital by issuing new shares.

Accelerate the Development of a Multi-Layer Capital Market and Expand the Size of Direct Financing

While consolidating the current layers of the market, efforts should be made to accelerate the development of the OTC market, expand market coverage, promote direct financing and establish a mutually-complementary, mutually promoting and well-coordinated multi-layer capital market. Zhongguancun Science Park is on a pilot of agent equity transfer program. Based on its experiences, efforts should be made to expand the scope of the program to facilitate public equity transfer of qualified companies that are not listed in hi-tech development areas. Efforts should be made to formulate administrative measures on unlisted public companies and establish the relevant regulatory system.

Promote Innovation of the Capital Market and Improve Regulation Mechanism

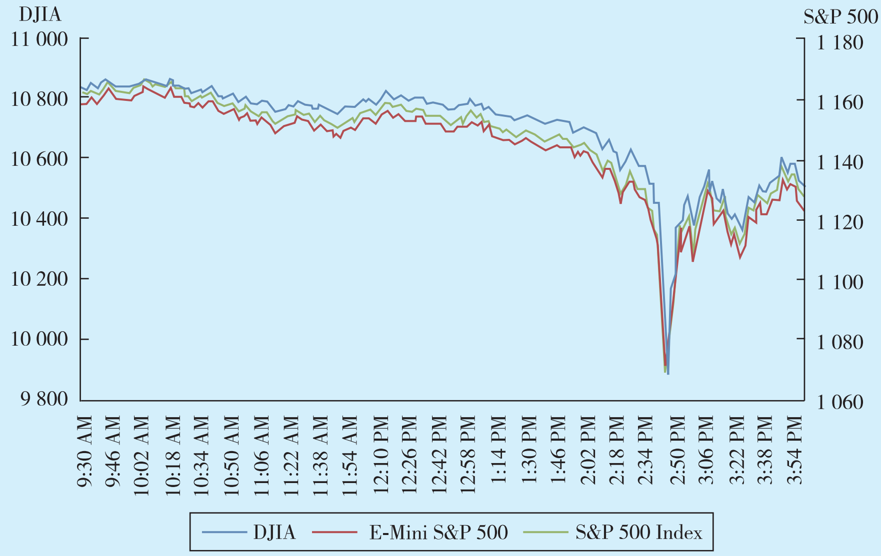
Innovation of China's capital market, which is lackluster, should be encouraged, with the precondition of risk predictability and controllability. Measures should be taken to improve specialized and customized services, encourage the development of investment counseling service, and speed up the upgrading of brokerage business. Administrative measures and supporting rules on margin trading and short selling of securities firms should be improved. Steady progress should be made in the pilot programs of cross-market and cross-border exchange traded fund. Institutional arrangements on private equities should be studied to standardize their development. Efforts should be made to promote innovation of futures products and businesses, such as studying crude oil futures, commodities options, commodities index and trading of carbon emission, and launching the pilot program of investment counseling by futures companies. As the increased complexity and inter-connectedness between specific markets along with the innovation of institutions and products on the capital market, new regulatory mechanism and means should be actively explored to respond to upcoming challenges.

Box 10 A Case Study of the Impact of High-frequency Trading on the Stock Market

In recent years, new models of trading have been popping up on the securities market of the developed countries, with high-frequency trading as one of the major means of trading. Enhancing efficiency and increasing liquidity on the one hand, such trading contains potential risks, and may even inflict market collapse in certain circumstances on the other hand. According to TABB Group, the share of high-frequency trading increased from 1/5 in 2005 to around 2/3 in 2009 in the US stock market. The US stock market plunge on the 6th of May was a typical case of abnormal movements of the stock market as a result of the new means of trading.

At 2:40 pm on May 6th of 2010, the Dow Jones Index and S&P 500 Index plunged more than 5 percent within just 5 minutes, which was an abnormal movement. The Dow Jones dropped 998 points, or 9.2 percent, hitting the largest absolute value of single-day plunge. In the following 20 minutes, the strike prices of more than 20 000 transactions of more than 300 securities deviated more than 60 percent from their prices at 2:40. The strike prices of some stocks deviated seriously from their normal trend, with some lower than 1 cent while the others higher than USD100 000. Following up, the stock index futures and ETFs also plummeted, even more drastically than the stock market. Minutes later, the stock market, stock index futures market and ETFs went back to normal expeditiously, showing a deep V trend (Figure 3.5).

Figure 3.5 Time Trend of Dow Jones, S&P 500 and E-Mini S&P Futures Contracts on May 6th



Source: the Joint Investigation Report by CFTC and SEC

US regulatory authorities attributed authorities this extreme event to a series of factors. First, pessimism prevailed the US stock market as a result of several bearish factors such as the European sovereign debt crisis, leading to a drastic decline of buyers' demand. Second, high-frequency traders took advantage of uncertainties on the market, buying and selling futures positions without holding any underlying assets for long, and thus created unreal liquidity on the market. It was estimated that 27 000 E-mini S&P 500 futures contracts were traded within mere 15 seconds on the afternoon of May 6th, accounting for 47 percent of the trading value that day, while the net purchase of contracts was only 200. Third, misled by the unreal liquidity, a mutual fund started to sell large-value E-mini S&P 500 futures contracts through program trading, leading to flash crash of the stock index futures market. Fourth, the sudden meltdown of the stock index futures market provided cross-market arbitragers opportunities to make profits among the stock index futures market, the ETF market and the spot stock market, leading to plummeting of the latter two. The pro-cyclical operation of high-frequency and program trading had a herd effect, aggravating cross-market contagion and leading to a downward spiral of relevant markets.

Although the development stage of China's market is different from that of the US, and high-frequency trading has not been common in domestic securities and futures market, close attention should be paid to such new model of trading and the potential challenges it poses to the operation of Exchanges, effective supervision and fairness of the market.

Chapter IV

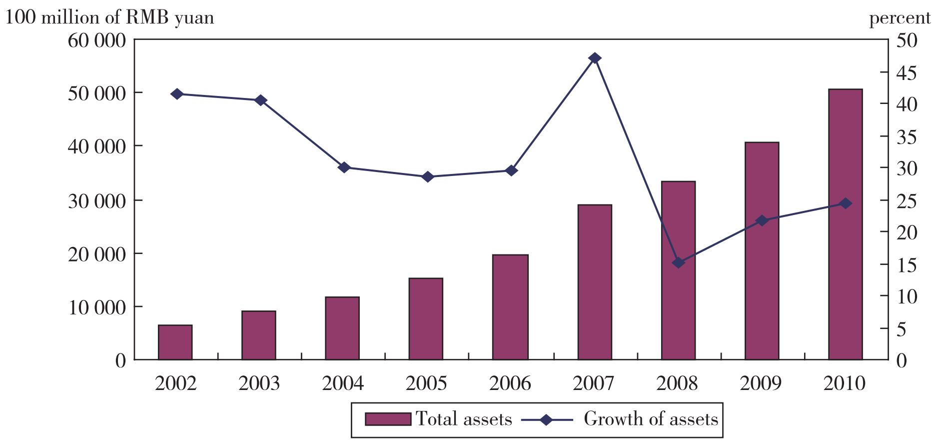
Insurance Sector

In 2010, the insurance sector maintained healthy development, with achievements and progress made in the transformation of development pattern, substantial increase of profits and improved supervision. The sector played a positive role in economic compensation and social risk management.

Recent Developments

Assets continued to increase and sector structure improved. By the end of 2010, total assets of the insurance sector registered RMB 5.05 trillion yuan, an increase of 24.4 percent y-o-y (Figure 4.1), among which assets of foreign insurance companies amounted to RMB 264.94 billion yuan, accounting for 5.24 percent, an increase of 29.1 percent y-o-y. The balance of invested insurance funds grew by 23.1 percent y-o-y to RMB 4.6 trillion yuan, among which RMB 1.39 trillion yuan or 30.21 percent was of bank deposits, RMB 2.3 trillion yuan or 49.85 percent was of bonds, RMB 511.7 billion yuan or 11.11 percent was of stocks (equity) investments, and RMB 262.07 billion yuan or 5.69 percent was of securities investment funds. The number of incorporated insurance institutions increased by 4 from the previous year to 142, including 8 insurance group companies, 54 property insurance companies, 61 personal insurance companies, 9 reinsurance companies, 9 insurance asset management companies and 1 export credit insurance company. The number of specialized insurance intermediaries, concurrent agencies and individual sales representatives decreased by 20 to 2 550 y-o-y, increased by 41 thousand to 190 thousand, and increased by 390 thousand to more than 3.29 million respectively.

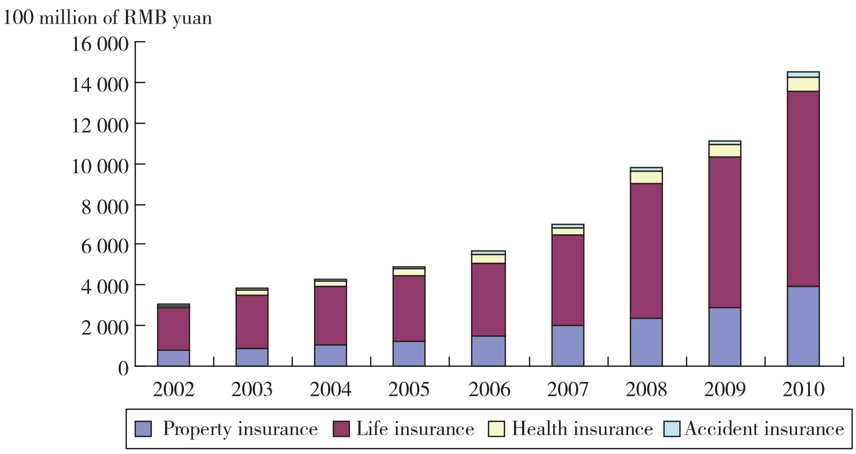
Figure 4.1 Asset Changes in the Insurance Sector



Source: CIRC.

Premium income increased significantly with further expansion of insurance coverage. In 2010, premium income nationwide amounted to RMB 1.4528 trillion yuan, an increase of 30.4 percent y-o-y (Figure 4.2). This included RMB 389.56 billion yuan from property insurance, an increase of 35.5 percent y-o-y, up 12.4 percentage points from the previous year; RMB 967.95 billion yuan from life insurance, an increase of 29.8 percent y-o-y, up 17.8 percentage points from the previous year; RMB 67.75 billion yuan from health insurance, an increase of 18 percent y-o-y; and RMB 27.54 billion yuan from accident insurance, an increase of 19.7 percent y-o-y. Premium income of foreign insurance companies reached RMB 63.43 billion yuan, an increase of 38.5 percent y-o-y, accounting for 4.37 percent of the total nationwide. Insurance density amounted to RMB 1 083 yuan, an increase of RMB 249 yuan y-o-y; insurance penetration amounted to 3.65 percent, up 0.35 percentage points y-o-y. In the annuity market, more than 97 percent of the corporations with annuities chose pension insurance companies as trustees and more than 45 percent of annuity funds were managed by insurance institutions. The insurance sector has taken an active part in serving and supporting agriculture, rural areas and farmers with a total number of 140 million households participating in agricultural insurance and RMB 394.3 billion yuan worth of risk protection, up 5.2 percent and 3.4 percent from the previous year respectively. Rural micro-insurance expanded, covering 24 provinces with more than 20 million participants.

Figure 4.2 Premium Income Growth



Source: CIRC.

Insurance supervision continued to be strengthened and institutional arrangements further improved. In 2010, CIRC improved the mechanism of Dynamic Solvency Testing (DST) and Cash Flow Testing (CFT), clarifying criteria for recognizable investment assets, such as unsecured enterprise (corporate) bonds, real estate, and equities of unlisted companies. Efforts were made to strengthen supervision on equity of insurance companies, raise the access criteria for shareholders, strengthen the responsibilities of shareholders, and define overall framework and fundamental elements of insurance group company supervision. The *Basic Rules for Internal Control of Insurance Companies* and *Guidelines* *on Comprehensive Risk Management of Personal Insurance Companies* were released, requiring insurance companies to establish comprehensive risk management systems. The *Interim Measures on the Administration of Insurance Funds Management* was released, promoting integration, specification and adjustment of current policies on insurance funds management and further loosening constraints on objects, scope and proportion of insurance funds investment (Table 4.1). In protecting policyholders' interests, CIRC established and improved mechanisms of disclosure of insurance service standards and claim procedures. In terms of the accounting system, the *Notice on the Insurance Sector's Implementation of the Interpretation No.2 of the Accounting Standards for Business Enterprises* was released, requiring insurance companies to implement the new accounting standards comprehensively. In information disclosure, the *Measures on Administration of Information Disclosure by Insurance Companies* was issued, requiring insurance companies to disclose their operational information to the general public.

Table 4.1 Adjustment of Objects, Scope and Proportion of Insurance Funds Investment

Objects	New Regulations	Previous Regulations
Deposits, Government Bonds, Central Bank Bills, Policy Bank Bonds, Money Market Funds	No less than 5 percent of total assets	Sum of government bonds, central bank bills, and bonds and subordinated bonds of policy banks no less than 5 percent of total assets
Secured Enterprise (Corporate) Bonds	Discretion on investment amount, with domestic credit rating of A or above	Discretion on investment amount, with domestic credit rating of AA or above
Unsecured Enterprise (Corporate) Bonds	No more than 20 percent of total assets, with domestic credit rating of AA or above	No more than 15 percent of total assets, with domestic credit rating of AAA or above
Stocks and Securities Investment Funds	Sum no more than 25 percent of total assets	No regulations on the sum
Of which：Stocks and Equity Funds	Sum no more than 20 percent of total assets	Stocks no more than 10 percent of total assets
Securities Investment Funds	No more than 15 percent of total assets	No more than 15 percent of total assets
Overseas Investment	No more than 15 percent of total assets, investment in Hong Kong Main-Board Market permitted	No more than 15 percent of total assets, no regulations on specific investment objects
Shares of Unlisted Companies	No more than 5 percent of total assets	No regulations, investment in shares of unlisted banks no more than 3 percent of total assets
Real Estate	No more than 10 percent of total assets	No regulations
Infrastructure Bond Investment Plan	No more than 10 percent of total assets	No more than 6 percent and 4 percent for life insurance companies and property insurance companies respectively

Source: CIRC.

Box 11 Development of Accounting Standards for Insurance Contracts and its Impact

For a long time, there was no internationally unified accounting practice for insurance contracts in various countries, with low transparency and comparability, thus made it difficult for financial statement users to understand the financial condition and performance of insurance companies. Therefore, the IASB put forward a two-stage solution for the problem, with requirements for insurance companies to disclose fair value of insurance contracts at the first stage, and a focus on recognition and measurement of the contracts at the second stage. In 2004, IASB published *International Financial Reporting Standards* (*IFRS*) *4*: *Insurance Contracts*, finishing the work of the first stage. IFRS 4 stipulates definition of insurance contract and raises requirements on significant insurance risk testing, separation of mixed insurance contracts and adequacy testing. Currently, IASB is carrying out the work of the second stage and plans to publish formal standards in 2011 Q_2, in effect in January 1, 2013.

In 2007, China launched the task of achieving convergence with international accounting standards. The MOF issued the *Provisions on the Accounting Treatment Related to Insurance Contracts* in December 2009 and CIRC issued the *Notice on the Insurance Sector's Implementation of the Interpretation No.2 of the Accounting Standards for Business Enterprises* in January 2010, establishing accounting standards for insurance contracts to achieve convergence with international standards. The new standards have regulations on three main aspects including separation of mixed insurance contracts, significant insurance risk testing and measurement of insurance contracts reserve. First, the new standards require that mixed insurance contracts should be separated when satisfying specific conditions. Second, the standards also require significant insurance risk testing when recognizing insurance contracts. Third, insurance contracts reserve should be measured on the basis of reasonable estimate of insurers' expenditure to perform the contracts, while marginal factors and time value should also be taken into account. At the date of initial recognition of insurance contracts, insurers should not recognize the gain but the loss of that date. Insurers should make assumptions for measurement of insurance contracts reserve, including the discount rate, accident frequency, surrender rate, expense ratio and policy dividend, on the basis of information available at the date of balance sheet.

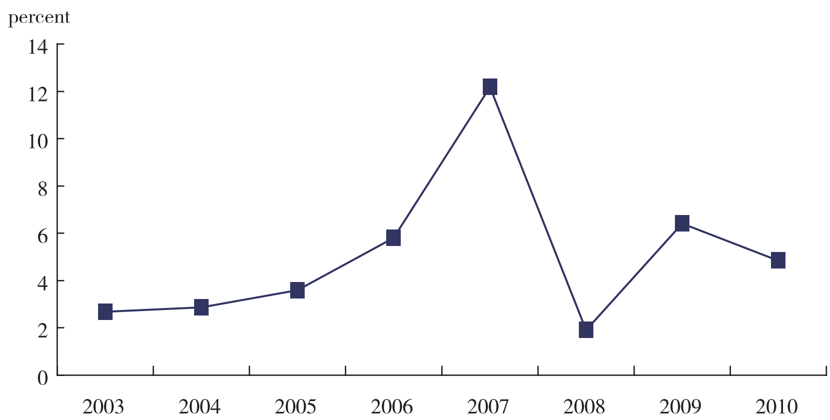
The new standards have eliminated, to the greatest extent, discrepancies between domestic and overseas financial statements of listed companies, pushing China's accounting standards for insurance contracts towards latest international standards. The impact of these standards on the insurance sector is worth attention. First, scope of premium income has changed by requirements on separation and significant risk testing. The portion separated from universal insurance or investment-linked insurance into the investment account and premium from contracts that fail to pass the significant risk tests will no longer be recognized as premiums. Second, a framework for insurance contracts reserve measurement, which is easy to understand, comparable and objective, has been established. The new framework has improved time distribution of profit realization of long-term insurance contracts and reported financial condition and performance of insurance companies in a more objective manner with increase in net assets and net income of most insurance companies in varying degrees.

Soundness Assessment

Profits of the Insurance Sector Increased Significantly while ROI of Insurance Funds Decreased

In 2010, gross profits of the insurance sector amounted to RMB 83.65 billion yuan, an increase of 57.7 percent y-o-y, among which life insurers realized a profit of RMB 47.64 billion yuan, up 9.6 percent y-o-y; property insurers realized a profit of RMB 22.56 billion yuan, up 542.9 percent y-o-y, with the underwriting businesses turning loss into a gain for the first time in recent years. Main reasons for surge in property insurers' profits included that CIRC strengthened supervision on market conduct and promoted the 'Cash before Cover' approach, effectively preventing misappropriation and encroachment upon the premium by insurance intermediaries. The commercial auto insurance information platform was established with the unified standard of premium rates for auto insurance to contain vicious competition. Meanwhile, property insurers strengthened internal control and increased operational efficiency. In 2010, the comprehensive loss ratio of property insurance companies decreased by 3.2 percentage points y-o-y to 63.1 percent and the comprehensive expense ratio decreased by 3.9 percentage points y-o-y to 34.2 percent. The slump of the bond market and the stock market in 2010 had negative impact on insurance funds management. In 2010, average ROI of insurance funds registered 4.84 percent, down 1.57 percentage points y-o-y (Figure 4.3). In the insurance investment portfolio, proportion of bank deposits increased by 2.1 percentage points y-o-y, while that of bonds, stocks and securities investment funds decreased by 1.1, 0.1 and 1.7 percentage points y-o-y respectively. With the rapid increase of assets, it is urgent for the insurance sector to improve its funds management.

Figure 4.3　Average ROI of Insurance Funds

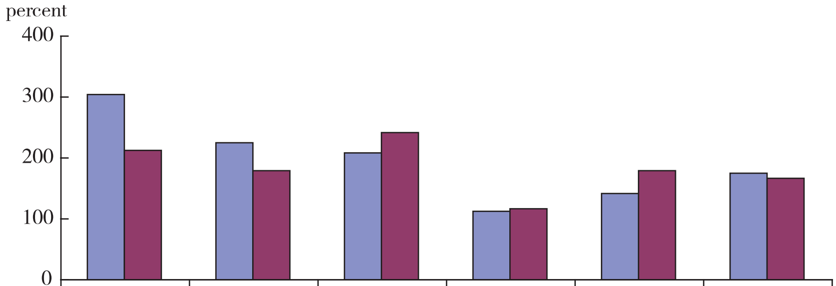


Source: CIRC.

Solvency of Insurance Companies was Generally Adequate, While Pressure for Capital Replenishment Increased

By the end of 2010, the solvency level of the entire sector was generally adequate. The number of companies with solvency adequacy ratio below the supervisory requirement decreased by 1 from the previous year to 7, with obvious improvements in key solvency indicators for the 7 companies. With rapid expansion of their operations, insurance companies need more capital to meet the supervisory solvency requirement, increasing the pressure for capital replenishment (Figure 4.4). Currently, insurance companies have narrow channels to replenish their capital, mainly through getting investment from original shareholders or issuing subordinated debts. In 2010, 46 insurance companies raised RMB 33.17 billion yuan from original shareholders, a source which lacks sustainability, and 8 companies issued subordinated debts of RMB 22.55 billion yuan. Subordinated debts are not high-quality capital and have low loss-absorbency capacity for insurance companies as a going concern. Meanwhile, such debts face other problems such as a narrow investor base, high issuance cost, restricted financing scale and low liquidity.

Figure 4.4 Changes in Solvency of Listed Insurance Companies in China in 2009 and 2010



	China Life	Ping An Life	CPIC Life	PICC P&C	Ping An P&C	CPIC Property
2009	303.59	226.7	208	111	143.6	173
2010	212	180.2	241	115	179.6	167

Source: CIRC.

Market Concentration Generally Declined but More Imbalance in Product Structure

In 2010, insurance market structure in China was further optimized. The Herfindahl-Hirschman Index (HHI)① of property and life insurance sector registered 0.194 and 0.154 respectively, down by 0.004 and 0.030 y-o-y respectively. The market share of the largest life insurance company by premiums registered 31.7 percent, down 4.5 percentage points y-o-y and that of the top five largest life insurance companies registered 72.8 percent, down 4.4 percentage points y-o-y. the market share of the largest property insurance company registered 38.2 percent, down 3.4 percentage points y-o-y but that of the top five largest property insurance companies grew by 0.6 percentage points from the previous year to 74.7 percent. Premium increased rapidly in 2010 with intensified concentration on specific products. For life insurance products, premium income from participating life insurance reached RMB 745.5 billion yuan, accounting for 77 percent of total life insurance premium income, up 6 percentage points y-o-y. For property insurance, benefiting from rapid growth of auto sales in China, premium income from auto insurance amounted to more than RMB 300.4 billion yuan, an increase of 39.4 percent y-o-y, and the proportion in total property insurance premium rose by 2.6 percentage points y-o-y to 74.6 percent (Table 4.2).

① HHI is the sum of the squares of the market share of each institution in one sector. Higher HHI means higher market concentration.

Table 4.2 Proportion of Major Insurance Products in Life and Non-life Insurance Premium Income

	Life Insurance				Property Insurance			
	Participating Life Insurance	Investment-linked Insurance	Universal Insurance	Common Life Insurance	Auto Insurance	Agricultural Insurance	Liability Insurance	Enterprise Property Insurance
2009	71.0%	2.0%	14.2%	12.9%	72.0%	4.5%	3.1%	7.4%
2010	77.0%	1.6%	11.6%	9.8%	74.6%	3.4%	2.9%	6.7%

Source: CIRC.

Sales Channels Experienced Imbalanced Development and Bancassurance Called for Further Improvement

In 2010, China's insurance companies collected RMB 1 099.114 billion yuan in premiums through the insurance intermediary channel, accounting for 75.8 percent of total insurance premiums, among which contribution of professional insurance intermediaries, cross-sector insurance intermediaries and insurance sales representatives reached RMB 84.464, 546.442 and 468.208 billion yuan respectively, accounting for 5.82, 37.68 and 32.29 percent of total premiums respectively. Among cross-sector intermediaries, bancassurance contributed to about 50 percent of life insurance premiums, playing an important role in broadening the coverage of insurance services and increasing intermediate business income of commercial banks but also saw irregularities and offenses such as commercial bribery and misleading sales in recent years. In November 2010, regulations were published by relevant agencies to further regulate bancassaurance business, some of which brought challenges to development of the business since some small-sized insurance companies may no longer be qualified to have banks as their sales channels. Sales capacity may be reduced when sale representatives are forced to leave bank outlets, which requires bank clerks to develop skills for selling insurance products in a short time. According to statistics, scale of bancassurance of most insurance companies declined after the issuance of the new regulations.

Outlook and Reform Measures

International experiences show that commercial insurance tends to enter into a booming period, when per capita GDP reaches USD 3 000-10 000. In 2011, China will maintain steady and rapid economic development with per capita GDP over USD 4 000. With the increase of household income and rapid pace of population aging, there are increasing demands for insurance products and a broader space for the development of the insurance sector. Taking advantage of the opportunities, the insurance sector should transform the extensive development pattern, strengthen product and service innovation, prevent risks and improve quality of development.

Promote Adjustment of Business Structure and Product Innovation to Better Meet Social Demands

Insurance companies should be encouraged to choose differentiated development paths based on their own strengths, with transformation from price and scale competition to rational competition on products, services and quality of management, to increase profitability. Business Structure should be further adjusted to develop insurance businesses that meet consumers' demands and represent their core strengths. Insurance product innovation should be promoted to serve the development of emerging industries and economic restructuring. Insurance coverage, with a priority on agricultural insurance, pension insurance, medical insurance and health insurance, should be expanded to support the agricultural development strategy, social security system and urbanization. Establishment of the catastrophe insurance system should be accelerated to effectively prevent systemic risks imposed to the society, economy and the insurance sector caused by natural disasters.

Establish a Multi-channel Capital Replenishment Mechanism and Strengthen Supervision on Solvency

Rapid development of the insurance sector calls for a scientific and effective capital replenishment mechanism. Measures should be taken to increase insurance companies' ability to replenish capital through internal accumulation, support listing and financing of qualified insurance companies, encourage listed insurance companies to achieve capital replenishment via various channels including convertible bonds, allotment, secondary offering and non-public offering, and normalize conditions for issuing subordinated debts. Meanwhile, supervisors should intensify supervision on solvency and strengthen capital constraint. For companies with inadequate capital, supervisors should take such measures as restrictions on business conduct and distribution of shareholders' dividend. Furthermore, relevant agencies should gradually establish risk-based modern solvency supervisory standards by drawing on development of the international financial regulatory reform.

Improve the Management of Insurance Funds and Prevent Investment Risk

According to adjustment of macroeconomic policies and changes in market condition, insurance companies should improve their ways of utilizing funds and risk management skills, enhance capabilities of risk identification, analysis and measurement, make rational resource allocation and strengthen investment management. Regulations on insurance funds management should be strictly implemented in order to contain investment impulse. Supervisors should further elaborate on regulations on funds management, improve risk monitoring mechanism, implement supervision on allocation of asset classes, and promote custody of insurance investments in order to prevent investment risk.

Regulate Market Order and Effectively safeguard the Interests of the Insured

Measures should be taken to further normalize bancassurance, strengthen on-site examinations on auto insurance and agricultural insurance, impose heavier penalties on irregularities and offenses, and crack down on commercial bribery in order to regulate the insurance market order. Priority should be given to solving outstanding problems such as misleading sales and difficulties in insurance claim, promoting simplification of policies and standardization of terms, improving standards on claim services, and establishing and improving the complaint settlement mechanism in order to effectively safeguard the interests of the insured.

Chapter V

Financial Markets

In 2010, China's financial markets continued to perform in a sound and stable manner against the background of reform and innovation, and maintained a steady development momentum. It brought the fundamental role of improving financing structure and allocating resources into full play, thus contributing to the effectiveness of macroeconomic adjustment policies and decision-making of individual economic agents.

Market Overview

Trading on the Money Market Remained Brisk

The volume of money market maintained notable growth. In 2010, the market liquidity was generally abundant but demand and supply of short-term money differed in the course of time and across various institutions. Trading on the money market was brisk with the turnover volume growing by a larger margin than the previous year. Among that, the turnover of inter-bank borrowing registered RMB 27.9 trillion yuan, a y-o-y increase of 44 percent; the turnover of bond repos reached RMB 87.6 trillion yuan, a y-o-y increase of 24.6 percent.

Short-term transactions accounted for a large share of total trading. In 2010, the turnover of overnight inter-bank borrowing reached RMB 24.5 trillion yuan, accounting for 87.9 percent of the total volume of inter-bank borrowing, an increase of 4.4 percentage points compared with last year. The volume of 1–day bond pledged repo totaled RMB 67.7 trillion yuan, accounting for 80 percent of the total bond repos, up by 2.3 percentage points from last year. Short-term transactions dominated the market, a sign that the role of money market in adjusting liquidity was further enhanced.

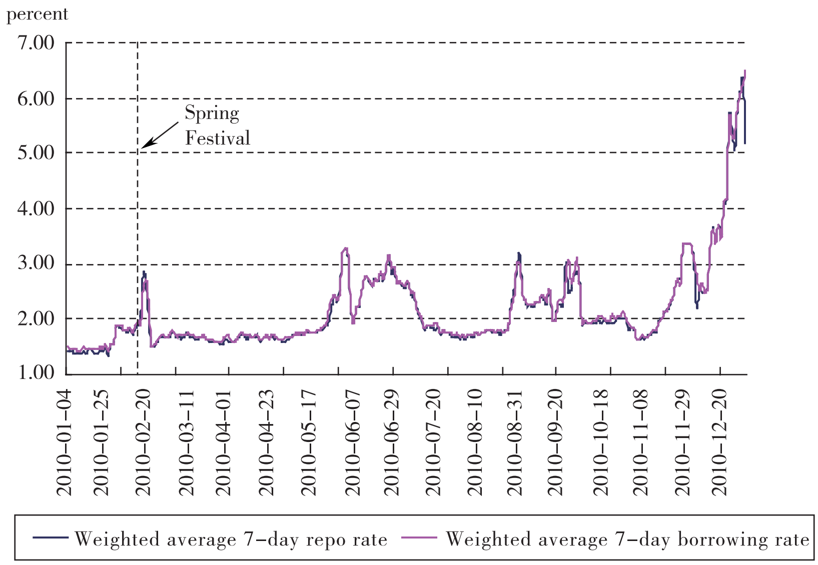
Interest rates on the money market rose remarkably. In 2010, interest rates on the money market went upwards. Money market interest rates continued to edge up when it was close to the end of the year. At the end of the year, the inter-bank overnight borrowing rate closed at 4.52 percent, a large increase of 340 basis points from the beginning of the year. The weighted average interest rate of 7–day bond pledged repo closed at 5.17 percent, a surge of 377 basis points. In December, the weighted average interest rates of inter-bank borrowing and bond pledged repo registered 2.92 percent and 3.12 percent, up by 176 and 193 basis points from January respectively (Figure 5.1).

The bond Market Grew Stably

Bond market expanded further[①]**.** In 2010, the bond market witnessed robust innovation of products, the issuance amount of debenture bonds stayed at a high level and the channels for enterprise to finance directly from the market had been expanded further. The bond market played an important role in the effective allocation of financial resources and transmission of the monetary policy. The aggregated RMB bonds issued on the bond market during the year registered RMB 5.1 trillion yuan, up 3.1 percent y-o-y. And the amount of government securities, bonds issued by policy banks and short-term financing bills

① Issuance and deposited amount do not include central bank bills.

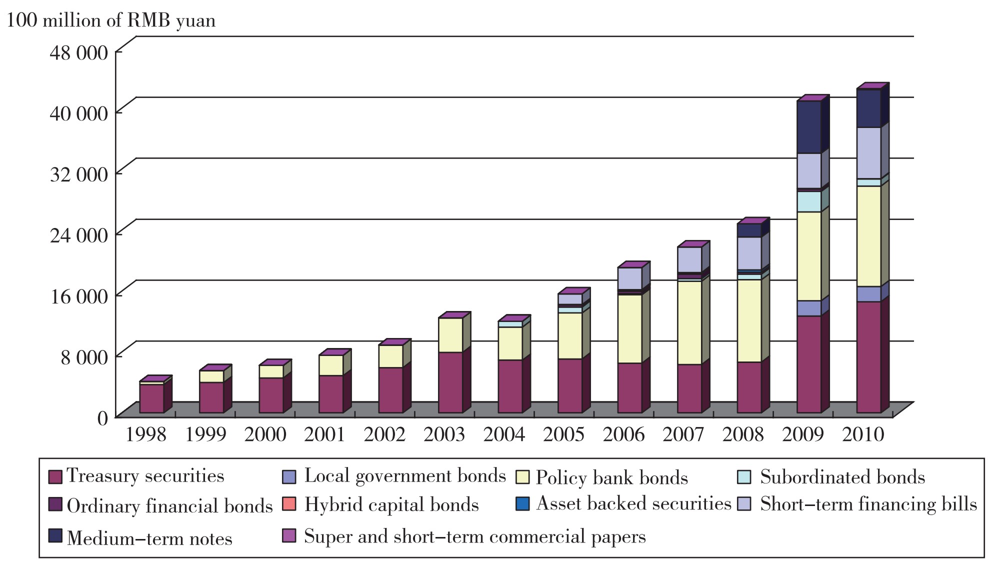
Figure 5.1 Interest Rate Movements on the Money Market in 2010



Source: National Interbank Funding Center.

all went up from the amount of last year (Figure 5.2). As of the end of the year, total amount of bonds deposited on the bond market reached RMB 16.3 trillion yuan, among which RMB 15.8 trillion yuan was deposited on the inter-bank market, up 21.5 percent y-o-y.

Figure 5.2 Issuance of Major Bonds on the Inter-bank Bond Market in Recent Years[①]



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

① Excluding the special Treasury securities issued in 2007.

Box 12 Covered Bonds

Covered bonds[①] (CBs) are debt instruments secured by a cover pool of mortgage loans or public-sector debts to which investors have a preferential claim in the event of default. CBs have the following characteristics: they are issued by a credit institution that is subject to public supervision and regulation; bondholders have full recourse to the credit institution and have a claim against a cover pool of financial assets in priority to the unsecured creditors. CBs could enrich the market-based risk management mechanism. Since the credit risk of the underlying assets is retained by the issuer, the problem of moral hazard caused by the mismatch of risk and yield and the unavailability of information could thus be avoided.

CBs are mostly issued in European countries. They are financial instruments with a long history and were first created in 1770 in Prussia for the financing of a public project. With the establishment of a platform for issuance and trading of large asset-backed bonds on the EU inter-bank market in 1995, the CB market experienced strong growth. After ten years of development, today there are more than 29 countries which have introduced CBs and more than 300 issuers.

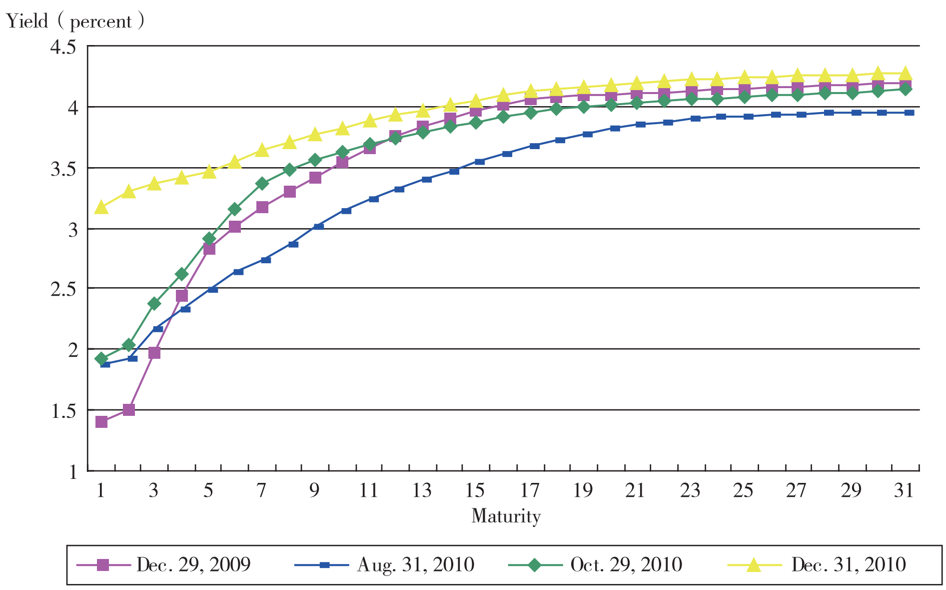
Because of its strict regulatory framework, high credit rating, good liquidity, wide distribution among various countries and diverse maturity structures, CBs have been favored by investors such as credit institutions, investment funds, pension funds, insurance companies and central banks. By the end of 2009, total outstanding amount of CBs reached EUR 2.4 trillion. And it was one of the first markets to recover following the global financial crisis. The announcement of the ECB in May 2009 to purchase about EUR 60 billion CBs also boosted the development of CBs. The United States also actively promoted the development of CBs on its domestic markets. With deepening understanding of and more researches on CBs, more jurisdictions would introduce these stable and safe bonds into their markets, which will bring about a new round of robust issuance and trading of CBs.

① According to the definition by the European Covered Bond Council.

Medium-and short-term bonds dominated the bond market. In 2010, the issuance of bonds with the maturity within 5 years accounted for 40 percent of the total, down 8.8 percentage points from last year; the issuance of 5–10 year bonds accounted for 34.7 percent of the total, up 7.9 percentage points y-o-y; and the issuance of bonds with a maturity of 10 years or longer accounted for 25.2 percent of the total, an increase of 0.8 percentage points from last year.

Both trading volume and prices of bonds edged up. In 2010, turnover of the inter-bank bond market saw a 35.5 percent y-o-y increase to RMB 64 trillion yuan. Bond indices moved upwards throughout the year. The index of bond on the inter-bank market rose from 130.23 points in the beginning of the year to 132.74 points at the end of the year, registering an 1.9 percent increase. The index of government securities in the exchanges picked up from 122.34 points in the beginning of the year to 126.28 points at the end of the year, registering a 3.2 percent increase. Yield curve of government securities moved stably upwards (Figure 5.3).

Figure 5.3 Yield Curves of Government Securities on the Inter-bank Market in 2010



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

Investors in the bond market diversified further. Starting from August 2010, foreign institutions including central banks or monetary authorities, RMB liquidation banks in Hong Kong and Macao and overseas participating banks for cross-border RMB settlement were allowed to make investments in China's domestic inter-bank bond market as a part of a pilot program, which not only provided foreign institutions with a way to store the value of their RMB holding, but also expanded the channel for the backflow of RMB. By the end of 2010, there had been 10 235 participants in the inter-bank bond market, an increase of 988 participants compared with last year, showing that investors in the bond market diversified further.

Box13 Innovations on China's Bond Market

In 2010, against complicated and changing macro-economic conditions and on the basis of enhancing risk prevention, PBC actively facilitated innovations on the inter-bank bond market, which contributed to economic and financial developments.

Facilitating the pilot program of credit-risk mitigation tools. In October 2010,PBC promoted NAFMII to launch credit-risk mitigation tools. These tools feature simple trading structure, reasonable risk allocation, high transparency, and well-controlled leverage. The launch of credit-risk mitigation tools was in line with the development of China's financial market. It would provide investors with alternative ways to manage credit risks and contribute to the improvement of risk sharing mechanism of the bond market. As an important innovation facilitated by market participants, it has profound and significant impact on the development of China's financial market and the stability of the financial system.

Formally launching the super and short-term commercial papers(SCPs) on a pilot basis. In December 2010, NAFMII formally began to accept registrations for the issuance of SCPs. Compared with other debt-financing instruments, SCPs are highly market-based and widely applicable, featuring straightforward information disclosure, high registration efficiency, and easy issuance procedures. And as a market-based instrument, it can be widely used by a large variety of institutions and can help broaden the direct debt-financing channels for large enterprises, improve their liquidity risk management, enrich product varieties on the money market, meet the variable demands of investors, increase the sensitivity of the real economy to interest-rate policy and lay a solid foundation for macroeconomic adjustment. At end-2010, a total value of RMB 15 billion yuan's SCPs had been issued.

Steadily expanding the scope of financial bond issuers. In order to expand financing channels of foreign legal-person banks and address foreign banks' mismatch of assets and liabilities, PBC allowed foreign legal-person banks to issue bonds on the inter-bank bond market. Besides, financial leasing companies and auto financing companies were facing with more financing channels, which helped to improve their capability to support small and medium-sized enterprises and the development of automobile consumption credit.

Allowing three types of overseas institutions to make investments in the inter-bank bond market on a pilot basis. In parallel with the pilot program for RMB settlement of cross-border trade, three types of overseas institutions were allowed to invest in the inter-bank bond market on a pilot basis, including central banks or monetary authorities, RMB liquidation banks in Hong Kong and Macao and overseas participating banks for cross-border RMB settlement. It opened a channel for these institutions to preserve the value of their RMB holdings, and was a necessary arrangement to support the RMB settlement scheme for cross-border trade.

The bill Market Grew Rapidly

In 2010, a total of RMB 11.95 trillion yuan of commercial drafts were issued, an increase of 16.36 percent y-o-y. Discounted bills registered RMB 48.64 trillion yuan, a 1.1 times' growth y-o-y. Rediscounted bills amounted to RMB 167.1 billion yuan, rising 5.7 times compared with last year. At the end of 2010, outstanding commercial bills stood at RMB 5.61 trillion yuan, up 35.8 percent y-o-y. Outstanding discounted bills declined by 32.4 percent from last year to RMB 1.48 trillion yuan. And outstanding rediscount bills saw a 7.4 times' growth y-o-y to RMB 79.1 billion yuan.

In 2010, the price on the bill market showed an upward movement. In the first ten months of the year, price generally remained flat and stable apart from a sudden peak in the middle of the year. However, price climbed up rapidly from the end of November. The ICBC Bill Inter-bank Discount Price Index closed at 3 026 points at the end of the year, a remarkable increase of 2 071 points from the beginning of the year. In the first half of the year, the inter-bank discount interest rate hovered at a low level due to abundant market liquidity and robust demand. However, macroeconomic policies and liquidity conditions changed in the second half of the year, leading to steadily rising rates in the bill market. In the last five weeks, bill market rates soared, due to pressure from huge capital demand at the end of the year and market expectations for a tightening monetary policy.

The Foreign Exchange Market Fluctuated within a Larger Band

In 2010, the RMB foreign exchange spot market developed soundly, turnover on the forward market increased rapidly, and the volume of swap and "currency pairs" trading increased by a large margin. In 2010,the turnover of spot RMB foreign exchange transactions increased by 3.5 percent y-o-y; and the turnover on the RMB foreign exchange forward market increased by 234.5 percent y-o-y. The trading in inter-bank foreign currency pairs spot market was brisk, with the total trading volume of the year reaching USD 50.2 billion, up 44.4 percent y-o-y. After the resume of the RMB exchange rate reform, the growth of swap volume moderated remarkably. And the publication of a notice by SAFE to set a minimum level for banks' outstanding FX positions calculated on cash basis changed the structure of RMB foreign exchange derivatives market. In 2010, the turnover of RMB foreign exchange swap totaled USD 1.3 trillion, up 60.1 percent y-o-y.

The gold Market Saw Both Price and Trading Volume at Record Highs

In 2010, international gold price[①] continued to rise to a record high of USD 1 421 per ounce in the beginning of November and closed at USD 1 410.25 per ounce at the end of the year, registering a 25.75 percent increase from the beginning of the year. Domestic gold price soared from RMB 241.15 yuan per gram in the beginning of the year to RMB 301.17 yuan per gram at the end of the year, an increase of 24.89 percent throughout the year. And the spread of price home and abroad became larger compared with last year.

In 2010, trade volume of gold on the Shanghai Gold Exchange totaled 6 051.50 tons, up 1340.68 tons or 28.46 percent y-o-y; and accumulated turnover posted RMB 1 615.781 billion yuan, up RMB 586.905 billion yuan or 57.04 percent y-o-y. Trade volume of silver registered 73 614.96 tons, an increase of 57 367.17 tons or 353.08 percent y-o-y; and accumulated turnover posted RMB 386.328 billion yuan, up RMB 327.670 billion yuan or 558.61percent y-o-y.

Overview of Financing in the Market

In 2010, bond issuance grew steadily, and financing on the stock market reached a record high. Financing by domestic non-financial sectors (including the household, corporate, and government sectors) continued to rise and displayed a diversified financing structure.

Bond Financing Developed Very Fast

Bond financing has become one of the major direct financing channels in China. The fast development of bond markets facilitated enterprise financing and played an important role in promoting a stable growth of economy during the international crisis. The proportion of bond financing in direct financing

① Note: London Gold Price PM Fix. This is the AM Fix on November 31, because there was no fixing price quote in the afternoon of the day.

(excluding financing by financial institutions) began to exceed that of stock financing in 2005. In 2010, total bond financing amounted to RMB 2 trillion yuan, 3.3 times of stock financing. The share of bond financing accounted for 77 percent of direct financing (Table 5.1).

In 2010, there was an upward trend in bond issuance rates. Affected by the two hikes in the benchmark interest rate and the heightened inflation expectations, the upward trend affected bond issuance rates of all maturities. The fixed interest rate of 5-year book-entry interest-bearing government securities issued in December 2010 was 3.64 percent, 0.74 percentage points higher than that of the same products issued in late 2009. The interest rate of 30-year fixed-rate bonds issued by CDB in November 2010 was 4.61 percent, 0.19 percentage points higher than that of the same products issued in March 2010.

Table 5.1　Issuance of Bonds in 2010

Type of bonds	Issuance (100 million of RMB yuan)	Y-o-y growth(%)
Government securities①	19 778	10.3
Of which: Municipal bonds	2 000	0
Financial bonds and issued by CDB and other policy banks	13 193	13.0
Bank subordinated bonds and hybrid capital bonds	920	-66.5
Bank ordinary bonds	10	-90.0
Enterprise bonds②	16 812	0.8
Of which: Short-term financing bills	6 742	46.2
Medium-term notes	4 924	-29.5
Corporate bonds	603	-18.0

Notes：① Including RMB 200 billion yuan of municipal bonds issued by MOF on behalf of local governments;
② Including enterprise bonds, short-term financing bills, medium-term notes, collective bills of SMEs, convertible bonds, bonds with detachable warrants, and corporate bonds.

Source: PBC.

Government Financing Became More Market-oriented

In 2010, 60 book-entry treasury bonds amounting to RMB 1.5 trillion yuan, with maturities from 91 days to 50 years were issued on the inter-bank bond market through market-oriented biddings. The term structure of bond market had a well-balanced coverage of the short-term, medium-term and long-term bonds, which optimized the yield curve of the treasury securities and provided a benchmark for other bonds' pricing. As of the end of 2010, outstanding amount of the treasury securities totaled RMB 6.7 trillion yuan, accounting for 41.1 percent of the overall stock of bonds in the bond market. Besides, MOF issued about RMB 200 billion yuan's municipal bonds on behalf of some provinces through market-based bidding. Thanks to the market-based bidding, the cost for the issuance of book-entry treasury bonds and municipal bonds was maintained at a relatively low level, which established a sound foundation for the smooth implementation of active fiscal policy and the effectiveness of state's macroeconomic adjustment measures.

Market Institutional Construction

The inter-bank real-time yield curves were officially launched. In February 2010, the National Interbank Funding Center released the inter-bank real-time yield curves based on benchmark bonds, which could be used as a reference for intraday price discovery, bond evaluation in trading time, real-time middle/back risk control and for choosing bonds from the bond pool.

The *Interim Administrative Measures on the RMB Bond Issuance by International Development Institutions* was revised. In September 2010, PBC, MOF, NDRC and CSRC jointly published the revised version of *Interim Measures for the Administration of the RMB Bond Issuance of International Development Organizations*, which allowed the issuers to remit fund raised in China abroad, clarified that the interim Measures were applicable to multilateral, bilateral and regional development institutions, and adjusted requirements for accounting standards and credit rating.

Bond transactions on stock exchanges by listed commercial banks were facilitated on a pilot basis. In October 2010, the CSRC, PBC and CBRC jointly released the *Notice on the Pilot Participation of Listed Commercial Banks in Bond Trading on the Stock Exchanges*, to promote the interconnection, efficiency, and healthy and coordinated development of the bond market.

Credit-risk mitigation tools were launched on a pilot basis. In the second half of 2010, the *Guidelines on the Pilot Program of Credit-risk Mitigation Tools on the Inter-bank Market* was released, which enriched the credit-risk management tools for investors and improved the credit-risk sharing mechanism on the bond market.

Loan transfer market was standardized. In September 2010, the national inter-bank loan transfer system was officially launched. As the first national inter-bank credit asset trading system in China, the system would facilitate the regulated development of the loan transfer market, optimize the credit structure of commercial banks, prevent and mitigate potential financial risks and provide more measures and products for financial institutions to meet capital adequacy requirements and manage their assets.

The reform of RMB exchange rate regime

was further promoted. In June 2010, PBC announced to further reform the RMB exchange rate regime, which had an obvious impact on RMB foreign exchange market. After the announcement, RMB appreciated at a faster speed with enhanced flexibility and expanded fluctuation band. Market makers still dominated the spot market while general members took a more active position in trading.

The institutional building of the gold market was strengthened. In July 2010, PBC, jointly with other relevant government agencies, released the *Opinions on Promoting Gold Market Development*, highlighting the direction for the development of the gold market and emphasizing the improvement of gold market trading methods, the standard-setting system, the warehouse and transportation system and the settlement service. The document required the improvement of gold market tax rules and relevant foreign exchange policies, better financing service for the gold market, expanded channels for gold supply, enhanced supervision over the market, and protection of investors' interests, which laid a good foundation for the healthy development of gold market.

Chapter VI

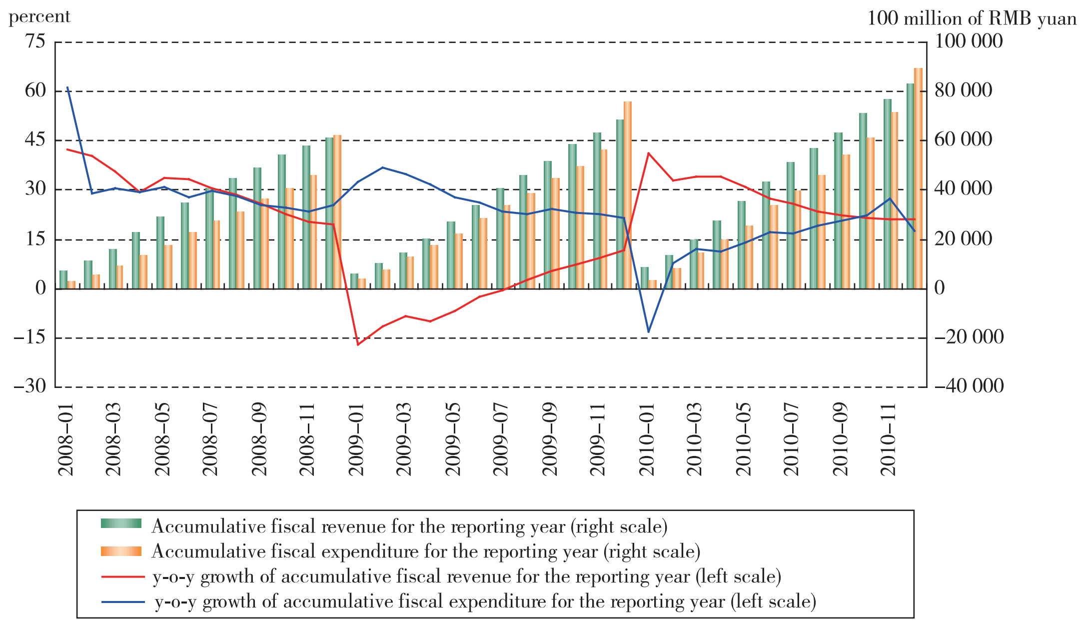
Financial Analysis of the Government, Corporate and Household Sectors

In 2010, the financial condition of the government sector was fairly good with a generally low debt level. Profitability of the corporate sector improved with a stable debt servicing capacity. Financial assets held by the household sector continued to increase, and the overall indebtedness of the household sector remained subdued with a low probability of default. However, efforts should be made to improve the distributional structure of national income and gradually bring up the share of household in national income distribution.

Government Sector

Growth in fiscal revenue accelerated. In 2010, the total fiscal revenue amounted to RMB 8 308 billion yuan, a y-o-y growth of 21.3 percent, up 9.6 percentage points from the previous year(Figure 6.1). In terms of revenue structure, tax revenue posted RMB 7 320.2 billion yuan, accounting for 88 percent; non-tax revenue posted RMB 987.8 billion yuan, accounting for 12 percent. Among the tax revenue, domestic VAT, corporate income tax and business tax were the main sources of revenue, posting RMB 2 109.2 billion yuan, RMB 1 284.3 billion yuan and RMB 1115.8 billion yuan, or with y-o-y growth rates of 13.3 percent, 7.9 percent and 24.4 percent respectively, and accounting for 25.4 percent, 15.5 percent and 13.4 percent of fiscal revenue in the same period. Annual non-tax revenue increased by RMB 88.1 billion yuan y-o-y, or 9.8 percent, down 17 percentage points from the previous year.

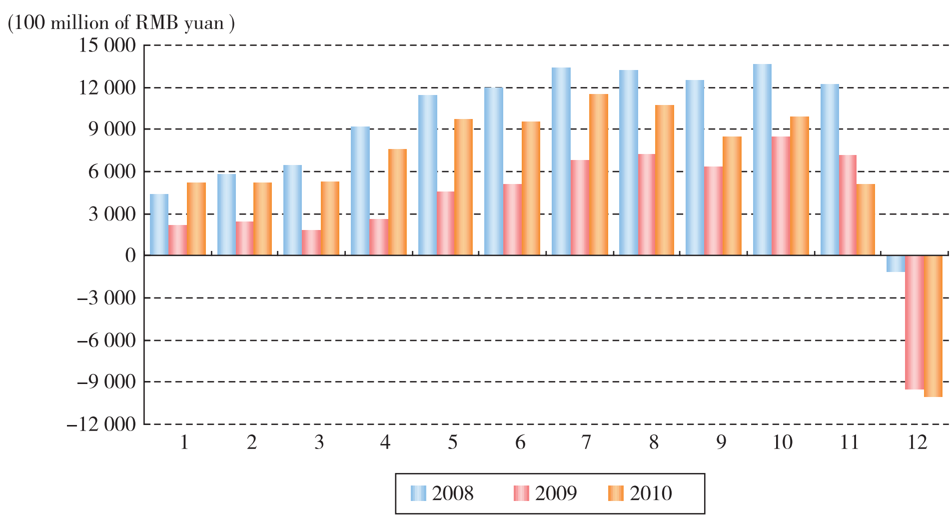
Figure 6.1 Accumulative Fiscal Revenue and its y-o-y Growth in 2008–2010



Source: NBS.

Growth in fiscal expenditures decelerated. Fiscal expenditures in 2010 posted RMB 8 957.5 billion yuan, an increase of 17.4 percent y-o-y, down 3.8 percentage points (Figure 6.1). Of the top five expenditure items, expenditures on education posted RMB 1 245 billion yuan, accounting for 13.9 percent of total expenditures, and an increase of 20 percent y-o-y; expenditures on general public services posted RMB 935.3 billion yuan, accounting for 10.4 percent, and an increase of 2 percent y-o-y; expenditures on social security and employment posted RMB 908.1 billion yuan, accounting for 10.1 percent, and an increase of 20.1 percent y-o-y; expenditures on the agricultural sector, forestry and water utilities posted RMB 805.2 billion yuan, accounting for 9 percent, and an increase of 21.4 percent y-o-y; expenditures on urban and rural communities affairs posted RMB 598 billion yuan, accounting 6.7 percent, and an increase of 19.8 percent y-o-y.

Figure 6.2 Accumulative Fiscal Balances in 2008–2010



Source：NBS.

Although the overall indebtedness level of the government sector was relatively low, the contingent liabilities warranted due attentions. Fiscal deficit in 2010 posted RMB 1 000 billion yuan (Figure 6.2), accounting for 2.5 percent of the GDP. At end-2010, outstanding central government bonds posted RMB 6 768.5 billion yuan, RMB 973.5 billion yuan more than that in the previous year, or a y-o-y growth of 16.8 percent, and accounting for 17.01 percent of the GDP. Overall, the share of outstanding nominal government debts in the GDP was low, however, there was a centain scale of contingent government debts, including the mutually managed funds which emerged from reforming large financial institutions; large amount of debts issued by policy or quasi-policy financial institutions; a high level of debt liability of some departments, e.g., the Ministry of Railway which has large outstanding debts; and unfunded medical care and pension funds, etc. In addition, the contingent debts of local governments should not be ignored. In 2010, growth in loans to local government financing platforms continued to grow rapidly, and their share in total loans was relatively high. In addition, operation of some local government financing platforms was not proper, and they may face elevated risk of losses once structural adjustments in economic sectors speed up. Moreover, contingent debts, such as unfunded social security funds and provident housing funds of local governments and debt liability of villages and townships, added to fiscal risks.

Corporate Sector

The Manufacturing and Operating Situation of Enterprises Continued to Improve With the profit-making Capacity Improving Considerably

Growth in enterprise sales continued to recover. During the first 11 months of 2010[①], main business income of enterprises above designated size increased 31.8 percent y-o-y, up 24.7 percentage points from the previous year. In 2010, sales of 5 000 industrial enterprises which PBC monitors (hereinafter referred to as 5 000 industrial enterprises) increased 20 percent y-o-y, up 21.3 points from the previous year.

The profitability of enterprises improved rapidly. During the first 11 months, profits of enterprises above designated size increased 49.4 percent y-o-y, up 41.6 percentage points from the previous year. In 2010, total profits of 5 000 industrial enterprises increased 32.1 percent y-o-y, up 11.2 percentage points from the previous year.

Enterprise operating capacity improved relatively. In 2010, the operating cycle of 5 000 industrial enterprises was 119.8 days, 5.4 days less than that in the first quarter, and 6.3 days less than that in the previous year. The total asset turnover ratio was 0.9 times, at par with the first quarter and the previous year.

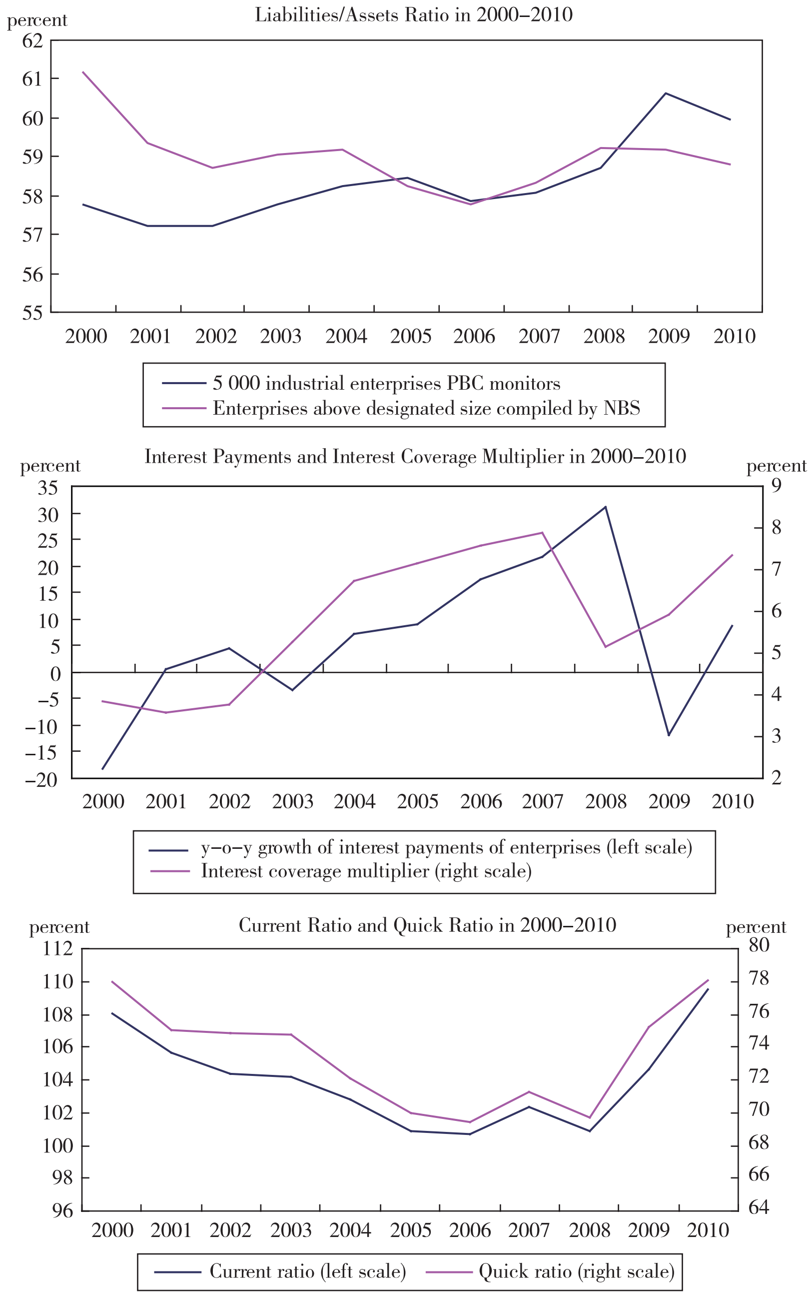
The Enterprises' Debt-servicing Capacity Improved with Relatively Abundant Liquidity

The enterprises' debt-servicing capacity improved steadily. As of end-November 2010, the liabilities/assets ratio of industrial enterprises above designated size was 58.8 percent, down 0.5 percentage points from a year earlier. At end-2010, the liabilities/assets ratio of 5 000 industrial enterprises was basically stable, or 60.2 percent, at par with that at end-2009. Enterprises' capacity in paying interests strengthened. At end-2010, the interest coverage multiplier of 5 000 industrial enterprises was 7.3, 2.2 times that at end-2009, and the capacity of enterprises

① Currently, as to full-scale profitability data of industrial enterprises above designated size, NBS only has data for January-February, January-May, January-August and January-November. For other months and the full-year data, only data for 22 provinces and municipalities on a consolidated basis is available. Therefore, data for January-November is used here to reflect the production and operating situations of industrial enterprises above designated size.

to repay long-term debts was basically stable. In terms of short-term debt-servicing capacity, at end-2010, the current ratio and quick ratio of 5 000 industrial enterprises was 109.5 percent and 78.1 percent, up 6.5 and 4.6 percentage points respectively from the end of the previous year, and the capacity of enterprises to repay short-term debts improved correspondingly (Figure 6.3).

Figure 6.3 Financial Condition of the Corporate Sector



Source：PBC, NBS.

Liquidity situation of enterprises improved somewhat. In terms of assets, as of end-2010, outstanding liquid assets of 5 000 industrial enterprises accounted for 47.6 percent of total assets, up 1.8 percentage points from a year earlier. In particular, outstanding money funds accounted for 30 percent, while low liquidity assets including receivables, advances and inventories accounted for 59.4 percent. In terms of the liabilities, outstanding liquid liabilities/total liabilities ratio of 5 000 industrial enterprises was 72.5 percent. In particular, the share of short-term debts in total liquid liabilities was 26.4 percent, and the share of payables and advances was 46.3 percent.

Costs of Enterprises Went up Relatively and Some Enterprises Faced Financing Pressure

According to the entrepreneurs survey conducted by PBC in Q4 2010, the purchasing price index of raw materials rose noticeably, and most entrepreneurs forecasted that prices of raw materials would increase amid fluctuations in 2011, although at a reduced magnitude. Due to fierce market competitions, some enterprises could not cover the increased costs by charging higher sale prices. In the meantime, as the impact of policy adjustment in the real estate sector gradually unfolded, it was expected that real estate developers and related housing enterprises would witness a slowdown in production and operation. Besides, according to a survey conducted by PBC, working capital in most enterprises was basically normal and the overall liquidity condition was good. However, due to impacts of continued liquidity tightening policies, reduced supply of credit, improved bargaining power of commercial banks as well as increased demand for funds by enterprises, financing costs would rise, and some enterprises, small and micro enterprises and real estate developers in particular, would face tightened liquidity situation. Moreover, with the pace of economic structural adjustment speeding up, attentions should be paid to changes in such areas as operation, profitability, financial management and risk control of the corporate sector.

Household Sector

Financial Assets of the Household Sector Increased Steadily and the Structure of Financial Assets Remained Basically Stable

Financial assets of the household sector increased steadily. China's rapid economic recovery in 2010 contributed to a steady growth of household income and laid a solid foundation for growth in financial assets of the household sector. At end-September 2010, total financial assets of the household sector stood at RMB 48.2 trillion yuan, representing a y-o-y growth of 17.4 percent, and a growth of 17.2 percent from end-2009 (Table 6.1). However, China's per capita financial assets were still at a low level. In terms of US Dollars, China's per capita financial assets at end-September 2010 were only USD5 361, while those of US, UK, Germany and Japan were USD147 000, USD108 000, USD77 000 and USD136 000 respectively[①].

Table 6.1 Financial Assets and Liabilities of the Household Sector

(100 million of RMB yuan)

	2004	2005	2006	2007	2008	2009	Q3 2010
Financial assets	180 369	209 083	251 600	335 495	342 870	410 869	481 727
Domestic currencies	17 820	19 945	22 469	25 211	28 622	31 982	34 735
Deposits	129 575	150 551	17 1737	181 840	228 478	268 650	308 066
Securities	15 190	14 399	23 945	58 311	25 139	49 997	60 041
Bonds	6 293	6 534	6 944	6 707	4 981	2 623	2 847
Equities	8 897	7 865	17 001	51 604	20 157	47 374	57 194
Shares in Securities Investment Funds	1 905	2 449	5 618	29 716	17 011	8 383	7 638
Customer Margins	1 339	1 566	3 128	9 904	4 760	5 695	4 197
Insurance reserves	14 113	18 315	22 680	27 097	37 831	46 226	54 540
Wealth management products of financial institutions	—	—	—	—	—	—	12 776
Settlement funds	-77	23	17	0	0	0	0
Others (net)	504	1 835	2 005	3 415	1 030	-64	-267
Financial liabilities	29 431	32 972	39 636	50 652	57 892	82 744	108 572
Loans	29 431	32 972	39 636	50 652	57 892	82 744	108 572
Net financial assets	150 938	176 111	211 964	284 843	284 978	328 125	373 156

Source: PBC.

The structure of financial assets remained stable. Financial assets of China's household sector were mainly composed of deposits with commercial banks, securities-related assets and insurance reserves. Due to increased fluctuations in the capital market in 2010, the share of securities-related assets declined somewhat, while the share of deposits witnessed an increase and that of insurance reserves remained basically stable. At end-September 2010, the share of deposits with commercial banks in total financial assets was 64 percent, down 1.4 percentage points from end-2009. The share of securities-related assets, including treasury bonds, equities and shares in securities investment funds, was 14.1

① Among which, data for financial assets of Germany was for end-April 2010, while the data for US, UK and Japan was for end-September 2010. The financial assets and liabilities of US, UK, Germany and Japan derived from stock data of their respective "Flow of Funds Accounts", if not indicated otherwise. The household sector included the household sector and non-profit organizations that provided services to the household sector.

percent, at par with end-2009. The share of insurance reserves in total financial assets of the household sector was still relatively low (Table 6.2).From 2004 throughout Q3 2010, the share of insurance reserves rose from 7.8 percent to 11.3 percent, but still lower than the average level of 20 percent in developed countries.

Table 6.2 Structure of Financial Assets of the Household Sector

(percent)

	2004	2005	2006	2007	2008	2009	Q3 2010
Domestic currencies	9.9	9.5	8.9	7.5	8.3	7.8	7.2
Deposits	71.8	72.0	68.3	54.2	66.6	65.4	64.0
Securities	8.4	6.9	9.5	17.4	7.3	12.2	12.5
Treasury bonds	3.5	3.1	2.8	2.0	1.5	0.6	0.6
Equities	4.9	3.8	6.8	15.4	5.9	11.5	11.9
Shares in Securities investment funds	1.1	1.2	2.2	8.9	5.0	2.0	1.6
Settlement funds of customers	0.7	0.7	1.2	3.0	1.4	1.4	0.9
Insurance reserves	7.8	8.8	9.0	8.1	11.0	11.3	11.3
Wealth management products of financial Institutions	—	—	—	—	—	—	2.7

Source: PBC.

Liabilities of the Household Sector Increased Rapidly, and the Overall Credit Quality was Good

Liabilities of the household sector increased rapidly. At end-September 2010, financial liabilities of the household sector posted RMB 10.9 trillion yuan, representing an increase of 31.2 percent from the end of the previous year, and accounting for 27.4 percent of the GDP. The main component of financial liabilities was bank loans. In terms of maturity, short-term loans accounted for 31.3 percent, and medium- and long-term loans accounted for 68.6 percent. In terms of financial liabilities/assets ratio①, from 2004 throughout Q3 2010, this ratio for China's household sector showed a slow increase (Table 6.3), but still lower than the 30-percent level in developed countries during the same period. In terms of the ratio of financial liabilities to disposable income, compared with the over 100 percent in developed countries, this ratio for China's household sector was relatively low and ranged from 30 percent to 33 percent from 2004 throughout 2008②, indicating that the financial sustainability of the household sector was robust as a whole (Figure 6.4).

① The ratio of total financial liabilities/total financial assets.

② Data on China's personal disposable income comes from the *Flow of Funds Accounts* (*Real Transactions*).

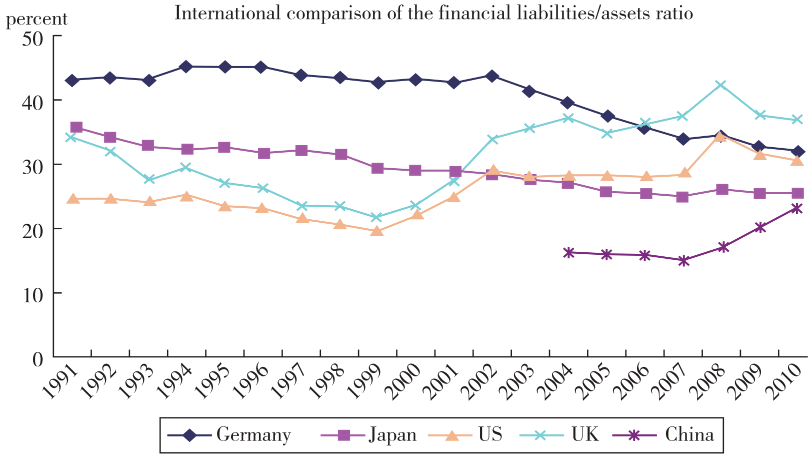
Table 6.3 The Structure and Level of Financial Liabilities of China's Household Sector from 2004 Throughout Q3 2010

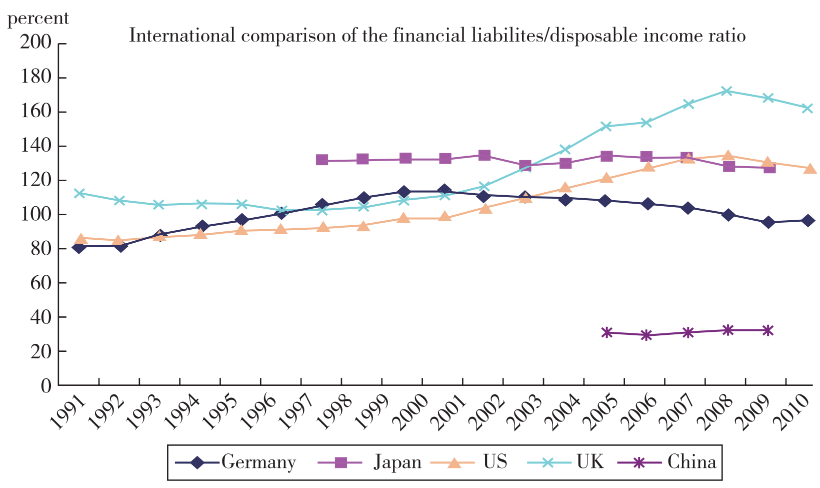
(percent)

	2004	2005	2006	2007	2008	2009	Q3 2010
Short-term loans/bank loans	34.1	33.6	33.9	31.4	33.6	32.5	31.3
Medium and Long-term Loans/bank loans	65.9	66.4	66.1	68.6	66.4	67.5	68.6
Financial liabilities/financial assets	16.3	15.8	15.8	15.1	16.9	20.1	22.5
Liabilities/disposable income	30.5	29.6	30.7	32.4	31.7	—	—

Source: PBC.

Figure 6.4 Liabilities of the Household Sector

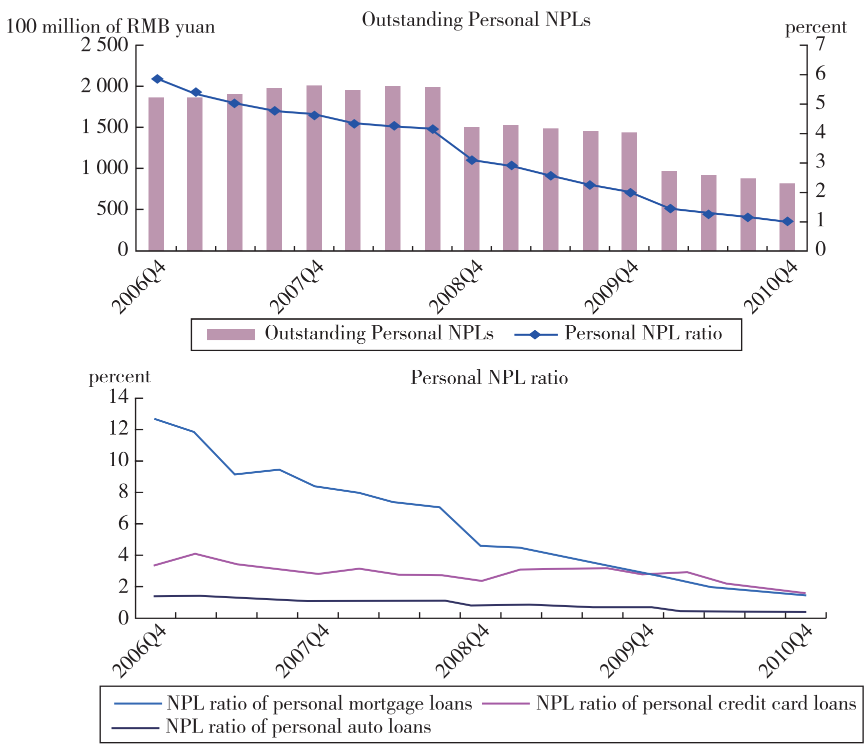




Source：Statistics from Flow of Funds Accounts of reporting countries, among which statistics for Germany was data at end-April 2010, statistics for US, Japan and UK were data at end-September 2010, and statistics for China was data at end-June 2010.

The quality of household sector loans was generally good. Over the recent years, both outstanding NPLs and NPL ratio[①] for domestic personal loans (excluding personal business loans) continued to fall (Figure 6.5). Outstanding personal NPLs at end-2010 posted RMB 82.2 billion yuan, RMB 61.6 billion yuan less than that at the beginning of the year; the NPL ratio was 1 percent, 1 percentage point lower than that at the beginning of the year, and 1.4 percentage points lower than the average NPL ratio for all loans in the same period. In particular, outstanding NPLs for personal mortgage loans posted RMB 21 billion yuan, RMB 6.1 billion yuan less than that at the beginning of the year, and the NPL ratio was 0.4 percent, down 0.2 percentage points. The NPL ratio for auto loans was 1.4 percent, down 1.4 percentage points. Outstanding non-performing credit card loans posted RMB 7.4 billion yuan, RMB 400 million yuan less than that at the beginning of the year, and the NPL ratio was 1.5 percent, down 1.3 percentage points. The quality of household loans was generally good, but attentions should be paid to the impact on mortgage loan quality of possible changes in real estate prices.

Figure 6.5 Quality of China's Household Sector Loans in 2007–2010



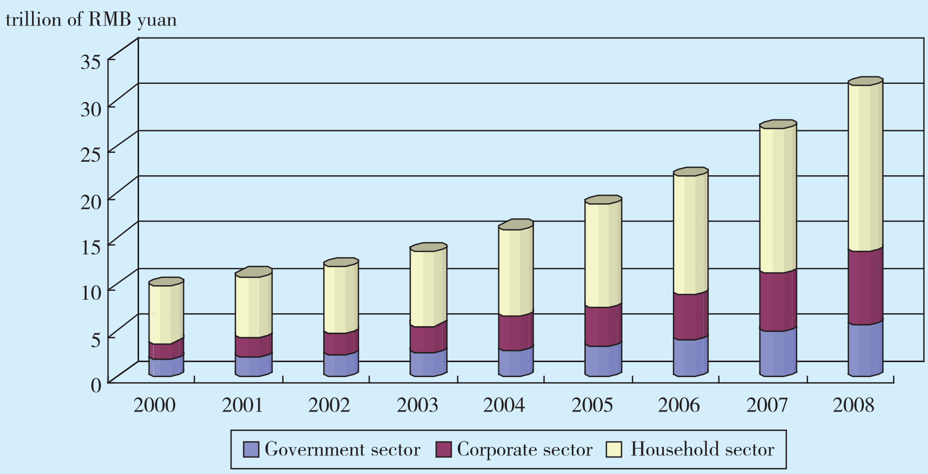
Source: CBRC.

① The NPL data came from CBRC, and the institutional coverage in 2007-2008 included state policy banks, state-owned commercial banks, JSCBs, city commercial banks, rural commercial banks, rural cooperative banks, foreign-funded financial institutions with legal person status and their branches, branches of foreign banks, UCCs (including single legal person UCCs and retained UCCs), RCCs, financial companies of enterprise groups, trust investment companies, financial leasing companies and auto financing companies. The institutional coverage expanded from 2009 onwards to include PSBC.

Box 14 Analysis on the Distributional Structure of National Income①

Over the recent years, income of government sector, corporate sector and household sector increased rapidly. In particular, in primary distribution, income of the corporate sector witnessed the most rapid growth, followed by the government sector, and then the household sector (Figure 6.6). However, the redistribution of national income did not change this pattern.

Figure 6.6 Primary Income Distribution to the Government, Corporate and Household Sectors



Source: NBS.

Income of the government and corporate sectors increased relatively faster. From 2000 throughout 2008, so far as the primary distribution is concerned, the average annual growth of income of government and corporate sectors was 15.8 percent and 20.2 percent respectively (Table 6.4). In 2008, income of the government and corporate sectors in primary distribution were RMB 5.5 trillion yuan and RMB

① This section was based on data from *Flow of Funds Accounts* (*Real Transactions*) of *NBS*. *Since* the statistics are released by two-year time lag, we do not have flow of funds accounts data for 2009-2010 for the time being.

8 trillion yuan respectively, accounting for 17.5 percent and 25.3 percent of the national income, down 0.2 percentage points and up 6.3 percentage points respectively from those in 2000 (Table 6.5).

The share of the household income in the national income continued to shrink. From 2000 throughout 2008, the annual growth rate of the household income in primary distribution was 14.4 percent (Table 6.4). In 2008, income of the household sector in primary distribution were RMB 18.1 trillion yuan, accounting for 57.2 percent of the national income, down 6.2 percentage points from that in 2000 (Table 6.5).

Table 6.4 Primary Distribution and Redistribution and the Average Growth fpr Government, Corporate and Household Sectors

(trillion of RMB yuan)

	Government Sector		Corporate Sector		Household Sector	
	Primary Distribution	Redistribution	Primary Distribution	Redistribution	Primary Distribution	Redistribution
2000	1.729760	1.891640	1.857630	1.635480	6.212650	6.325170
2001	1.999350	2.229770	2.182160	1.903520	6.625210	6.743750
2002	2.279820	2.523560	2.419700	2.163140	7.210160	7.330490
2003	2.618340	3.005990	2.829150	2.486710	8.069960	8.170700
2004	2.700748	3.121643	3.747085	3.375470	9.510871	9.651369
2005	3.240481	3.763686	4.309768	3.901592	11.030607	11.123527
2006	3.892423	4.713973	5.036012	4.366328	12.823835	12.904749
2007	4.900746	5.938949	6.310202	5.338550	15.565414	15.657596
2008	5.538799	6.797415	7.987065	6.900591	18.097019	18.242955
Average growth	15.8%	17.5%	20.2%	20.0%	14.4%	14.3%

Source：NBS.

Income redistribution does not improve the unbalanced cross-sector distribution of the national income. From 2000 throughout 2008, the average annual growth of income (disposable income) derived from redistribution for the government, corporate and household sectors was 17.5 percent, 20.0 percent and 14.3 percent respectively (Table 6.4). Among which, the annual growth of disposable income of the government sector was higher than that of income from primary distribution by 1.7 percentage points, whereas the annual growth rates of disposable income of the corporate and household sectors were lower than that of income from primary distribution by 0.2 percentage points and 0.1 percentage point respectively. The average shares of income of government and household sectors after redistribution were higher than those in primary distribution by 2.7 and 0.2 percentage points respectively, with the incremental part coming from the corporate sector (Table 6.5). The share of government income after redistribution increased rapidly, whereas the share of household sector remained basically unchanged, indicating income was mainly transferred from the corporate sector to the government sector after redistribution and the income transfer mechanism has not significantly increased the incomes of the household sector.

Table 6.5 Share of Income for the Government, Corporate and Household Sectors After Primary Distribution and Redistribution

(percent)

	Government Sector			Corporate Sector			Household Sector		
	Primary Distribution	Redistribution	Growth	Primary Distribution	Redistribution	Growth	Primary Distribution	Redistribution	Growth
2000	17.7	19.2	1.5	19.0	16.6	-2.4	63.4	64.2	0.8
2001	18.5	20.5	2.0	20.2	17.5	-2.7	61.3	62.0	0.7
2002	19.1	21.0	1.9	20.3	18.0	-2.3	60.5	61.0	0.5
2003	19.4	22.0	2.6	20.9	18.2	-2.7	59.7	59.8	0.1
2004	16.9	19.3	2.4	23.5	20.9	-2.6	59.6	59.8	0.2
2005	17.4	20.0	2.6	23.2	20.8	-2.4	59.4	59.2	-0.2
2006	17.9	21.4	3.5	23.2	19.9	-3.3	59.0	58.7	-0.3
2007	18.3	22.0	3.7	23.6	19.8	-3.8	58.1	58.1	0.0
2008	17.5	21.3	3.8	25.3	21.6	-3.7	57.2	57.1	-0.1
Average	18.1	20.8	2.7	22.1	19.2	-2.9	59.8	60.0	0.2

Source: NBS.

In the future, efforts should be made to improve the cross-sector distribution of the national income and gradually increase the share of the household sector. This is critical in expanding domestic demand and optimizing national economic structure, and will lay a solid foundation for the healthy development of the financial system in the long run.

Chapter Ⅶ

Financial Infrastructure

China made steady progress in building financial infrastructure in 2010. Successful efforts were made to strengthen the payment system, enhance the financial legal system, advance the accounting reform and convergence with international standards, improve the credit environment, and boost the effectiveness of anti-money laundering (AML) programs, which underpinned the sound performance of the financial sector.

Payment System

Significant Progress in Strengthening the Payment System

The payment system was constantly improved and operated safely and smoothly. First, the inter-bank market clearing house was integrated into the payment system, enabling the Large Value Payment System (LVPS) to play a stronger role in supporting financial market development. Meanwhile, clearing banks in Hong Kong and Macao were allowed to remit and transfer RMB funds to each other, which boosted the use of RMB for cross-border and overseas settlement. Second, the Bulk Electronic Payment System (BEPS) was extended to cover the Centralized Collections and Payments Center and China Union Pay, which improved settlement service for the retail payment market. Third, emergency exercises were conducted to improve the capacity to deal with possible failures of the Centralized Accounting Booking System (ABS), and efforts were made to promote remote data backup. Fourth, the inter-bank settlement system for online payments was successfully launched. Fifth, supervision and management of the payment system was strengthened to ensure its sound operation, including efforts to step up daily supervision on system participants, and to assess and improve contingent plans. In 2010, various payment systems processed 12 004 million RMB payment transactions, or RMB 1 663.86 trillion yuan, representing a y-o-y rise of 36.1 percent and 37.8 percent respectively.

New non-cash payment instruments were developed, and risk management was enhanced. The electronic commercial draft system was extended to have a nationwide coverage, and the circulating environment of checks was improved by promoting check financing. The use of bank cards was facilitated, as bank cards designed to assist vocational school students were widely adopted and bank cards for government employees were launched on a pilot basis. In the meantime, collaborating with other government agencies, PBC strengthened management of bank cards security, including actions to promote better risk management practices, encourage commercial banks to eliminate unqualified card holders and promissory shops, and carry out a special campaign against bank card-related crimes.

Management of non-financial institution payment services was enhanced, representing a major breakthrough in supervision over payment institutions. Based on a registration of designated non-financial institutions, which presented a clear picture of payment services provided by non-financial institutions, PBC issued the *Administrative Measures on Payment Services of Non-financial Institutions* and relevant detailed implementation rules, specifying the procedural requirements for such institutions to open payment services. This marked a significant progress in supervision of the payment services market.

Box 15 Oversight of Payment Services of Non-financial Institutions

Payment services offered by non-financial institutions emerge as a result of the rapid development of online information and communication technology and the payment market segmentation. In China, such payment services focus on online payment, mobile payment, telephone payment and issuance of pre-paid cards. Adding to the diversification of payment services, these payment activities bring the payment services to a higher degree of width and depth. They promote diversity of payment market players, satisfy the need of electronic commerce companies and individuals, and contribute to higher efficiency of payment services.

As these payment businesses grow in scope and volume, irregularities and risks gradually emerge. Key problems lie in the protection of rights and interests concerning the money deposited by customers, issuing and accepting of pre-paid cards, compliance of AML regulations, and disorderly competition. In response, and in order to better meet the need of social and economic activities for payment services, avoid unfair competition, protect the legitimate rights and interests of customers, and promote stable operation of the payment market, PBC, which is the legal supervisor of the payment system, enhances supervision and risk prevention by advancing institutional building in the market. Tailored to China's circumstances, market-oriented measures are designed to encourage innovation and market development.

In April 2009, PBC issued a notice that requires the registration of all non-financial institutions engaged in payment services in the Mainland. In June 2010, PBC released the *Administrative Measures on Payment Services of Non-financial Institutions* (referred to as the *Measures* hereinafter), which details the approval procedures, enhances PBC's supervisory responsibilities, specifies qualifications for market entry, and underscores that a Payment Services License is required for non-financial institutions to provide payment services. The PBC also issued a number of supplementary rules and regulations.

The *Measures* includes provisions on the management of customers' money. It provides that money deposited by customers does not constitute the proprietary assets of payment institutions, must not be embezzled in any forms, and should be deposited in a special account opened at one commercial bank. The paid-in currency capital of payment institutions must not be less than 10 percent of customers' money. The *Measures* also sets out requirements for sound business operation, including strictly following the approved business scope, reporting and disclosing of fee charges, developing and disclosing service agreement, checking customer identity, adopting the real-name policy, keeping customers' commercial secrets, maintaining business and accounting records, providing legal invoices, and performing AML obligations.

The *Measures* applies even-handedly to all non-financial institutions engaged in payment services in the Mainland, including those already in the business without approval prior to the issuance of the *Measures*, and those that plan to apply for approval. To ensure a stable transition, a license should be acquired by the former within one year after the release of the *Measures*, or their payment services will be suspended.

As of November 2010, when the registration closed, over 370 non-financial institutions submitted applications to PBC. The approval process is now underway.

Rural payment environment was improved, with markedly better payment services. PBC chose Shouguang, Shandong province and other 9 areas as the liaison counties to pilot a program in effort to explore the right approach to build rural payment environment in different regions with varying economic development levels. As of the end of 2010, in the 145 model counties covered by the program of building rural payment environment, collective settlement accounts exceeded 1 million, and individual settlement accounts totaled 160 million. Bank cards per capita exceeded one, a y-o-y rise of 30 percent, and bank card-based transactions reached up to RMB 200 billion yuan, up 50 percent y-o-y.

Account management was improved as the real-name policy was implemented. PBC issued the *Administrative Measures on RMB Settlement Accounts of Overseas Institutions*, which helps to regulate the opening and use of RMB settlement accounts by overseas institutions. PBC launched the pilot program of verifying existing individual accounts to ensure accounts opened before 2000, when the regulation that required real-name registration of individual accounts was put in place, are now registered under real names. PBC also took actions against fictitious accounts, false accounts and anonymous accounts that were opened with false and tampered identification documents, which marks a significant breakthrough in implementing the real-name policy. Moreover, PBC launched a program on local accounts comparison, which enhances PBC's off-site supervision on bank accounts.

Outlook for Payment System Development in 2011

In 2011, China should continue to develop and improve the legal system for payment and settlement to address vulnerabilities in the payment system, including amending the *Bill Law*, *Regulations on Payment and Settlement, Regulations on Letter of Credit Settlement*, and *Administrative Measures on RMB Bank Settlement Accounts*, releasing the *Regulations on Bank Cards*, and drafting the *Administrative Measures on Payment and Settlement System* to regulate online payment services provided by commercial banks. Infrastructure for payment services needs to be enhanced. In this regard, efforts will need to be made to launch the second generation of payment system and the centralized central banking accounting data system, achieve wider coverage of the clearing system for online payment across banks, support the development of electronic commerce, and improve system maintenance and emergency management capability. Market regulation and surveillance will be strengthened. A special on-site supervision on payment and settlement of banking institutions will be started nationwide, and management of payment services by non-financial institutions will be enhanced, including granting licenses in accordance with the law. Moreover, actions will be taken to build a more favorable payment environment in rural areas, taking advantage of the role of liaison counties and exploring new payment services in different regions at different economic development levels.

Legal Environment

Progress Was Made in the Legal Infrastructure in the Financial Sector

New laws were passed, enhancing the legal foundation to support performance of the financial sector. In October 2010, China passed a new law on the application of law in civil legal relations with foreigners, which addresses the application of law regarding financial business with foreign companies and provides legal support for the Going Global initiative in the financial sector. Another law that was passed at the same time, the *Social Security Law*, regulates the investment and operation of social security funds. The *Law on Guarding State Secrets* (*Amendment*), which was adopted in April 2010, ensures secrecies in financial decision-making are properly protected. In addition, a range of rules and regulations issued by the State Council are effective in helping maintain market order, regulate investment and financing, step up financial support for economic development, and prevent systemic financial risks.

Judicial interpretations were improved, supporting sound development of the financial sector. The Supreme People's Court released a series of judicial interpretations, including the *Second Interpretation on Laws Applicable to Counterfeit Currency Cases*, *Regulations on Limiting Excessive Consumption by Person Subject to Enforcement*, and *Notice on Trail about Validity* of *Guarantee Contracts arising from the Use of Foreign Funds by Financial Asset Management Companies in Resolving Non-performing Claims*. These judicial interpretations play a strong role in combating counterfeit currencies, facilitating enforcement of court judgments and resolving non-performing claims.

Ministerial regulations were issued to encourage sound operation of market players. The PBC *Regulations on Procedures of Inspection of Law Enforcement* provides guidance for supervision missions, and the PBC *Administrative Measures on Payment Services by Non-financial Institutions* helps promote healthy development of third-party payment and clearing. As efforts were made to encourage newly established financial institutions to focus on services and management, business management, which is centered on reporting of material events, was enhanced in these institutions. The comprehensive inspection of law enforcement and assessment program on banking financial institutions was also improved. In the meantime, supervisors issued a number of regulatory documents to improve supervision in relevant sectors, including the *Interim Administrative Measures on Working Capital Loans*, *Interim Administrative Measures on Individual Loans, Administrative Measures on Net Capital of Trust Companies*, Interim *Administrative Measures on Financing Guarantee Companies*, *Implementation Measures on Anti-money Laundering in the Securities and Futures Sector*, *Administrative Measures on Insurance Clauses and Premium Rates of Property Insurance Companies*, *and Interim Administrative Measures on the Use of Insurance Funds*.

Outlook for Legislation in 2011

In 2011, efforts will be made to further improve the *Law on Securities Investment Funds* (*Amendment*) and, in line with the notice on legislative plan for 2011 issued by the General Office of the State Council, to promote the issuance of the *Administrative Measures on Supervision of Listed Companies* to regulate the practices of listed companies. At the same time, work will be done to push for the release of a number of regulations at due time, including the *Administrative Measures on Borrowing International Commercial Loans*, *Regulations on Gold Market Management*, *Regulations on Credit Information Management*, *Regulations on Futures Trading* (*Amendment*) *and Regulations on Agricultural Insurance*. The development of other regulations will also be explored, including *Regulations on Securities Investor Protection Funds*, *Regulations on Bankruptcy of Banking*

Financial Institutions, *Regulations on Bank Cards*, *Regulations on Financial Statistics*, *and Regulations on Foreign Exchange Purchase*, *Sale and Payment* (*Amendment*).

Accounting Standards

Significant Progress has been Made in Accounting Reform and Converging with International Standards.

The new enterprise accounting standards were applied in a full scope. By the end of 2010, the rural cooperative financial institutions' financial reports basically complied with the new enterprise accounting standards; all the other financial institutions had adopted the new enterprise accounting standards, and the comparability of financial institutions' accounting information was improved. In order to eliminate the difference of A+H listed companies' annual reports, in addition to the *Enterprise Accounting Standards Interpretation No.2* issued in August 2008, MOF issued the *Provisions on the Accounting Treatment on Insurance Contracts* in December 2009, removing the accounting difference of A+H listed insurance companies in different capital markets.

Several reforms in accounting areas have made breakthrough. In April 2010, MOF and the other 4 authorities jointly released the *Implementation Guidelines for Enterprise Internal* Control, representing the standard enterprise internal control system in China had been founded. In October 2010, the Standardization Administration of China released *the Chinese National Standards on XBRL Specifications*, *and MOF issued the General Purpose Taxonomy of XBRL* based on China's enterprise accounting standards, laying foundation for the scientific, sound and internationally universal accounting information standardization system. In November 2010, MOF issued the *Accounting System of Small-sized Enterprises*, to meet the small-sized enterprises' needs in accounting confirmation, measuring and reporting.

Box 16 Development and Application of XBRL

XBRL is a computer markup language to deal with non-structural information. Through providing a standardized identifying tag or mark for each individual item of data, XBRL could facilitate the definition and communication of accounting information and other business report information.

XBRL changes the traditional mode of accounting information transmission, processing and disclosure, and therefore has important applicable value. XBRL enables data to be exchanged between different platforms in low cost, increasing the efficiency of reporting and using of financial reports; it enables automated processing and verification of business information, improving the accounting information management; and it improves transparency and comparability of accounting information, enhancing the working efficiency and quality of analyzing and comparing different business information by information users, especially supervisors. After the international financial crisis, risk management of financial institutions has got more and more concerns. In this regard, XBRL could collect financial institutions' data in a standardized manner, and fully analyze the operating conditions of financial institutions, so as to identify, resolve and mitigate risks in a timely manner and lay the data foundation for enhancing macro-prudential management. Upon its introduction, XBRL was rapidly applied in the areas of global financial reporting system and accounting information disclosure.

Application of XBRL in Chinese accounting system has made substantial progress. The relevant authorities took a series of measures to promote the application of XBRL. The stock exchange houses had completed XBRL taxonomy for listed companies' information disclosure, and CSRC stipulated XBRL taxonomy for securities investment funds information disclosure, and all regular reports have been covered by XBRL. In November 2008, China Accounting Informatization Committee and XBRL China Jurisdiction led by MOF was established, and the main members included PBC, CBRC,CSRC and CIRC, which laid foundation for the harmonized, standardized and orderly extension of XBRL in the area of accounting informatization. MOF released the *Guiding Opinions on Accelerating the Accounting Informatization in China* in April 2009, specifying the objective and main task of accounting informatization. It also released (the XBRL Taxonomy Architecture of China) in November 2009, and the *Chinese National Standards on XBRL Specifications* and the *General Purpose Taxonomy of XBRL* based on China's enterprise accounting standards in October 2010, which indicated that the application of XBRL in China's accounting area had moved into a new phase. 13 enterprises, including CDB and China Life, etc., will implement the General Purpose Taxonomy of enterprises' accounting standards from 2011.

The extension of XBRL has a good start in China, but the future development still faces challenges. Firstly, *the General Purpose Taxonomy* of enterprises' accounting standards to be implemented from 2011 involves many aspects and techniques, calling for close cooperation among relevant authorities. Secondly, relevant supervisors should conduct researches on the comprehensive application of XBRL in different supervisory areas taking into account supervisory requirements on the basis of the *General Purpose Taxonomy of enterprises' accounting standards*.

Active efforts were made to participate in international accounting standards setting. China took an active part in post-crisis reform of international accounting standards and convergence to international standards. Firstly, continued convergence mechanism of China's enterprise accounting standards with international standards has been established. In April 2010, MOF released the *Roadmap for Continued Convergence of China's Enterprise Accounting Standards with International Financial Reporting Standards*. It specified participation in international accounting reform as the major task of accounting standards work in 2010. In May 2010, IASB accepted China's suggestions, and made substantial modifications to IFRS1, acknowledging the accounting treatments for asset revaluation in the process of enterprises' restructuring and going public in China, which was an important breakthrough of two-way interaction in the process of China's convergence to international accounting standards. Secondly, China took an active part in international accounting reform. China suggested simplifying a few of accounting standards, improving the expected loss model of financial instruments impairment, and prudentially adopting the fair value measurement of financial instruments, insurance contracts, income confirmation, leasing and financial statement presentation, which received active responses from IASB. Besides, China actively participated in the related work undertaken by Asian-Oceanian Standards Setters Group (AOSSG).

Outlook for Financial Accounting Standards in 2011

In 2011, China will make great efforts to complete the amendments and improvements of enterprises' accounting standards in accordance with the development of international accounting standards reform, the domestic circumstances as well as the experience from the financial crisis, so as to provide high-quality information support for counter-cyclical macro-prudential management. China will continuously promote the convergence to accounting standards of major international capital markets, effectively reducing funding cost of enterprises and supporting China's enterprises going abroad to international capital markets. Measures should also be taken to press ahead with the implementation of financial institutions' internal control system, and steadily promote the extension and application of XBRL in banking, securities and insurance sectors.

Credit Environment

New Progress has been Made in Building the Social Credit System.

The role of credit information system in building the social credit system has become more and more significant. The nationwide central enterprise and individual credit information system has become the important infrastructure for the social credit system, and an indispensable step for commercial banks' examination of borrowers before loan extension. It also plays an important role in commercial banks' loan management. By the end of 2010, the enterprise and individual credit information system had established credit records for 17 million enterprises and 777 million individuals, and the accumulative number of enquiry reached 152 million and 812 million respectively. In 2010, a total of 1.275 million enquiries were made by individuals. Meanwhile, PBC, in collaboration with related agencies, incorporated gradually the administrative punishment information in the areas of product quality, environment protection, social security and foreign currency into the credit information system. The credit reports generated by the enterprise and individual credit information system have become the core credit information, and the economic identification which could fully reflect the creditworthiness of enterprises and individuals.

The establishment of credit information systems for SMEs and in rural areas made active progress. The credit records for SMEs and rural households were increasing and getting improved, which play an active role in addressing the issues of SMEs and rural households financing. By the end of 2010, credit information of 2.15 million SMEs having no borrowing from banks were added in the system, and 264 thousand SMEs have gained banks' credit lines, among which 156 thousand SMEs got loans from banks, with total outstanding loans reaching RMB 5.4731 trillion yuan. 2 484 counties had started building credit records for 134 million rural households, and 74.29 million rural households got loans.

Outlook for Social Credit Environment in 2011

The improvement and optimization of social credit environment is a long-term process and a systemwide project, which needs to be promoted in the areas of legal environment, institutional arrangements and financial literacy and with the involvement of different regions, public agencies and all sectors. In 2011, efforts will be made to step up the issuance of the *Regulation on Credit Information Management,* and to enact the *Measures on the Management of Credit Business of Commercial* Banks (*draft*). The role of the inter-ministerial joint conference of social credit system should be brought into full play, to conduct researches on establishment of the credit information sharing mechanism. The credit information system for SMEs and in rural areas should be continuously promoted, taking into account regional characteristics and conditions. Public education programs on credit information should be organized to cultivate favorable social environment for credit culture.

Anti-money Laundering

The Effectiveness of AML Work Were Enhanced Continuously.

The first nationwide assessment for money laundering risk was conducted. In 2010, PBC collected 409 money laundering cases which occured in recent years, made the first statistical analysis on the criminal proceeds and money laundering types, and assessed relevant risks with different industries, products, channels and regions at the state level, which laid the foundation for the nationwide assessment of money laundering risks. The analysis showed that, money laundering risks in financial sector were obviously higher than those in other sectors. In particular, the money laundering risks in banking and securities sectors were higher than those in insurance, futures and other sectors. In terms of financial business (products), the money laundering risks in cash related business, cross-border business, electronic business, foreign exchange business as well as investment and wealth management products were rather high, especially the risks in cash related business and electronic business. The money laundering risks centralized in the coastal advanced regions, and some coastal and border regions faced higher risks.

Freezing mechanism on financial institutions' terrorism assets has been set up. In May 2010, PBC continuously improved the legal system on CTF by issuing *the Notice of the People's* Bank *of China on Implementing the Notice of the Ministry of Foreign Affairs on Executing the Relevant Resolutions of the Security Council of the United Nations*, which specified the CTF list that financial institutions should pay attention to, and the responsibilities of imposing restrictions on transactions and reporting cases, etc.. This was the first specific regulation on terrorism asset freezing in China, indicating an important step forward in promoting legal system on CTF as well as improving the freezing mechanism on terrorism assets.

AML supervision was further enhanced. First, on-site examinations on some financial institutions were conducted. By the end of 2010, PBC had conducted AML on-site examinations on 2 426 banks, securities and insurance institutions, and administrative penalties were imposed. Second, the off-site supervision and analysis indicator system was modified, off-site supervisory assessment was conducted, and access to AML supervisory interaction platform extended to enhance efficiently supervisory techniques. Third, researches were undertaken to refine the large-value cash management system and guidance was directed to financial institutions to take more pertinent AML measures on large-value cash business.

Heightened efforts were made on AML investigations and assisted investigations on money laundering cases. PBC specified the requirements on the abnormal transaction reports which should be incorporated into the suspicious transaction reporting system, and guided directed financial institutions to reduce the number of suspicious transaction reports and improve the quality of reports. The number of suspicious transactions reported by financial institutions declined by 18.7 percent over the previous year, and the proportion of those developing into PBC investigation clues increased to 12.3 percent from the 10.5 percent in the previous year. The quality of AML investigation clues improved substantially, and AML investigations had become the important clue resources for local detecting agencies. In 2010, PBC discovered and received 8 240 suspicious transactions, and reported 911 cases to investigation agencies. The proportion of reported clues developing into case filing increased nearly 1 time over the previous year, and the effect of AML on combating crime is obvious.

International cooperation on AML went deeper. In 2010, the focus of international cooperation turned to active participation in the discussion of AML international standards and other activities. The assessment report of follow-up developments in recent three years was completed according to the timetable set by FATF, and the preparations for the fourth round of FATF assessment were made. PBC took an active part in the activities of Eurasian Group on Combating Money Laundering and Financing of Terrorism (EAG) and other relevant international organizations, playing an important role in regional AML organizations.

Outlook for Anti-money Laundering in 2011

In 2011, China will continue to promote the implementation of *Anti-money Laundering Strategy for China from 2008 to 2012*, explore the national and regional money laundering assessment methodology, and try to assess money laundering risks in different industries, products, channels and regions in a full scale. The off-site supervisory indicator system should be improved and on-site examinations reinforced with proper plans and emphases. Further efforts should be made to conduct large-value cash monitoring pilot program, explore to build up AML supervisory mechanism for the non-financial payment industries, and continue to study the AML supervisory system for the real estate sector. The efficiency of AML investigations should be enhanced. Great efforts should also be made on the follow-up of FATF assessment, trying to complete the follow-up procedures in June 2011. China will take active part in the amendments of FATF standards to ensure that domestic policies are consistent with FATF standards, and to play its role in regional AML cooperation.

Chapter VIII

Setting up the Macro-prudential Framework

With the deepening of post-crisis financial regulatory reform, the international community and major jurisdictions have increasingly recognized that it is not enough to just focus on the soundness and compliance of an individual institution or a single sector and that financial risk prevention must be strengthened also from a holistic perspective. Currently, the core of the financial regulatory reforms both at national and global level is embodied in further improving systemic risk prevention regime and putting in place the macro-prudential framework. Although the financial system in China was slightly affected in the global financial crisis, the potential systemic risk in the domestic economic and financial system could not be overlooked. Therefore, the 12th Five-Year Plan clearly puts forward to set up a countercyclical financial macro-prudential framework, which has a practical implication for further strengthening and improving macro financial adjustment, enhancing systemic risk prevention capacity, smoothing economic cyclical fluctuations and maintaining sound and relatively rapid economic and financial development.

The Background and Content of Macro-prudential Framework

The concept of macro-prudential framework has taken shape since the worsening of the global financial crisis in 2008. An international consensus has now been achieved on the causes of the crisis. First is the cyclicality within the financial system. Before the crisis, the high market price and over-optimism intertwined with rapid credit growth generated asset bubble. After the outbreak of the crisis, the interaction of falling asset prices, panic and credit crunch caused further drop of asset prices and exacerbated the crisis, reflecting the typical features of cyclicality. In addition, the cyclicality is also embedded in supervisory standards and practices, accounting standards and credit rating sector etc.. Second is the risk posed by SIFIs. Because SIFIs have large size, complex organizational structures and clusters of counterparties, they are highly interconnected with other institutions and investors and lack substitutability. Once in distress, not only does a SIFI per se face enormous rescue cost but it could also affect its counterparties and market confidence, exacerbate market panic and lead to the instability of the financial system. Meanwhile, SIFIs could cause moral hazard issue due to the "Too Big to Fail" problem. The failure of a SIFI could be very costly, which involves consideration of risk transmission and burden sharing as well as issues of equal treatment of cross-border shareholders and creditors. Therefore, the international community widely agreed that higher prudential standards should be adopted for SIFIs supervision and effectiveness and efficiency should be ensured for SIFIs resolution.

Taking into account the above-mentioned factors, in the beginning of 2009, BIS began to use the term "macro-prudential" to summarize the issues of cyclicality, "Too Big to Fail", weak supervision and low standards that have caused the crisis. The concept was gradually adopted by G20 and other international institutions. The terminologies of "macro-prudential management" and "macro-prudential policy" emerged in the final documents of G20 Pittsburgh Summit. The fundamental framework of macro-prudential management further evolved at G20 Seoul Summit which mainly included supervision and policies at macro level and was required to be implemented by G20 members. Since then, FSB and BCBS, together with CGFS and G30 have proposed various detailed policy measures to strengthen macro-prudential management.

Macro-prudential framework is evolving with an objective to prevent systemic financial risk and maintain financial stability, featured by building a more robust and countercyclical policy regime. Macro-prudential framework mainly involves prudential requirements for banks on capital, liquidity, leverage and provisioning, surcharges for SIFIs, accounting standards, credit rating, centralized clearing of derivatives trading and shadow banking supervision, etc. A number of macro-prudential policies have been applied by some jurisdictions in practice. In the aftermath of the global crisis, the international institutions and relevant jurisdictions have summarized and improved some internationally accepted policy measures and formed a fundamental macro-prudential framework, which has been applied more widely. It needs to point out that in the framework, setting up countercyclical adjustment mechanism and strengthening supervision on SIFIs are the new content in the aftermath of the crisis and related work has made substantial progress. A profound understanding of the policy mechanism and implementation standards could have a practical implication for accelerating establishment of the macro-prudential framework in China.

International Progress of Strengthening Macro-prudential Management

Setting up the Countercyclical Capital Buffer Regime

BCBS published the *Guidance for National Authorities Operating the Countercyclical Capital Buffer* in December 2010. The document sets out procedures and guidance for the countercyclical capital buffer regime and regards it as an essential part of banking supervisory reform in order to reduce the procyclicality in the banking system.

The constraining effect of capital on credit growth is highlighted. When there is an excessive credit growth and buildup of systemic risk, the countercyclical capital buffer regime could require banks to conserve more capital, i.e. to build up a more forward-looking countercyclical capital buffer to constrain excessive credit expansion. While there is an economic downturn and a reversed credit cycle, the countercyclical capital buffer of banks could be released to absorb losses and protect the banking system from severe shocks. Therefore, the countercyclical capital buffer does not simply ensure that individual banks remain solvent through a period of stress, but ensures that the banking sector as a whole has the capital on hand to help maintain credit growth when the broader financial system experiences stress after a period of excess credit growth. To this extent, it could serve as a stabilizer in the phases of expansion and contraction throughout the financial cycle.

The deviation of credit/GDP ratio from its long-term trend is used as the reference variable. The key of calculating countercyclical capital buffer is to judge whether there is an excess of credit growth. Based on historical data of member jurisdictions, BCBS did extensive analysis on variables from macroeconomic level, banking sector performance and cost of funding. The result demonstrated the credit/GDP ratio related to macroeconomic level had highest correlation with banking crises. Therefore, BCBS set deviation of credit/GDP① ratio from its long-term trend as the reference variable to calculate countercyclical capital buffer. If the credit/GDP ratio in a jurisdiction is close to or lower than its long-term trend, this indicates a low credit risk and the countercyclical capital buffer could be set as zero. If the credit/GDP ratio is significantly above its long-term trend, this is an indication of excessive credit growth and buildup of systemic risk and a countercyclical capital buffer should be considered to build up.

However, BCBS stressed that credit/GDP was not the only reference variable. Because credit change can be a lagging indicator of stress and credit/GDP might not send a timely signal. The indicator also could not fully reflect the different stages of economic and financial development in various jurisdictions. Therefore, each jurisdiction is allowed the discretion to choose the reference variable to calculate its countercyclical capital buffer based on domestic credit condition and systemic risk assessment. But it should make sure that the selected variables do not send misleading signals. Meanwhile, BCBS pointed out that jurisdictions could dynamically adjust the scale of buffer according to the market condition, releasing buffer quickly as crisis breaks out or allowing banks to use the capital buffer at their own discretion when there is a reverse of credit cycle and no obvious volatility of the financial system. Furthermore, BCBS proposed that national authorities should update the assessment of credit change and risk profile periodically and disclose the decision-making related to countercyclical capital buffer on a timely basis.

Implementation standards and transitional arrangement have been clarified. BCBS requires that countercyclical capital buffer be calculated in addition to minimum common equity capital adequacy ratio and capital conservation buffer②, and the specific requirement is 0–2.5 percentage point(s)

① BCBS pointed out that correlation between credit/GDP and crises would decrease when public sector credit was calculated into the total credit and proposed that the deviation of private sector credit/GDP from its long-term trend should be used as reference variables, which was simplified as credit/GDP in this Chapter.

② According to BCBS requirements, common equity capital ratio of banks must be at least 4.5 percent, and capital conservation buffer is an increase of common equity capital ratio by 2.5 percentage points, therefore, the minimum common equity requirement plus the capital conservation buffer are 7.0 percent of risk-weighted assets. The countercyclical capital buffer is calculated in addition to that and it is 0–2.5 percentage point (s) increase of common equity capital ratio.

above common equity capital adequacy ratio. Since the countercyclical capital buffer in fact enhances the capital constraint on banks, considering that banks in various jurisdictions need time to adjust their credit strategies, BCBS has made a transitional arrangement starting from 1 January 2016. This means that the countercyclical buffer requirement will be 0.625 percent in 2016 and increase in each subsequent year by an additional 0.625 percentage points, to reach its final maximum of 2.5 percent on 1 January 2019. Countries that experience excessive credit growth during this transition period will be encouraged to accelerate the buildup of the countercyclical buffer. In addition, BCBS made special countercyclical capital buffer requirement for internationally active banks. Since each jurisdiction could have its own discretion and hence different countercyclical capital buffer requirements, BCBS required that the buffer for an internationally active bank should be a weighted average of the buffers deployed across all the jurisdictions to which it has credit risk exposures.

The countercyclical capital buffer framework needs to be improved continuously in practice. The countercyclical capital buffer framework received a welcome in BCBS member jurisdictions. Up to now, some jurisdictions have started to set up their domestic countercyclical capital buffer regimes. For instance, Switzerland announced that it would require two big banks, Swiss Credit and UBS, to build up a countercyclical capital buffer of 0–2.5 percent. But the countercyclical capital buffer also faces a number of difficulties and problems in practice. The fact that national authorities have discretion on reference variables and buffer release would lead to inconsistency of the countercyclical capital buffer requirement across jurisdictions, and thus the internationally active banks could adjust their credit exposures in different jurisdictions to realize a lower countercyclical capital buffer, pushing the credit flow to risky areas. Furthermore, it is unfair for all domestic banks within a jurisdiction to comply with a uniform countercyclical capital buffer requirement, which might induce the adverse selection of domestic banks and encourage them to conduct risky business to search for high yield. The challenge of improving the countercyclical capital buffer framework is that whether it could make specific buffer requirements for targeted individual banks.

Strengthening Supervision on SIFIs

In October 2010, FSB released *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions.* The report sets out SIFIs policy framework including intensifying supervision, enhancing loss absorbency capacity, improving resolution regime and maintaining policy consistency across jurisdictions. FSB and BCBS are conducting researches on detailed assessment methodologies and higher loss absorbency measures and enhancing effectiveness of supervision and resolution regimes of SIFIs, and related policy measures will be introduced in 2011.

Assessment methodology of SIFIs. According to the guidance to assess SIFIs proposed by IMF/FSB/BIS in October 2009, three key criteria in identifying the systemic importance of institutions are size, interconnectedness and substitutability, in which, size reflects the status of an individual institution in the financial system; interconnectedness captures the impact that the operation and risk profile in one institution could have on other institutions, counterparties and the industry; and substitutability indicates the reliance of clients and other institutions on this institution. Given that G-SIFIs have dominant positions in international financial activities and key impact on international financial stability, identification of G-SIFIs needs to consider indicators that could reflect the degree of their international activity, such as cross-border assets and liabilities. If the indicators reach a certain percentage, then the institution will be classified as a G-SIFI. In addition, since most SIFIs conduct business globally or are closely interconnected with the global financial system through balance sheets, the complexity indicator should also be analyzed in the assessment methodology to reflect their organizational structure and degree of business complexity.

Strengthening loss absorbency capacity of SIFIs. FSB requested that SIFIs maintain a capital surcharge in addition to the minimum capital required by Basel Ⅲ. However, a consensus has not been reached with respect to the components and specific percentage of the capital surcharge. Some members noted capital surcharge requirement should be common equity in tier 1 capital. But others suggested that capital surcharge requirement could be met in such a way as contingent capital, debt instruments and bail-in debts. Some authorities have started to impose capital surcharge requirement for SIFIs in their jurisdictions. Some jurisdictions proposed a capital surcharge of 1–2 percent of common equity tier 1 to risk-weighted assets. While others put forward a higher requirement of 6 percent. There are some opinions arguing that the determination of a specific percentage should avoid making the capital cost of financial institutions too high. In addition to capital surcharge, relevant international organizations are also considering other policy measures including imposing more stringent large exposure restrictions and liquidity surcharges on SIFIs to restrain them from conducting risky business and excessive expansion.

Enhancing intensity and effectiveness of SIFIs supervision. FSB proposed that national authorities improve domestic financial supervisory system from five aspects. First, mandates and independence of supervision should be clarified to identify risks and make early intervention when needed. Second, supervisors should have the power to conduct risk-based differentiated supervision on SIFIs. Third, the supervisory measures targeting complexity and interconnectedness of the financial system should be strengthened and supervisory standards should be enhanced to realize the integration of risk monitoring both at macro and micro levels. Fourth, jurisdictions should establish data collection and sharing mechanism among different supervisory bodies to promote supervisory coordination. Fifth, national authorities should establish supervisory colleges jointly for large cross-border financial institutions and hold meetings with them periodically to assess their business conduct and risks comprehensively. FSB also required that BCBS, IOSCO and IAIS take into account the above-mentioned proposals in their initiatives to update relevant core principles and that national authorities improve supervisory approaches and techniques.

Improving resolution regime. FSB proposed that all SIFIs have resolution plans in place to make sure that once in crisis they could be orderly resolved. According to FSB requirement, relevant international organizations are conducting researches on key instruments for effective resolution of SIFIs, key attributes of resolution plans, assessment criteria of resolvability, bail-in instruments and firm-specific cross-border cooperation agreements. National authorities should designate an agency responsible for resolution, clarify relevant powers and put in place institutional arrangements to avoid taxpayers' exposure.

Box17 Central Banks' Role in Macro-prudential Management

In the aftermath of the global financial crisis, an international consensus has been reached in strengthening macro-prudential management and emphasizing central banks' key role in macro-prudential management.

In the summary of the seminar on "Macro-Prudential Policies: An Asian Perspective", IMF pointed out that macro-prudential policies should be incorporated into macroeconomic policy framework and monetary policy makers should play a key role in macro-prudential framework. As the sole or leading agency in macro-prudential management, central banks should have the power to propose and implement monitoring policies with respect to systemic risk. The Managing Director of IMF, Dominique Strauss-Kahn said, conventional macroeconomic policies and macro-prudential tools were intrinsically linked, and a holistic approach was needed which meant a changing role for central banks in the years ahead. The President of ECB, Jean-Claude Trichet, pointed out that central banks were naturally endowed with the function of maintaining financial stability and their policies were long-term oriented and should play a key role in macro-prudential management.

Economist Olivier Blanchard is in the view that macro-prudential responsibility endowed in central banks would help them to analyze and adjust the potential impact of monetary policies on leverage and risk appetite. The effective integration of monetary policies and macro-prudential policies could provide countercyclical tools to address crisis. The General Manager of BIS, Jaime Caruana, said the close link between monetary policies and financial stability determined that central banks must play an important role in macro-prudential framework, since central banks served as the lender of last resort and were the only institution that could inject enormous liquidity into the financial system in a short period of time, the payment and settlement system was the core of the modern financial system and central banks had large amount of resources to conduct analysis of macro-economy and financial situations. Member of the ECB's Executive Board, Lorenzo Bini Smaghi, believed it was difficult for central banks to realize the two targets of price stability and assets price stability solely by using interest rate instrument, so central banks need other instruments to address assets price change and these instruments were macro-prudential in nature. Economist Goodhart pointed out that central banks created liquidity through adjusting their own balance sheets and liquidity management was the key of financial stability. If central banks were responsible for liquidity management but had no macro-prudential power, then situation would be very complicated. The UK Chancellor, George Osborne, said central banks were the only agency with a profound understanding, authority and knowledge to make macro-prudential decisions. As the lender of last resort, central banks need to know all aspects of the financial institutions they supported.

Bernanke, the Chairman of US Federal Reserves, augured that the greatest lesson from the crisis was the "Too Big to Fail" problem of financial institutions. The Fed should have done more with respect to capital standards of banks but it lacked the power to supervise financial institutions comprehensively. The Fed was, to the greatest extent, suitable to supervise large and complex financial institutions. Paul Volker, President Obama's Economic Advisor, thought that monetary policies and financial stability could not be split so the Fed should be authorized to supervise systemically important banks. Fed needed to get the valuable and first hand information about banks' operation so as to have an overall perspective for market and economy. Masaaki Shirakawa, The Governor of Bank of Japan, pointed out that central banks were indispensible in maintaining financial system stability and must play a key role in macro-prudential management. Before the crisis, Bank of Japan started to make macro-prudential management and conducted on-site examinations on financial institutions with accounts in central banks, so as to get more information about business operation and assets quality of financial institutions and analyze and assess the overall financial system risk.

Accelerate Establishment of the Macro-prudential Framework in China

In recent years, China's financial management authorities have made positive progress in enhancing macro-prudential management. PBC continued to enrich and improve relevant policy instruments based on current macro-prudential practices. In the next stage, according to China's domestic circumstances, an integrated macro-prudential framework should be set up by drawing on lessons of the crisis and international leading practices. A mechanism to coordinate macro-prudential management and micro-prudential supervision should be put in place, with the leading role of the central bank and strengthened cross-agency coordination, to effectively maintain financial stability and increase sustainability of the financial support to economic growth.

Addressing Several Key Issues on Macro-prudential Management

To set up China's macro-prudential framework, several key issues should be addressed. First, a balance should be struck between financial stability and financial system efficiency, sticking to the principle of being prudent proactive and learning by doing. At the initial stage, the objective is to set up fundamental mechanism and delineate division of responsibilities with appropriate policy intensity. Second, a balance should be struck among macro-prudential management, micro-prudential supervision and monetary policies. Macro-prudential management has a core to make countercyclical adjustment in a timely manner based on an objective and correct judgment on macroeconomic condition, and in essence it is an integral part of macroeconomic management and financial stability. Agencies responsible for developing macro-prudential policies should be sensitive to macroeconomic condition and changes in risks and have strengths in experiences, instruments, data and talents for credit management and judgment on macro economy. Meanwhile, learning lessons from the financial crisis, macro-financial management should pay more attention to stability of the overall price level in a broader sense and give priority to issues on financial stability and overall risks at macro level. Therefore, macro-financial management should give full play to traditional instruments such as the interest rate, and meanwhile incorporate macro-prudential management to enrich and supplement the toolkit. Third, a balance should be struck between macro-prudential management and accounting standards, designing and implementing policy instruments with the precondition of compliance to accounting standards. Fourth, a balance should be struck between domestic characteristics and international standards implementation. On one hand, it needs to promote standard consistency and international coordination to prevent supervisory arbitrage. On the other hand, it is necessary to determine the instruments and parameters according to national circumstances to increase flexibility of policy adjustment.

Setting up the Countercyclical Macro adjustment Mechanism

The international leading practice to enhance macro-prudential management in economies reliant heavily on bank financing is to set up a countercyclical mechanism. Due to historical and institutional reasons, there remains a high proportion of bank credit to social financing in China and high correlation between credit volatility and changes in economic cycles and systemic financial risk. Therefore, setting up a countercyclical credit management mechanism is an integral part of improving macro-prudential management in China. In recent years, PBC continued to explore ways of countercyclical credit adjustment with close attention to both changes in price indicators and money and credit growth. PBC strengthened risk warning through window guidance and enhanced macro-prudential management by implementing measures including credit policy, differentiated reserve requirement, Loan-to-Value (LTV) adjustment, in order to guide steady money and credit growth. Among the measures, dynamic adjustment of differentiated reserve requirement is determined by deviation of bank credit from economic growth and price index as well as the institutions' impact on total trend, systemic importance, and soundness, which is helpful to guide rational, prudent and steady credit extension of financial institutions, and optimize credit structure. Meanwhile, such instrument may foster a mechanism flexible to financial institutions' self-constraint and self-adjustment, which increases the resilience of financial institutions by means of increasing capital and improving asset quality, to achieve the objective of avoiding systemic risk build-up.

In the next stage, actions should be taken to improve differentiated dynamic adjustment mechanism, combining adjustment of aggregate credit and liquidity with establishment of the macro-prudential framework and guiding appropriate credit growth, to improve resilience of financial institutions. In this course, efforts should be made to strictly capture the aggregate level and expansion of banking institutions' credit, closely monitor financial institutions' capital adequacy, asset quality, liquidity, provision coverage ratio and leverage ratio, and obtain relevant data in a timely manner in order to assess soundness of financial institutions comprehensively and correctly, while taking into account information including annual audit conclusions, credit rating, internal control, lawsuits and payment risk. On this basis, it is necessary to appropriately set and improve soundness adjustment parameters and adjust differentiated reserve requirement accordingly, in order to incentivize banks to adjust their behaviors towards sound operations and sustainable development.

Researches show that deviation of credit/GDP from its long-term trend generally antedates changes in economic cycles. It will be helpful to use credit/GDP as the reference variable to establish the countercyclical capital buffer of the banking system to prevent the risk of bank loan loss, promote more forward-looking macroeconomic policies and enhance capital constraint on commercial banks' operations. Therefore, studies should be conducted to establish a countercyclical capital buffer mechanism in line with characteristics of the banking system in China.

Policy Measures to Reduce SIFIs Risks in China

In recent years, China saw more inter-linkages across financial sectors and financial markets, substantial increase in the complexity of financial products and gradual growth of size and strength of large financial institutions, which well served economic and social development while their operations and potential risks having systemic impact. In order to maintain financial stability, efforts should be made to develop the methodology for identifying SIFIs in China and policy measures to reduce risks in line with international trend and tailored to domestic circumstances.

From the perspective of preventing and mitigating systemic risk and maintaining financial stability, quantitative indicators and qualitative judgment should be combined in developing the methodology for identifying SIFIs in China, jointly determined by macro-prudential authorities responsible for financial stability together with sector-based supervisory agencies. Quantitative indicators should include size, interconnectedness and substitutability, while qualitative judgment should include corporate governance, internal control mechanism, risk management capability, risk transmission channels.

There is a close relationship between business and risk management of SIFIs, and systemic risk. From a system-wide perspective, SIFIs should be subject to higher supervisory requirements and standards. First, SIFIs with various degree of systemic importance should be charged with different capital surcharges. Second, higher supervisory requirements and standards should be developed regarding leverage ratio, liquidity, large exposures and provisioning, and stress tests should be conducted on a regular basis. Third, authorities should research on administrative policies of SIFIs' M&A and investment activities and be prudent to approve new businesses, new branches and allocation of outlets of SIFIs.

In order to reduce negative effects of failure of SIFIs on the financial system and address moral hazard, orderly resolution and liquidation arrangements should be established for SIFIs in distress. Efforts should be made to enhance liabilities of shareholders, creditors and managers, develop special liquidation arrangements, establish the deposit insurance system as a resolution platform, give play to the supporting role of the central bank and establish an effective cross-border cooperation mechanism.

Box 18 Macro-prudential Analysis: An Updated Financial Network Model Based on Data from Payment and Settlement System

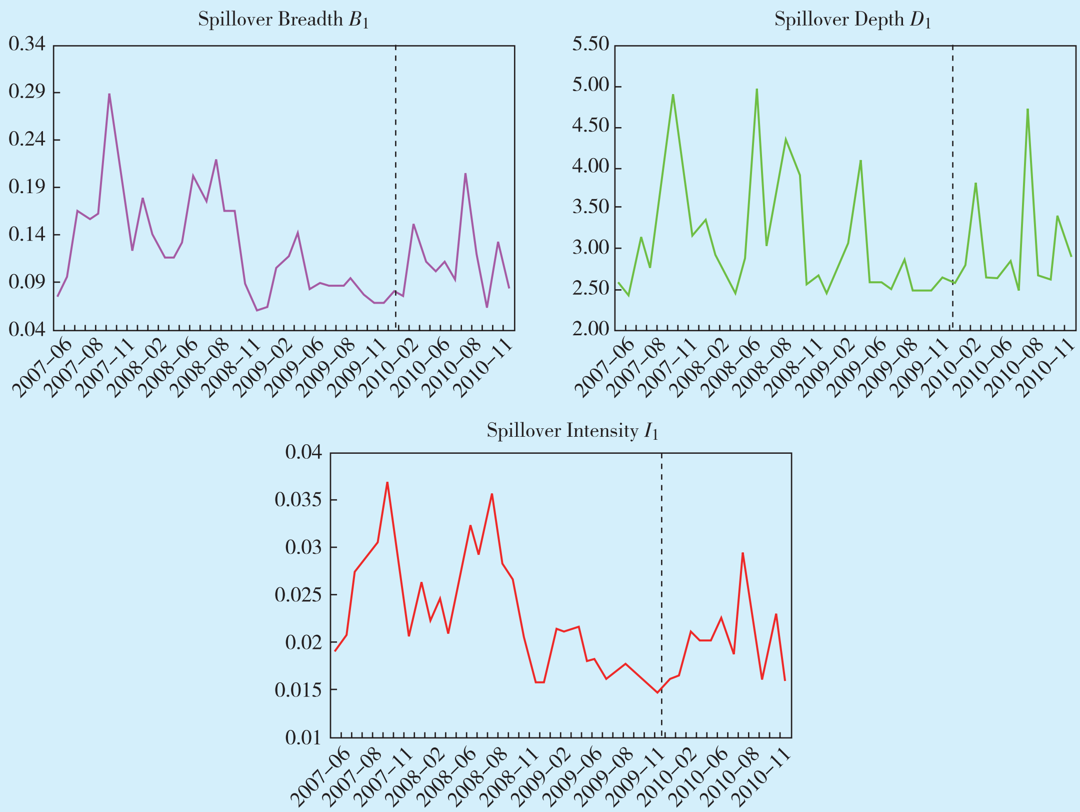
With deepening rethinking of the current financial crisis, the discussion of systemic risk has come into a new phase, particularly focusing on the systemic and network risk resulting from interconnectedness and contagion among different institutions. The financial network refers to an integration of financial institutions (mainly banks) through various financial transactions, while financial network structures specifically describe the overall pattern and structural features of different networks and analyze the internal characteristics and risk transmission mechanism of the entire financial system from an interconnectedness perspective. Based on the financial network model using data from inter-bank payment and settlement system constructed in 2010, the analysis adds the spillover intensity indicator to further reflect the network structure and its stability. Through empirical analysis of data from payment and settlement system throughout 44 months from May 2007 to December 2010, we make a comprehensive dynamic mapping and analysis of the overall stability of the entire financial network, its structural changes and liquidity risk transmission process among financial institutions (mainly banks).

Mapping Financial Network Stability in China

Based on empirical analysis of data from payment system, we get the values of three indicators, breadth (B_1), depth (D_1) and intensity (I_1), of financial network stability in China. Research shows that the change of stability indicators mainly results from liquidity change of each node, and change of degree of interconnectedness of network structure and nodes. Depth indicator (D_1) is more sensitive to network interconnectedness, while breadth indicator (B_1) and intensity indicator (I_1) more reflect the change of risk tolerance of nodes.

From the movements of financial network stability indicators (Figure 8.1), the year of 2010 witnessed a strengthening at a low level of breadth (B_1), depth (D_1) and intensity (I_1). Compared to historical trend, although B_1、D_1 and I_1 in 2010 were not high from the perspective of the average level, they experienced upward movements and fluctuations in some specific periods, such as August and November. Among the three indicators, the movements of B_1 and I_1 were broadly similar and both experienced an inverse V trend while the fluctuations of D_1 were relatively intense. This reflected both the impact of liquidity change of nodes and change of degree of network interconnectedness. But the impact of liquidity change of nodes on the network stability was more prominent than that of change of network structure per se, which were broadly consistent with the tempo of financial macro-prudential adjustment in 2010.

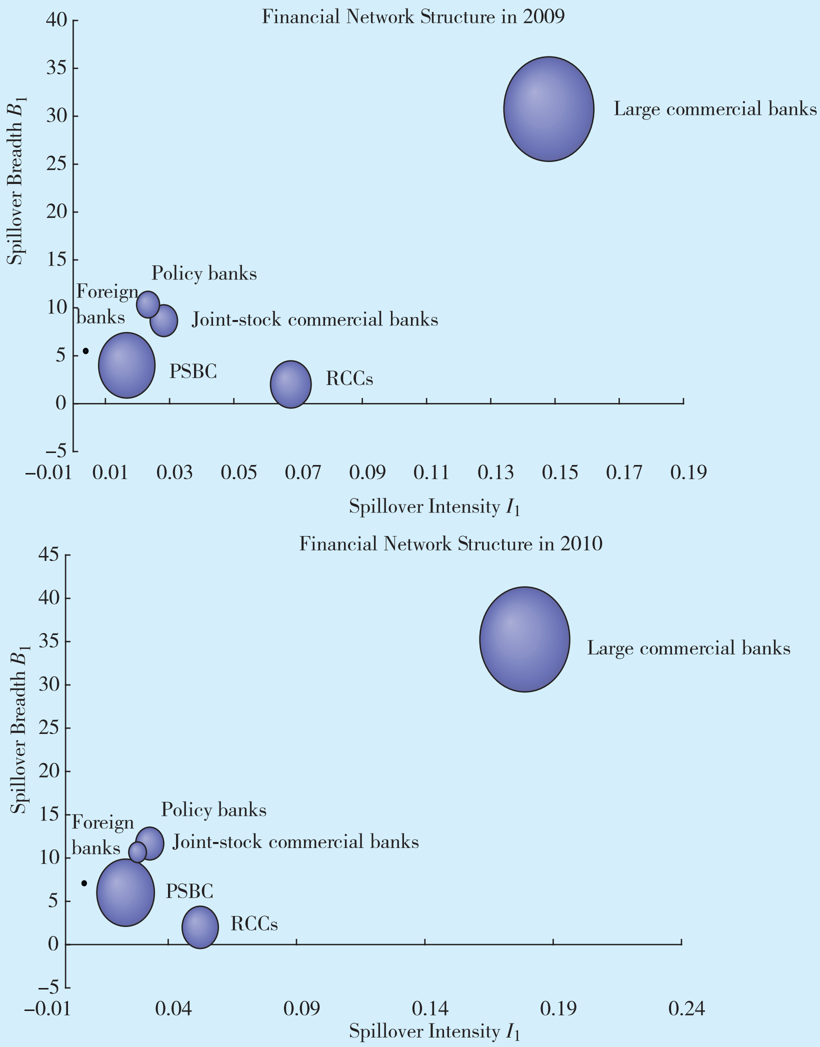
Figure 8.1 Movement of Financial Network Stability Indicators



Structural Changes of the Financial Network in China

We select June 2010 as the time point for updated analysis of structural characteristics of the banking network and its changes in China (Figure 8.2). Considering difficulties in getting granular data and comparability in time dimension, the analysis mainly focuses on the payment network composed by 84 nodes, including large commercial banks[①], policy banks[②], joint stock commercial banks, city commercial banks, rural commercial banks, rural cooperative banks, RCCs, UCCs, PSBC and foreign banks. In particular, city commercial banks, rural commercial banks, UCCs and RCCs are taken as four single nodes.

Figure 8.2 Comparison of Financial Network Structures in 2009 and 2010



Note：Figure 8.2 shows network stability indicators of large commercial banks, joint stock commercial banks, policy banks, PSBC, RCCs and foreign banks in 2009 and 2010. The areas of the spheres represents average position of institutions of various types.

① In Box 18, large commercial banks refer to four banks, ICBC, ABC, BOC and CCB. BOCOM is included in joint stock commercial banks.

② In Box 18, policy banks refer to three banks, CDB, EXIM and ADBC.

(1) Large Commercial Banks

From the perspective of liquidity risk transmission, when there are liquidity shocks coming from large commercial banks, on average around 30 banks would be affected more or less, accounting for 36 percent of selected institutions. The spillover would last for 5 rounds on average, and the affected fund accounts for 18 percent. The affected nodes are mainly policy banks and foreign banks, while other institutions are not affected severely. If the four largest commercial banks are regarded as a whole, the spillover would last for 7 rounds, and the proportions of affected fund and institutions are both over 80 percent, and except PSBC, city commercial banks and a few foreign banks, most banks would be affected. It shows that compared to June 2009, the dominant position of large commercial banks in the network has been intensified and the coverage of each large bank in the network is not completely overlapping.

(2) Policy Banks

When there are liquidity shocks coming from policy banks, on average 10 institutions would be affected compared to 5 in June 2009, the spillover could last up to 6 rounds, the affected fund is 3 percent on average and the affected institutions are all foreign banks. In general, although the overall significance of policy banks in the network is not heavy, compared to historic data their impact on the network has been enhanced notably. This is mainly because there has been some diversification of the behavior of various policy banks nodes in the network. Some policy banks demonstrated a relatively stronger reliance on the network while others have more impact on the network.

(3) Joint-stock Commercial Banks

If all joint-stock commercial banks are regarded as a whole, liquidity shock coming from joint stock commercial banks would last for 3 rounds, affecting 48 institutions in total and 44 percent of total fund. The affected institutions include policy banks, RCCs and a number of foreign banks. However, when there are liquidity shocks coming from individual joint stock commercial banks, 11 institutions are affected on average and the spillover would last 3 rounds affecting 3 percent of the total fund only. This shows that joint-stock commercial banks are extensively interconnected and their overall intensity of impact on the network has been strengthened compared to June 2009, but the impact of an individual node is far weaker than large commercial banks.

(4) PSBC and RCCs

Although PSBC has a relatively large scale of assets, its impact on the network and the intensity of being affected by the network are not high and it remains relatively isolated in the network. But notably compared to June 2009, the network interconnectedness of PSBC is enhanced to some extent. Its liquidity shock could affect 7 institutions, the spillover could last 4 rounds and the affected institutions are mainly foreign banks.

Liquidity shock coming from RCCs as a whole would last for 2 rounds, remaining the same compared to June 2009, and the affected institutions and fund are decreased to 3 percent and 5 percent respectively. When there is a liquidity shock arising from an individual large commercial bank or joint stock commercial banks as a whole, RCCs would not be affected severely. It shows RCCs as a subgroup are becoming more isolated in the network.

（5）Foreign Banks

When there are liquidity shocks arising from individual foreign banks, an average of 7 institutions would be affected and the spillover would last 2 rounds affecting 0.7 percent of the transaction volume. It reflects a weak impact of foreign banks on the network. But since the number of foreign banks nodes in the network is large, it could influence the breadth（B_1）and depth（D_1）of the financial network stability. Empirical study shows in August and November 2010, enhanced network interconnectedness of some foreign banks nodes with PSBC, RCCs, some joint stock commercial banks and policy banks caused higher fluctuations of network stability indicators.

In summary, there has not seen a big change of the financial network structure in China and network stability foundation remains solid. But the enhanced network interconnectedness among foreign banks, some joint stock commercial banks and policy banks and the change of cash position of banks led to some fluctuations of the overall network stability.

Stepping up Establishment of the Financial Statistical System and Systemic Risk Monitoring and Warning System

Risk monitoring and warning system is an integral part of macro-prudential framework, in which effective monitoring and warning depends on authentic, timely and complete financial data and information. In order to ensure that development of the financial statistical system keeps pace with economic development and financial innovation, efforts should be made to accelerate the establishment of a comprehensive financial statistical system with full coverage, uniform standards and information sharing; a statistical system covering banking, securities and insurance sectors as well as domestic and overseas businesses; and statistics for financial holding companies, off-balance sheet entities and financial derivatives. Measures should be taken to actively promote financial statistics standardization, reinforce information sharing and transparency of statistical information, avoid repeated statistics, enhance information security and confidentiality, and establish a platform for cross-agency communication and information sharing. Meanwhile, on the basis of comprehensive improvement in financial statistics, it is necessary to develop a financial monitoring indicator system comprehensively reflecting conditions within the financial system and the relationship between the financial system and real economy, improve the systemic financial risk monitoring and assessment framework and establish a forward-looking risk warning system.

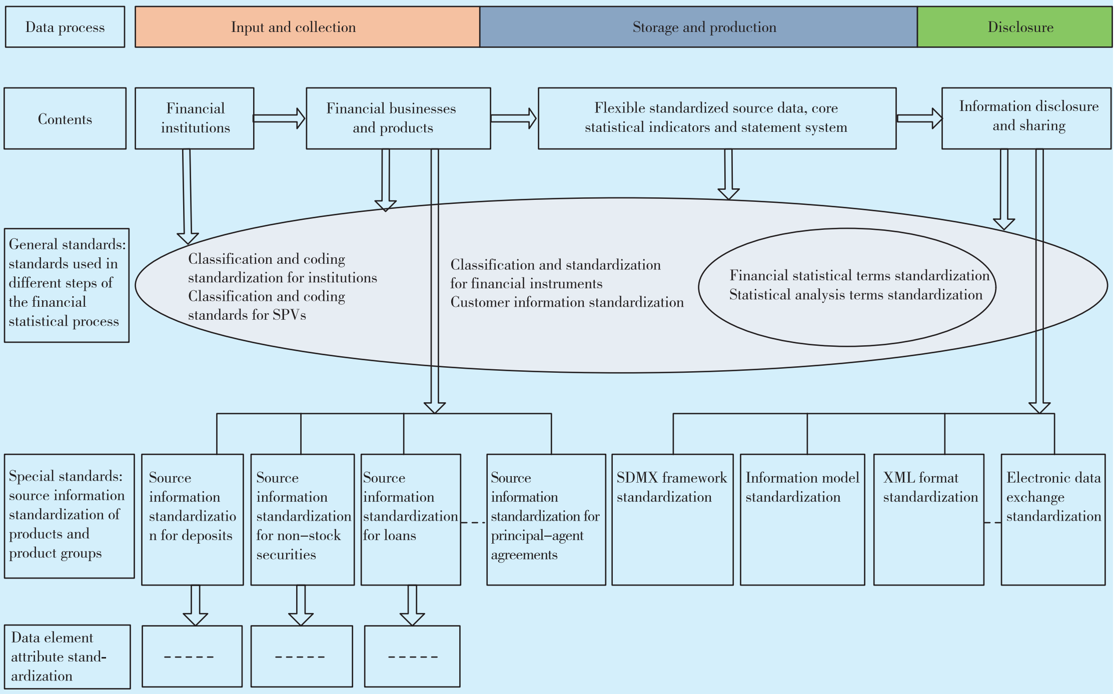
Box 19 Strengthening Financial Statistics Standardization

With the rapid development of economic globalization and financial innovation, the problem that current statistical indicator system fails to meet demands of the new circumstances becomes increasingly prominent. Specifically, the global financial crisis breaking out in 2007 underscored the urgent needs for monitoring cross-institution, cross-market and cross-border activities, innovative institutions and products. The international community has reached a consensus on setting up a systemic financial risk monitoring indicator system covering banking, securities and insurance sectors as well as domestic and overseas businesses. Some international organizations and countries have made positive progress in this area and established some statistical systems, but still failed to solve the problems such as data gap and weak information sharing.

Financial statistics standardization is the precondition for a unified and scientific comprehensive financial statistical system and an important measure to increase the level of financial statistics in China and improve the monitoring system. By means of statistical information standardization, it could be achieved from the origin to promote coordination of various types of financial information, improve data quality and effectively promote information sharing. Restructuring the financial statistical system of the central bank should both meet the needs of macro-prudential management and be tailored to domestic circumstances.

Financial statistics standardization in China streamlines statistical information based on international leading practices, including classification standards for agencies, financial institutions and financial instrument statistics, measurement standards for financial instruments and terminology standards for financial statistics. Specifically, standards are classified into general standards, special standards and data element standards.

Figure 8.3 Framework for Financial Statistics Standardization



The framework for financial statistical standardization (Figure 8.3) clarifies the scope of financial statistics by standardized classification of statistical institutions. Besides banking, securities and insurance institutions, the framework also includes financial institutions such as annuities, loan companies, rural creditshops, village and township banks, SPVs and extends to financial institutions for trading and settlement, financial holding companies and microcredit companies, according to the national accounting theory and features and development of the financial system in China. Standardization of classification for financial instruments statistics should normalize logical classification and definition of standards according to features of financial assets. It should include banking, securities, insurance and cross-sector financial businesses, unify understanding of various financial instruments and products and increase homogeneity, consistency and comparability of macro data. Standardization of financial statistical terms and financial statistical information during the process from information collection to disclosure is conductive to avoiding ambiguity and misunderstanding because of lack of terms standards, and increasing efficiency and precision of information exchange. Moreover, efforts should also be made to realize standardization of statistical process including input, collection, storage, production and disclosure.

Currently, PBC has issued standards including *Coding Standards for Financial Institutions, Classification and Coding Standards for Financial Instruments*, *Classification and Coding Standards for Loans, Classification and Coding Standards for Deposits, Coding Standards for Special Purpose Vehicles (SPVs)* and *Data Element Standards for Wealth Management and Funds Trust Statistics*. In the next stage, efforts should be made to further improve the framework for financial statistical standardization, contributing to the foundation of macro-prudential framework in China.

Improve the Framework for Crisis Management and Systemic Risk Resolution

The experiences of US and some European jurisdictions in response to the global financial crisis show that the lender of last resort function of central banks, treasuries unconventional rescue and deposit insurance systems played important parts. China should further improve the function of the central bank as the lender of last resort and enrich its policy instruments and measures. Efforts should be made to improve the cost sharing mechanism of risk resolution, delineate the functions, responsible agencies and application condition and parameter of various rescue instruments, enhance cross-agency coordination and cooperation, and improve quick response mechanism for unexpected financial risks. Establishment of a well-designed deposit insurance scheme with powers commensurate with responsibilities should be accelerated, and a market-oriented exit mechanism of financial institutions should be established with phase-in of relevant rules and regulations.

Special Topic Ⅰ

International Financial Regulatory Reform and Implications for China

One of the main reasons of the outbreak and spread of the global financial crisis is that the financial supervisory regime didn't keep pace with financial development. In 2010, the US, EU and some other jurisdictions launched financial reforms to overhaul the financial regulatory regime, which pioneered the trend of global financial supervisory development. The reforms mainly aim at preventing and mitigating systemic risks and focus on coordinating monetary policy, financial stability and financial supervision. With the reform measures implemented, the financial supervision tends to be more stringent, and the behavior of financial institutions would get more prudent. All these would have positive impact on the global financial stability. Therefore, China should learn from the experience and practice of these jurisdictions, tailor to the need of domestic financial reform and development, further deepen financial reform, and improve the institutional arrangements to maintain financial stability.

Major Reform Measures

Highlights of the US Financial Regulatory Reform

In July 2010, the US President Barack Obama signed "The Dodd-Frank Wall Street Reform and Consumer Protection Act" ("Dodd-Frank Act") into law. "Dodd-Frank Act" aims at strengthening the capacity to prevent and mitigate systemic risks, and focuses on the following aspects to improve financial supervisory system.

FSOC is established to identify and mitigate systemic risk. FSOC consists of ten voting members and five nonvoting members and is authorized with the following responsibilities: identifying systemically important financial institutions, tools and markets as well as risks that could arise from inside or outside the financial industry and market; With a 2/3 vote determining a nonbank financial company as a SIFI and requiring it to be supervised by the Federal Reserve; Making recommendations to the Federal Reserve for increasingly strict rules for SIFIs; approving Federal Reserve' decision to sell or transfer asset of financial institutions that severely threaten financial stability when necessary.

The regulation scope is extended to fill supervision gaps. First, the Federal Reserve becomes the preeminent financial regulator and is authorized with broadened supervisory scope as the following: to supervise bank holding companies with USD 50 billion or more in consolidated assets, securities, insurance companies, financial holding companies that are designated as being systemically important, and hedge funds and private equities that are determined to have grown too large or too risky; to conduct examinations on the activities of financial holding companies and any associated subsidiaries (including non depository subsidiaries); to obtain information directly from financial holding companies; to require non-bank companies that engage in non financial activities to establish an intermediate holding company as the Federal Reserve may determine necessary and appropriate for managing financial business; to intensify supervision on payment and settlement activities and financial market infrastructures that are systemically important, and to provide discount window support and preferential lending when necessary. The Federal Reserve supervision on intermediate and small banks is also retained. Second, OTC derivatives, hedge funds, private equity funds and rating agencies are incorporated into supervision scope. OTC derivatives are supervised by the Commodities Futures Trading Commission (CFTC) and SEC. In order to increase transparency and reduce counter-party risk, the central clearing of OTC derivatives transaction is promoted; hedge funds and private equities are required to register with SEC and submit reports to SEC regarding trades and portfolios etc., and firms with assets over USD 150 million are subject to supervision and periodic inspection by SEC; the supervision of SEC on credit rating agencies is retained, reducing the interests interconnectedness among credit rating agencies, firms and broke dealers, and deregistering a rating agency for providing bad ratings over time. Third, the Federal Insurance Office is established within the Treasury, responsible for recommending to FSOC the list of systemically important insurance companies subject to stringent regulation.

Financial regulation standards are enhanced and"Too Big to Fail"risk is reduced. First, Federal Reserve establishes more stringent standards and requirements on SIFIs, including capital, leverage ratio limits, liquidity, risk management and resolution plans, etc. FSOC and Federal Reserve could require a firm that threatens US financial stability to preserve specific debt-to-equity ratio or to sell part of assets. Second, the Volcker Rule is implemented. The Volcker Rule prohibits a banking entity from engaging in proprietary trading. To the extent a banking entity sponsors or invests in a hedge fund or private equity, the banking entity will be permitted to maintain a 3 percent or less of total ownership interests of the fund, and shall not exceed 3 percent of its Tier 1 capital. The liabilities of a financial institution, through M&A, shall not be more than 10 percent of the total liabilities of all financial institutions. Third, the risks related to asset securitization are under control. Asset securitization is required to realize risk sharing. Companies that sell products like mortgage-backed securities are required to retain at least 5 percent of the credit risk.

Corporate governance and compensation regime are improved and the discipline of financial institutions is strengthened. The oversight of shareholders and board of directors are strengthened, and shareholders are given a say with the right of non-binding vote on executive pay and golden parachutes. Listed companies are required to have a compensation committee consisting only of independent directors and having authority to hire compensation consultants. A compensation claw-back rule is established, requiring public companies to set policies to take back executive compensation if it was based on inaccurate financial statements that don't comply with accounting standards. Management interlocks are prohibited by extending the prohibition of management interlocks between depository institutions to non-bank financial institutions regulated by Federal Reserve.

An orderly resolution and liquidation mechanism is created and the role of FDIC is highlighted. First, the supervisory power of FDIC has been expanded: to supervise any state banks with assets no more than USD 50 billion, state depositary institutions and their holding companies; to be authorized the back-up power to implement special inspection on systematically important non-bank financial institutions and large banks; to take enforceability measures for depository institution holding companies; to increase minimum reserve ratio of the Deposit Insurance Fund from 1.15 percent to 1.35 percent of insured deposits; to permanently increase the deposit insurance limit to USD 0.25 million and make the increase retroactive to cover the period ever since January 1, 2008; to shift the FDIC assessment base for premium from deposits to total assets. Second, FDIC is authorized to implement orderly liquidation. The determination of a failing financial institution as systemically important is determined by the Federal Reserve and FDIC, but for securities or insurance companies it is determined by the Federal Reserve, SEC and Federal Insurance Office, in consultation with FDIC. The Treasury, Federal Reserve and FDIC jointly determine to initiate the liquidation procedure. When the authority is used, FDIC is appointed as receiver and liquidates the failing company by establishing one or several bridge banks to retain and preserve the going-concern value of assets, liabilities and operations as necessary. Shareholders and unsecured creditors will first bear the loss without using taxpayers' fund. Large complex financial institutions must submit a resolution plan for a rapid and orderly resolution in the event of distress or failure to the Federal Reserve and FDIC jointly for approval.

Consumer Financial Protection Bureau (CFPB) is created to enhance financial consumer protection. CFPB is an independent bureau housed at the Federal Reserve with the authority of consumer protection originally belonging to seven financial supervision institutions. CFPB's authorities include: to issue rules to regulate unfair, deceptive and abusive practices; to conduct behavioral supervision on banks and non-banks providing credit card, mortgage lending and other financial products and services, and to conduct examinations on depository institutions, investment consultant and large financial service providers etc.; the increased staff and budget is provided by the Federal Reserve; the financial literacy is strengthened and products sales and loan granting is regulated. The investment threshold is increased to ensure hedge funds and private equities only sell to investors who could identify and bear the risks; the minimal national standard of housing mortgage lending is established to require banks to ensure borrowers have the ability to repay loans through reviewing income, credit record and employment condition.

Highlights of the UK Financial Regulatory Reform

In July 2010, UK published a financial regulatory reform proposal—*A New Approach to Financial Regulation: Judgment, Focus and Stability*, proposed a significant financial supervisory reform on UK's tripartite regulatory system consisting of the Treasury, Bank of England (referred to as the Bank hereinafter) and Financial Service Authority (FSA), and clarified the leading position of the Bank for both micro and macro-prudential supervision.

The Bank is charged with macro-prudential management. Financial Policy Committee (FPC) is created in the Bank with macro-prudential tools and primary responsibility to maintain financial stability. FPC will have a total membership of eleven, comprising five executives of the Bank, directors of Consumer Protection and Markets Authority (CPMA) which is newly created, four members from the outside recommended by the Chancellor and one nonvoting representative from the Treasury. The governor of the Bank will serve as the chairman of FPC. FPC is accountable to the Court of Directors of the Bank, the Treasury and the Parliament.

FSA is to be abolished. The Government will transfer operational responsibility for prudential regulation from FSA to the newly created Prudential Regulation Authority (PRA), a new subsidiary of the Bank. PRA will change the supervision from a rule-based approach to a risk-based approach. PRA will report to FPC on detailed supervisory information of financial institutions and FPC is responsible for related macro-prudential analysis. According to the requirement of macro-prudential management from FPC, PRA will take detailed regulatory actions upon financial institutions. The responsibility of macro and micro-prudential management is concentrated in the Bank to address the issues of ambiguous duty and supervision gaps.

CPMA is created. CPMA is responsible for financial consumer protection and financial service business, and will take on all the FSA's responsibilities, as well as arm's-length oversight of the Financial Ombudsman Service, the Consumer Financial Education Body, and the Financial Services Compensation Scheme. CPMA regulates all aspects of the conduct of participants in retail and wholesale markets, as well as exchange and market infrastructure. The regulatory objective is protecting consumers and promoting confidence in the integrity and efficiency of UK's financial markets.

Highlights of the French Financial Regulatory Reform

In January 2010, France promulgated an act to launch significant reform on financial supervisory system, including underpinning the central role of Banque de France, together with the prudential supervision authority (ACP) and financial markets authority (AMF), to broadly prevent financial group risks and ensure coordination and cooperation on macro-prudential issues.

The banking and insurance regulatory bodies are merged and the regulatory functions are transferred to the newly created ACP. ACP is responsible for maintaining financial stability, protecting consumer interests, and supervising the banking and insurance sectors. The banking sector includes credit institutions, investment firms, payment institutions and bureaux de change. The insurance sector includes insurance and reinsurance firms, mutual insurance companies and provident fund institutions. ACP is authorized with powers as the following: to issue licenses and conduct on-site and off-site inspections, to exam compliance with liquidity requirements and solvency requirements of all supervised institutions, to review the claims payment of insurance companies to the insured. ACP should seek Banque de France's opinions on the issues of banking sector examination and payment system security. In the meanwhile, ACP could expand its power to establish an enforcement committee to impose penalty on malpractice of financial institutions, to disclose relevant information to the public and represent France to participate in international financial supervisory activities.

The close link and cooperation among Banque de France, ACP and AMF has been clarified. First, the close link between Banque de France and ACP is ensured. The Act stipulates that the Deputy Governor of Banque de France holds the Chairman of ACP, which is also backed by Banque de France with resource, staff, information, financial and economic analysis etc. ACP is not an independently legal entity; instead, Banque de France will sign all its legal contracts and provide all that it needs to carry out its functions. Second, the cooperation between AMF and ACP is strengthened. AMF is created to supervise market integrity, investor protection and listed companies. AMF and ACP have set up a joint team to supervise financial market products to make sure the enforcement of the regulations; a joint information counter is set up to review investment services providers. The chairman of the AMF is a member of the ACP Board and *vice versa*. Third, the coordination among Banque de France, ACP and AMF is strengthened. AMF and ACP make an agreement with Banque de France to use its branches and nationwide service network to exam consumer protection. AMF could delegate or jointly with Banque de France and ACP to conduct on-site and off-site inspection on large banks. The chairman of AMF, the chairman of ACP and the governor of Banque de France are members of the French Financial Regulation and Systemic Risk Council, in which they share their expertise and knowledge on financial markets to forecast and identify systemic risks.

Highlights of the EU Financial Regulatory Reform

In September 2010, European Parliament reached a new financial regulatory Act. According to this Act, since January 2011, European Systemic Risk Board (ESRB), European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) will be created to strengthen the supervision on financial system at both macro and micro levels.

ESRB is created to be a new macro-prudential regulator for the financial sector. ESRB is responsible for macro-prudential regulation throughout the EU, including providing an early warning system, producing uniform ratings for different levels of identified systemic risks and recommending remedial action to relevant authorities. ESRB consists of the broad, executive council and secretariat. The membership of the broad comprises the governor of the central banks from each EU member, the governor and deputy governor of ECB, a representative from EU Commission, and each chairman of EU supervisory authorities. Other members include representatives of supervisory authorities, and chairman of economic and financial commissions from each EU member. ESRB could obtain macro data and information from ECB to carry out systemic risk research, and through its secretariat obtain information from EBA, ESMA, EIOPA, central banks and supervisory authorities of each EU member.

Sector-based supervisory authorities are created for micro-prudential regulation. The newly created authorities include EBA, ESMA and EIOPA, with statutory responsibilities within EU to formulate regulations and ensure implementation effectively, conduct supervisory coordination and do research on regulation of financial innovation. EBA, ESMA and EIOPA could require national supervisory authorities and financial institutions to submit information, and set up periodic and occasional information sharing mechanism with ESRB. In the meanwhile, a joint committee of European supervisory authorities has been set up to coordinate with EBA, ESMA and EIOPA, and address cross-border management and issues of financial conglomerates etc..

Implications for China

The financial regulatory reforms of the above jurisdictions reflect the mainstream trend of global financial regulatory reform and represent the international reflection of the lessons from the crisis and correction on financial regulation. Although there are just reform initiatives in some aspects, it could provide us a number of insights on how to promote financial reform and development to maintain financial stability.

Further Deepening China's Financial Reform by Drawing on the International Experiences.

There are some valuable lessons from the financial regulatory reforms of some jurisdictions, in which strengthening macro-prudential management, coordinating monetary policy with financial stability and financial supervision, establishing orderly resolution and liquidation arrangements have become internationally accepted practice. However, there still exist some compromises in these reforms. For example, that Dodd-Frank Act limits the Federal Reserve to provide emergency loans and enforces Volcker Rule is the prescription based on the US financial circumstances, and it is inappropriate to copy directly in jurisdictions where economic and financial systems are quite different from US. Meanwhile, the reform intention should be understood correctly. For instance, the implementation of the Dodd-Frank Act will result in revenue decline of financial institutions in short term. But in long term it could effectively limit financial institutions to engage in risky business and prevent excessive risk-taking. Therefore, drawing on international experiences in financial reform should be based on a holistic perspective of maintaining financial stability and a clear understanding to avoid blindly following the trend.

Amidst the global financial crisis, China's financial system, on the whole, has stood the test of turmoil, although slightly affected. It is mainly because of the sound economic development environment, a host of financial reform measures including shareholding reform of state-owned commercial banks and the improvement of the legal system and supervision capacity of China's financial system. Besides, China is still at the initial stage of financial development and financial services and product innovation is relatively underdeveloped. This objectively protected China from losses. However, China's financial system is in the process of rapid development, the existent financial regulatory regime and reformed financial institutions have not experienced a full economic cycle, and China may also encounter the problems that exposed in the advanced economies. Currently, efforts should be made to study the achievements of financial reforms in related jurisdictions on a solid basis, drawing on the experiences of international financial regulatory reform proactively, identify the potential risks and problems in financial system, and further deepen financial reforms in order to lay a solid foundation for long-term and stable development of China's financial system.

Establishing a Counter-cyclical Financial Macro-prudential Framework

The lessons from the global financial crisis show that it should not only focus on risks of individual financial institutions or a single sector, and preventing systemic risks should be based on a macro and holistic perspective. Recent supervisory reforms in some jurisdictions focus on mitigating systemic risks, through establishing and improving macro-prudential framework and mechanism to strengthen systemic risk management and maintain financial stability. The 12th Five-Year Plan articulates to "establish a counter-cyclical financial macro-prudential framework". It is a major deployment based on learning lessons from the financial crisis intensively, summarizing domestic experiences comprehensively, and accurately grasping the direction of financial regulatory system reform. Currently, as required by the 12th Five-Year Plan, we should put in place and improve macro-prudential framework in a timely manner, conduct researches and formulate policy measures to enrich tools and instruments continually, as a significant institutional arrangement to prevent systemic risks.

Strengthening the Central Bank's Role in Managing Systemic Risks

In recent years, the independence of the monetary authorities was overemphasized and the responsibility of financial supervision was split from Central Banks, which weakened the interactive relationship among monetary policies, financial stability and financial supervision. The financial reforms in the aftermath of the crisis have rectified that to some extent and reemphasized the profound collaboration among monetary policies, financial stability and financial supervision, and the leading role of the Central Bank in preventing and mitigating systemic risks. Currently, based on China's domestic circumstance of financial development, the relationship among monetary policy, financial stability and financial supervision should be dealt with correctly to promote the coordinated development and establish the early warning mechanism and resolution regime for systemic risks. The Central Bank, in collaboration with other agencies, should boost the financial statistics level, explore China's early warning system for systemic risks, and strengthen the monitoring and assessment of linkages between macro economy and financial system as well as among financial system and cross borders. Macro-prudential measures should be conducted to eliminate the vulnerabilities within financial system and prevent external shocks from macro economy and asset prices. The coordination among agencies and policy tools should be strengthened to jointly resolve financial risks. The lender of last resort function of the Central Bank should be enriched and the cost sharing mechanism in risk resolution should be improved to keep the balance sheet of the Central Bank healthy.

Strengthening Supervision on SIFIs

Strengthening supervision on SIFIs to prevent "Too Big to Fail" risk and moral hazard is the key of the global financial supervisory reforms. China's financial system heavily relies on indirect financing and slightly involves in financial derivatives trading, with limited international exposure and relatively simple balance sheets. In this content, the Chinese financial institutions are adequately capitalized and operate well. However, in recent years, financial institutions expanded rapidly, inter-sector connection within financial system increased gradually, and large commercial banks, insurance companies and financial holding companies with complex structures and diversified business activities are becoming systemically important. Currently, reinforcing supervision on SIFIs should focus on preventing moral hazard. Financial institutions should be prevented from growing excessively large and complex and also prohibited from taking excessive risks. Meanwhile, the regulatory regime on SIFIs should be improved by applying more stringent standards, improving resolution and liquidation regime, and strengthening shareholders and creditors' responsibility in loss sharing.

Establishing Deposit Insurance Scheme in a Timely Manner

During the crisis, many jurisdictions had taken measures to enhance deposit insurance mechanism. For example, US had increased

FDIC's deposit insurance coverage level from USD 0.1 million to USD 0.25 million. Some jurisdictions in EU and Asia have also increased the coverage level and even provided full guarantee, which has boosted confidence of depositors and safeguarded financial stability. Particularly, FDIC has implemented early rectification measures, such as "purchase and assumption, bridge banks and direct payouts" to mitigate risks effectively. The Dodd-Frank Act authorizes FDIC, as a platform of resolution and liquidation for banking, securities and insurance sectors, to play and improve the leading role of the deposit insurance mechanism in financial safety net. In June 2009, BCBS and IADI jointly published *Core Principles for Effective Deposit Insurance Systems* to encourage jurisdictions to establish the deposit insurance mechanism. Currently, due to the absence of deposit insurance scheme in China, there exist moral hazards that heavily rely on government and sovereign creditworthiness. Facing the increasingly complex international and domestic financial situation, a fully and effectively functioning deposit insurance scheme with appropriate powers and responsibilities should be established in a timely manner in order to exert positive impact on protecting depositor interests, safeguarding public confidence and stability, and improving the market-based exit mechanism of financial institutions.

Enhancing Financial Consumer Protection

The lessons from the international financial crisis indicate that the mixed responsibility of consumer protection and financial supervision will result in conflict of supervisory objectives. Therefore, China should deal with the relationship among industry development, financial supervision and consumer protection from an institutional perspective, and prevent consumer protection failure while biasing towards enhancing sector development. With regard to detailed measures of protecting financial consumers, financial institutions should seriously assess the risk appetite, risk identification and loss bearing capacity of customers, and make efforts to "sell proper products to appropriate persons". Information and risk disclosure of financial products should be improved. Financial literacy should be strengthened. Measures should be taken to avoid misleading sales, fairly protect financial consumers, and prevent financial institutions from abusing rights.

Special Topic II

An Overview of BCBS Regulatory Reform

The recent international financial crisis severely shocked the global financial system, and revealed its vulnerabilities. As a member of BCBS, China is actively participating in the work of BCBS, which in return deepens China's banking reform.

Evolution of the Basel Accords

Ever since the establishment in 1974, BCBS has been dedicated to improving banking risk management. BCBS has formulated broad supervisory standards, guidelines and recommendations for best practice in banking supervision, which are referred to as the Basel Accords. Given that the Basel Accords are responses to the risk management experiences and lessons of the international banking system for a certain period of time, as well as a trend of banking supervision, BCBS is acting as a major international forum to promulgate standards of banking supervision.

Basel Ⅰ Developed a Harmonized Framework for International Banking Capital Supervision

Back to 1980s', the debt crisis in Latin America posed significant losses to the banking sector in western developed countries; while some other banks evading from the crisis began to take funding cost advantages and accumulated assets at an astonishing pace, which led to increasing complaints of unfair competition. To address these concerns, in 1988, BCBS published *International Convergence of Capital Measurement and Capital Standards*, commonly referred to as Basel I. Basel I aimed to limit banks' excessive expansion and risk exposures through capital constraint, serving to strengthen the soundness of the banking sector. Basel I took the minimum capital requirement as the core of the framework, based on which Basel I adopted a 3-tier approach to capital measurement. Core, or Tier 1, capital consisted of common equity, disclosed reserves, retained earnings and perpetual non-cumulative preference shares. Other elements, such as general loan-loss provisions, hybrid capital instruments[①], and subordinated term debts, were designated as Tier 2 capital. Banks might also use Tier 3 capital, consisting of short-term subordinated debts with an original maturity of at least two years. Basel I recommended a risk-weighted approach to calculate risk assets and then CAR, in which different risk weights were assigned to different on/off balance sheet exposures according to generic natures of the counterparties. Accordingly, Basel I indicated that the minimum ratio of capital to risk-weighted assets should be set at 8 percent, while the Tier 1 CAR would be at least 4 percent. The publication of Basel I marked a milestone in the efforts towards the formal establishment of international banking supervisory framework. Since then, the framework has been progressively introduced

① BCBS made the following requirements for hybrid capital instruments: issued and fully paid-up, unsecured, not redeemable at the initiative of the holder and so on.

in virtually over 100 countries.

Basel Ⅱ Entailed a More Comprehensive Supervisory Framework with Three Reinforcing Pillars

Basel I recognized the great importance of capital, however, the accord failed to cover enough risky financial activities, banks' credit-risk portfolios failed to be well diversified, and the regulatory capital standards still lacked risk-sensitivity. Furthermore, the high pace of financial innovations threw light into deficiencies of Basel I for incurring regulatory arbitrage. Consequently, BCBS proposed revisions to Basel I and released *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* in 2004, popularly known as the new Basel Accord, or Basel II.

On the basis of risk management and risk measurement, Basel II developed a new supervisory framework, which comprised three reinforcing pillars: minimum capital requirement, supervisory review process and market discipline. Pillar 1 introduced the Internal Ratings Based (IRB) Approach to measure credit risk, representing a fundamental shift from a standardized set of risk weights, which were pre-decided by supervisors. Pillar 1 set out explicit regulatory capital charges against market risk and operational risk, in addition to credit risk. It also strengthened the risk capture of the capital framework, in particular for trading book and securitisation exposures. Under Pillar 2, supervisors were charged with responsibilities of reviewing and assessing banks' internal management practices. Pillar 3 required banks to disclose in a timely and appropriate manner the capital adequacy, risk assessment, management practices and etc.. Given that Basel II brought CAR into closer alignment with risk management practices, it achieved broad endorsements among international organizations and supervisory authorities. Currently, many jurisdictions are launching Basel II.

The Amendment to Basel Ⅱ Formulated Higher Regulatory Standards on Off-Balance Sheet Business and Securitisation Exposures

The recent global financial crisis revealed the weakness of Basel II, under which the capital requirements for off-balance sheet exposures and securitisation exposures appeared inadequate. To address these weaknesses, BCBS announced an amendment to the new Basel Accord in 2009. In the amendment, banks were required to apply much higher risk weights to securitisation exposures, especially to resecuritisation exposures. The Committee laid great importance on supervision of the banks' overall risk management, and promoted more rigorous standards on risk concentration, off-balance sheet exposures, reputation risk, etc.. Also the Committee supplemented the disclosure requirements for securitisation, trading activities and off-balance sheet exposures in detail, and imposed a "stressed value-at-risk" approach. In addition, BCBS released *Principles for Sound*

Stress Testing Practice and Supervision, a comprehensive framework covering stress-testing methodologies, scenario selections and applications. The principles placed great emphasis upon the integrity of stress testing with overall risk management of the bank.

Basel Ⅲ is Implemented to Strengthen Capital and Liquidity Supervision

In light of the recent global financial crisis, the international society has reached a common understanding to reform the existing financial supervision, so as to strengthen the soundness of the financial sector. As part of financial supervisory reform navigated by G20, BCBS takes the responsibility to establish new benchmarks of international banking supervision. On December 12th 2010, BCBS officially issued *A Global Regulatory Framework for More Resilient Banks and Banking System* and *International Framework for Liquidity Risk Management, Standards and Monitoring*, referred to as Basel Ⅲ. Basel Ⅲ reforms to strengthen capital and liquidity rules, with the goal of promoting a more comprehensive banking supervisory system.

Main Contents of Basel Ⅲ

The fundamental reforms embodied in Basel Ⅲ are rigorous and exercisable. Besides the strengthened micro-prudential supervision, Basel Ⅲ also introduces a macro-prudential focus, to address the weaknesses in systemic risk management. It is believed that Basel Ⅲ will assist to raise the quality of banks' capital base, improve banks' liquidity management, promote risk resilience of the whole banking sector, and continuously bolster the momentum of the global macro-economy.

Raising Capital Supervisory Requirements

The banking sector in major developed countries maintained an insufficient level of high quality capital, which could not absorb losses efficiently. In response to these shortcomings, Basel Ⅲ narrows the definition of capital, ensuring that the dominant form of capital must be common equity and retained earnings. Criteria for classification as common equity, Tier 1 capital and Tier 2 capital are standardized, and Tier 3 capital instruments, which were only available to cover market risks, are eliminated. To ensure the loss absorbency of regulatory capital, Basel Ⅲ applies eight deductions from the common equity capital, including minority interests, goodwill and other intangibles, deferred tax assets, significant investments in the capital of financial entities that are outside the scope of regulatory consolidation, etc..

To strengthen risk coverage of the capital framework, and capture potential off-balance sheet risks, Basel Ⅲ significantly raises capital requirements for counterparty credit risk, and imposes a capital charge for potential mark-to-market losses associated with a credit value adjustment (CVA). In addition, BCBS is supporting the efforts of other international organizations, such as CPSS, to establish standards for CCPs. The capitalization of bank exposures to CCPs will be based in part on the compliance of the CCPs with such standards.

These criteria, together with higher capital requirements for bilateral OTC derivative exposures, will create strong incentives for banks to transfer OTC derivative exposures to CCPs.

Meanwhile, Basel Ⅲ tightens the minimum regulatory capital requirements. Common Equity Tier 1 (Common Equity Tier1 Capital / Risk-weighted Assets) is raised from 2 percent to at least 4.5 percent; Tier 1 Capital is lifted from 4 percent to 6 percent, while Total Capital remains to be 8 percent of risk-weighted assets. Above the regulatory minimum capital requirement, a capital conservation buffer of 2.5 percent, comprised of Common Equity Tier 1, is established, lifting the actual total capital requirement to 10.5 percent.

Establishing an International Framework for Liquidity Regulation

During the recent financial crisis, many banks, despite adequate capital levels, still experienced severe stress, because the liquidity evaporated quickly in face of the rapid reversal in market conditions. To promote better liquidity risk management, Basel Ⅲ develops a set of liquidity risk monitoring tools and two quantitative standards—Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Basel Ⅲ also enhances cross-border supervisory coordination and information sharing, aimed at identifying liquidity risk more efficiently, and promoting resilience of the banking sector under an international liquidity stress.

LCR, stock of high-quality liquid assets/ total net cash outflows over the next 30 calendar days reflects a bank's short-term funding capability under a significant stress scenario. The numerator of LCR is a stock of unencumbered high-quality liquid assets, including cash, high-liquidity marketable securities, etc.. The denominator of LCR is defined as the total expected cash outflows minus total expected cash inflows. The value of LCR should be no lower than 100 percent, to ensure that a bank holds sufficient high-quality liquid assets as a defense against short-term liquidity risk.

NSFR, available amount of stable funding/ required amount of stable funding identifies a bank's long-term funding capabilities. The numerator of NSFR is the amount of equity and liability financing expected to be reliable over a one-year time horizon, while the denominator of NSFR is the long-term liquidity characteristics of a bank's various assets. NSFR is structured to be greater than 100 percent, to ensure that a bank holds required amounts of stable funding for assets, and could answer the potential calls on liquidity arising from off-balance sheet commitments. NSFR provides a more sustainable maturity structure of assets and liabilities, and promotes long-term risk resilience of a bank's liquidity profiles.

In addition to the two regulatory standards above, Basel Ⅲ outlines a set of liquidity monitoring tools. Contractual maturity mismatch indicates how much liquidity a bank would require in specific time period. Concentration of funding is meant to identify counterparties or financial instruments of significance, so as to encourage the diversification of funding sources. Available unencumbered assets indicate assets that can be used as collaterals to raise funding in secondary markets or are eligible at central banks.

Enforcing Market Discipline and Corporate Governance

Basel Ⅲ addresses banks' reliance on external credit ratings through strict requirements for use of external credit assessment institutions (ECAIs). The requirements include incorporation of IOSCO's *Code of Conduct Fundamentals for Credit Rating Agencies*, and reduction of cliff effects[①] arising from credit risk mitigation. Banks are not allowed either to change ECAIs totally at discretion, or to "cherry-pick" the assessments provided by different ECAIs. ECAIs are required to fully disclose the credit assessment procedures under the securitisation framework.

BCBS issued *Principles for Enhancing Corporate Governance*, setting forth principles to promote sound corporate governance practices in banking sector. The key principles are highlighted below: the board should actively carry out the overall responsibility for the bank, and provide effective oversight of senior management; the board should exercise independent and objective judgments, and maintain appropriate qualifications and competence; the board of the parent company should extend adequate corporate governance across the group; the bank should maintain an independent risk management function with sufficient authority; supervisors should perform comprehensive evaluations of a bank's overall corporate governance, and require effective remedial to address material deficiencies in a bank's corporate governance practices. In addition, BCBS requests banks to design compensation systems consistent with their long-term strategies. Banks should provide compensation incentives symmetric with risk outcomes, and take efforts to diminish imprudent risk takings incurred by inappropriate compensation payouts. The compensation schedule should be structured more independently and professionally. The board should be responsible for the overall design and operation of the compensation system for the entire bank.

Reducing Procyclicality of the Banking Sector

One of the most destabilizing elements of the crisis has been the procyclical amplification throughout the banking sector. To make banks more resilient to such procyclical dynamics, Basel Ⅲ introduces a number of measures,

① Cliff effect occurs from rating cut-offs of guarantors, which may cause capital requirement surge and aggravate the procyclicality.

including conservative capital buffers, leverage ratio requirement, and forward-looking provisions.

Basel Ⅲ sets a new international regulatory capital standard - capital conservation buffer. The capital conversation buffer of 2.5 percent, comprised of Common Equity Tier1, is established above the regulatory minimum capital requirement. Capital distribution constraints will be imposed on a bank when its capital level falls within this range, which stimulates the bank to rebuild capital internally. Implementation of this standard will promote the build-up of adequate capital buffers, which can be drawn down in periods of stress and help increase sector resilience in a downturn period.

To prevent systemic risk preceded by excess aggregate credit growth, Basel Ⅲ brings in the countercyclical buffer regime, which aims to smooth the credit cycle by imposing capital constraints on credit availability. When excess aggregate credit growth is judged to be associated with a build-up of system-wide risk, banks will be subject to a countercyclical buffer requirement based on derivation of the credit-to-GDP ratio from its long-term trend. The requirement, comprised of Common Equity Tier1, varies between zero and 2.5 percent to total risk-weighted assets. When credit cycle reverses in downturn, the buffer will be released, to ensure that banks have sufficient capital to sustain credit availability.

As witnessed during the recent financial crisis, the banking sector was forced to reduce leverage in a manner that amplified downward pressure on asset prices, further exacerbating losses. Basel Ⅲ therefore introduces a 3 percent leverage ratio requirement (Tier 1 capital /Total exposures), as a supplementary measure to the capital requirement, and migrates this requirement to a pillar 1 treatment. The leverage ratio constrains leverage in banking sector, thus helping restrict excessive on/offbalance sheet exposures, and mitigate the risk of destabilizing deleveraging processes, which can damage the financial system and the economy.

Meanwhile, BCBS is updating its supervisory guidance. Such guidance will promote the forward-looking provisioning practices based on expected loss instead of incurred loss. BCBS also supports the initiative of IASB to change accounting standards towards an expected loss approach, which will reduce the procyclicality of the current approach.

Addressing Systemic Risk and Interconnectedness

Systemically important banks (SIBs) play an important role in economy. Extensive interconnectedness among them will transmit shocks across the financial system and real economy, and then destabilize the whole economy. In addition, there are moral hazard risks posed by the “Too Big to Fail” problem, thus SIB supervision should be intensified. Under Basel Ⅲ, SIBs are requested to have additional loss absorbing capacity beyond the minimum capital standards, and the work on this issue is ongoing. Besides, BCBS is exploring further measures to mitigate the risks and externalities associated with SIBs, including additional liquidity requirements, tighter large exposure restrictions, etc..

Under the Basel Ⅲ framework, BCBS is conducting a study of contingent capital, a well-integrated approach to enhance the additional loss absorbing capacity of SIBs. First of all, when the relevant authority in a jurisdiction determines that an institution has reached the point of non-viability or a public sector injection of capital is determined, all non-common equities must have the features to be converted into equity or be written-off. Moreover, a going-concern contingent capital mechanism could be established. The contractual contingent capital instruments may be converted into equity fully or partially on the occurrence of a contractually specified trigger (ie, CAR reaches a certain level), so as to recapitalise the bank. Lastly, a bail-in regime should be introduced. When a bank reaches the point of gone concern, authorities may write down or convert into equity the bail-in debts according to the ex ante terms, so as to release the bank's debt burden or recapitalise the bank, which in return restores the bank's viability.

Designing a Cross-border Bank Resolution Framework

BCBS identified the lessons learned from bank resolution during the recent financial crisis, and published *Report and Recommendations of the Cross-border Bank Resolution Group*. The report makes recommendations aimed at improving the efficiency of cross-border resolution and addressing the associated systemic risks. The recommendations list as follows. Firstly, ensure effective national resolution powers on cross-border banks. National authorities should have appropriate measures or tools to deal with all banks in difficulties, so that an orderly resolution can be achieved to maintain financial stability. Secondly, plan in advance against crisis. Global SIBs and national authorities should have contingency plans to address severe financial distress or financial instability. The plans should be capable of providing information critical to national authorities during severe financial distress and assisting their evaluation of possible resolution plans. Finally, strengthen risk mitigation mechanisms. Jurisdictions should promote the use of risk mitigation techniques to reduce the risk of contagion in a crisis. Such risk mitigation techniques may include enforceable netting agreements, collateralization, regulated central counterparties, etc..

Implications of Basel Ⅲ

The practices outlined in Basel Ⅲ trace the philosophy of bank supervision under Basel Ⅰ and Basel Ⅱ. Basel Ⅲ lies in the wake of the recent financial crisis, and acts as a conceptual leap in banking regulation. It enriches the content of regulatory capital, raises both quantity and quality of the regulatory capital base, supplements the capital adequacy requirement with a leverage ratio, and embodies the combination of micro- and macro-prudential supervision. Tracking the current Basel regulatory reform and learning from experiences embodied in Basel Ⅲ is of great importance to promote the soundness of China's banking sector.

The Macro-prudential Element is the Inherent requirement of Systemic Risk Prevention

The recent global financial crisis has revealed that soundness of individual financial institutions does not necessarily sum up to the soundness of the whole financial system. During the downturn, crisis may be further amplified due to procyclicality in the financial system. Basel Ⅲ, marking a new stage beyond micro-prudential supervision, has brought in a macro-prudential perspective. The reform, which converges reconsiderations of the international community about the recent crisis, is of great importance to effectively prevent systemic risk and increase system resilience.

At present, China's banking sector has achieved significant strides, but is still confronted with challenges to address systemic risk. On one hand, domestic credit continuously expands, excess liquidity issue stands out and inflationary pressure increases. On the other hand, there is a boom of cross-market and cross-border financial activities or financial products, and consequently, the existing supervisory regime, in which a group of supervisors enforce their duties by business sector, is confronted with increasing challenges. In light of the current situation, it is necessary to design the macro-prudential framework in china, in virtue of both Basel Ⅲ and jurisdictional discretion. To address the procyclicality in financial system, we should establish a counter-cyclical dynamic adjustment mechanism, by implementing the dynamic adjustment of differentiated reserve requirement to respond to extraordinary credit surge. This innovative approach may complement traditional monetary policy instruments and contribute to the timely and flexible countercyclical macro-economic adjustment. To address interconnectedness among financial institutions, effectiveness of SIBs supervision should be emphasized by imposing more prudential requirements on capital adequacy and liquidity, reinforcing risk management and corporate governance, and reducing risk concentration. Meanwhile, it is expected to improve the analysis, monitoring and assessment of the overall financial system, establish a forward-looking risk warning system, and foster greater harmonization between macro-prudential management and micro-prudential supervision.

Strengthened Micro-prudential Supervision is the Cornerstone to Promote soundness of the Banking Sector

When designing the capital and liquidity regulatory reform package, Basel Ⅲ inherits the soul of previous Basel Accords of minimum regulatory capital requirement, tightens the definition of capital, enhances the risk coverage, and introduces a leverage ratio, as well as new liquidity rules. All these measures provide meaningful guidance to promote soundness of individual banks, and also strengthen risk resilience of the overall banking sector.

As for China, we should learn from the valuable experiences of the micro-prudential supervision reform under Basel Ⅲ. To address issues like “scale emphasized, management neglected”, irrational expansion, etc., we should strengthen micro-prudential supervision, nourish banks’ inner impetus, impose capital constraints and raise liquidity requirements. Moreover, financial innovations and intermediary businesses, which are capital saving, should be encouraged, to achieve a harmonious and sustainable development between scale and benefit.

Basel Ⅲ Implementation Should be Effectively Launched in a Coordinated and Orderly Way

Besides capital and liquidity regulatory standards in banking sector, the package of Basel Ⅲ also covers other aspects in financial system, such as refinements of accounting standards, CCP arrangement, reforms of external credit ratings and so on. In the future, BCBS will continue to evaluate the impact of new regulatory rules on the real economy and financial system, cross check the quantitative impact studies, monitor the new regulatory indicators during transition periods, and conducts impact assessments of Basel Ⅲ on trade finance, external credit ratings, etc.. To foster harmonization and convergence among international regulatory requirements, BCBS needs to continue dialogues with CPSS, IOSCO and IASB.

It will be a systemic project to implement Basel Ⅲ in China, which should be launched in a coordinated and orderly way. Efforts are required to track the impact of reforms on macro-economy and the financial system, modernize financial infrastructures, encourage capital instrument innovations, fill financial market with vigor, broaden capital replenishment channels, promote standardization of credit transfer market and speed up securitisation. It is also expected to polish up the inter-bank market clearing system, encourage CCP transactions instead of OTC derivatives exposures, ensure financial consumer protection, accelerate the introduction of deposit insurance, enhance the effectiveness of market exit mechanism and resolution regime, and improve both accounting standards and external credit rating systems.

Appendix Ⅰ

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

In 2010, China's banking sector continued to maintain sound performance with its asset scale, profits and risk management steadily improved, capital adequacy further enhanced, and strongly supported the sound and rapid economic development. In order to make analysis of the operational condition of the banking sector and identify related risks as soon as possible, we selected the 17 major commercial banks[①] (hereafter referred to as major commercial banks) with their assets accounting for 64.84 percent of the total assets in banking institutions[②], and conducted a quantitative analysis in terms of profitability, assets, liabilities, capital and liquidity[③].

Profitability Analysis

Breakdown Analysis of ROE

In 2010, the ROE of the major commercial banks registered 20.22 percent, up almost 1.14 percentage points than that recorded in 2009. The breakdown analysis showed that the increase of ROE was primarily attributed to the increase of profit margin (Table B1.1), as well as the decrease of risk-adjusted returns and leverage ratio, slight increase of operational risks, indicating that the profitability of the banking sector enhanced, soundness improved, whereas operational risks slightly increased.

Table B1.1 ROE Breakdown of the 17 Major Commercial Banks

	Profit Margin (*percent*)		Risk-adjusted Return (*percent*)		Operational Risk (*percent*)		Leverage Ratio		ROE (*percent*)	
	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010
17 Major Commercial Banks	28.13	30.28	6.97	6.87	54.33	54.68	17.92	17.77	19.08	20.22
5 Large Commercial Banks	30.26	32.69	6.91	6.75	53.19	53.22	17.30	17.34	19.25	20.37
12 Joint-stock Commercial Banks	21.59	23.65	7.14	7.23	58.31	59.47	20.48	19.36	18.40	19.67

Note: $$\text{ROE}=\frac{\text{Net Profits after Tax}}{\text{Operating Income}}\times\frac{\text{Operating Income}}{\text{Average Risk-weighted Assets}}\times\frac{\text{Average Risk-weighted Assets}}{\text{Average Total Assets}}\times\frac{\text{Average Total Assets}}{\text{Average Owner's Equity}}$$

$$=\text{Profit Margin}\times\text{Risk-adjusted Return}\times\text{Operational Risks}\times\text{Leverage Ratio}$$

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

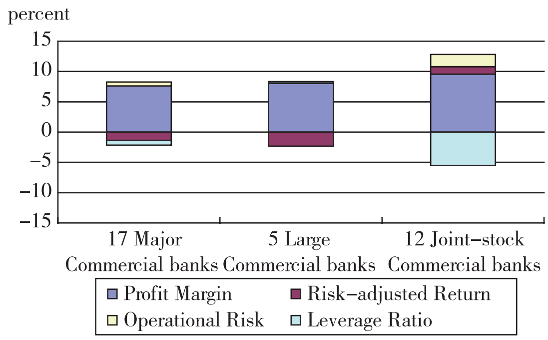
② Including policy banks, state-owned commercial banks, JSCBs, city commercial banks, rural commercial banks, rural cooperative banks, foreign banks, UCCs, RCCs, non-banking financial institutions (TICs, finance companies, finance leasing companies, auto finance companies and money brokerage companies),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

③ Source: PBC, CBRC, aggregate data at the legal person level.

The comparison suggested that the large commercial banks' ROE was higher than that of the JSCBs. In terms of the ROE breakdown analysis, the former had almost 40 percent higher profit margin than that of the latter, but lower risk-adjusted returns, operational risks and leverage ratio. Hence the JSCBs should further enhance their operational efficiency and reduce financial risk, while large commercial banks should improve risk management and enhance operational soundness.

Figure B1.1 described the fluctuation in the ROE breakdown of the 17 major commercial banks from 2009 to 2010 by dividing the banks into 2 groups, i.e., the large commercial banks and the JSCBs. The vertical axis showed the changes in the items compared with those recorded in 2009. The analysis concluded that, in 2010, the major commercial banks saw a rapid increase of profit margin, a slight increase of operational risks and fall of risk-adjusted returns and leverage ratio. In particular, the large commercial banks experienced a large increase of profit margin and a slight fall of risk-adjusted return,while the JSCBs saw a continuous rapid increase of profit margin, a slight increase of operational risks and risk-adjusted returns, a large decrease of leverage ratio.

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



Income Structure Analysis

In 2010, the major commercial banks' net operating income amounted to RMB 1 696.454 billion yuan, up 25.85 percent y-o-y. In particular, the net income of large commercial banks increased by 23.41 percent to RMB 1 314.943 billion yuan, while that of the JSCBs increased by 35.03 percent to RMB 381.511 billion yuan (Table B1.2).

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	
		2009	2010	2009	2010	2009	2010
Balance (100 million of RMB yuan)	Net interest income	7 234.82	10 017.40	5 322.06	7 201.52	1 912.76	2 815.88
	Net fee and commission income	2 055.84	2 745.14	1 754.69	2 324.91	301.15	420.23
	Investment income	3 748.05	3 909.40	3 240.37	3 404.40	507.67	505.00
	Other business income	441.75	292.60	337.91	218.60	103.84	74.00
	Net operating income	13 480.45	16 964.54	10 655.03	13 149.43	2 825.42	3 815.11
Proportion (percent)	Net interest income	53.67	59.05	49.95	54.77	67.69	73.81
	Net fee and commission income	15.25	16.18	16.46	17.68	10.66	11.01
	Investment income	27.8	23.04	30.41	25.89	17.97	13.24
	Other business income	3.28	1.73	3.18	1.66	3.68	1.94
	Net operating income	100.00	100.00	100.00	100.00	100.00	100.00

In 2010, the net interest margin of the major commercial banks expanded, the net interest income increased 38.49 percent, accounting for 59.05 percent of the net operating income, up 5.38 percentage points y-o-y, which remained the major source of operating income. The net fee and commission income of commercial banks accounted for 16.18 percent, up 0.93 percentage points y-o-y, the investment income accounted for 23.04 percent, down 4.76 percentage points y-o-y. In particular, the growth rate of net interest income of the large commercial banks and the JSCBs was 35.31 and 47.22 percent respectively, the proportion in net interest income of the large commercial banks and the JSCBs increased by 4.82 and 6.12 percentage points respectively y-o-y.

In 2010, the intermediate business income of the major commercial banks grew at a faster pace. In particular, the net fee and commission income increased by 33.53 percent y-o-y, the growth rate of the large commercial banks and the JSCBs were 32.5 and 39.54 percent respectively. The proportion of net fee and commission income in net operating income of the major commercial banks reached 16.18 percent, up 0.93 percentage points. In particular, the growth rate of the large commercial banks and the JSCBs increased by 1.22 and 0.35 percentage points y-o-y respectively, keeping growing in the latest 4 years. But the proportion of net fee and commissions in operating income of the JSCBs was still 6.67 percentage points lower than that of the large commercial banks, the gap was continuously expanding.

In 2010, the inter-bank market remained vigorously. The curve of bond yield flattened with an upward trend. The commercial banks' income from both overseas and domestic investments kept stable, the investment income of the major commercial banks increased by 4.31 percent y-o-y, in particular, the bond investment income rose by 7.57 percent and the equity investment income dropped by 16 percent. In 2010, the investment income of the large commercial banks increased by 5.06 percent while that of the JSCBs declined 0.53 percent, the proportion of investment income in operating income of the major commercial banks declined by 4.76 percentage points y-o-y, in particular, the large commercial banks and the JSCBs declined 4.52 and 4.73 percentage points respectively.

Cost Structure Analysis

In 2010, the operating cost① of the major commercial banks amounted to RMB 689.309 billion yuan, increasing by 16.51 percent. In particular, the operating cost of the large commercial banks increased by 15.39 percent to RMB 520.476 billion yuan, and that of the JSCBs rose by 20.11 percent to RMB 168.834 billion yuan.

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

In 2010, the cost/income ratio[①] of the major commercial banks was 34.66 percent, down 3.08 percentage points from the previous year. In particular, the cost/income ratio of the large commercial banks declined by 2.57 percentage points to 33.84 percent, and that of the JSCBs declined by 5.25 percentage points to 37.51 percent. In 2010, the cost/income ratio of the major commercial banks slightly dropped from last year, showed that the cost management efficiency of the major commercial banks was further enhanced (Figure B1.2). The net operating income grew faster than the net operating cost, in particular, the growth rates of net operating income of the large commercial banks and the JSCBs were 9.3 and 14.9 percentage points higher than those of the net operating cost of them respectively, the profitability was substantially improved (Figure B1.3).

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

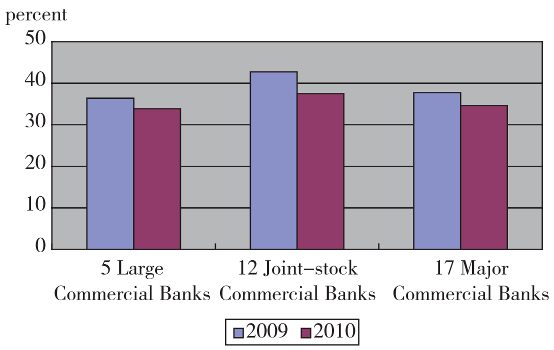
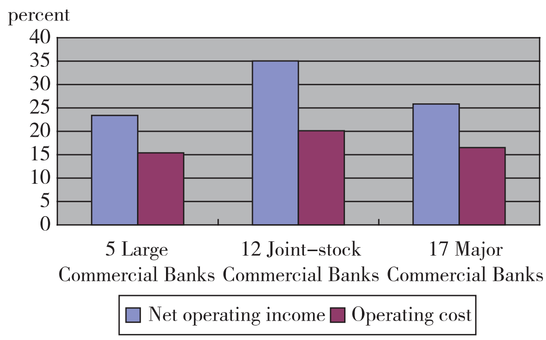


Figure B1.3 Growth of Net Operating Income and Operating Cost of the 17 Major Commercial Banks



Asset Analysis

The Scale and Structure of Total Assets

In 2010, the total assets of commercial banks maintained a stable growth. As of the end of the year, the total assets of the 17 major commercial banks amounted to RMB 61.8 trillion yuan, increasing by 17.45 percent, accounting for 64.84 percent of the total assets of banking institutions. In particular, the assets of the large commercial banks totaled RMB 46.89 trillion yuan, increasing by 14.93 percent; the assets of the JSCBs totaled RMB 14.9 trillion yuan, increasing by 26.06 percent.

In terms of the assets structure, loans and investments were still the main constituents of the total assets, accounting for more than 70 percent. In 2010, the share of deposits in the central bank in total assets of the

① Cost/income ratio = (operating cost−business tax and additions) / (net interest income + net fee and commission income +other business income + investment income) × 100%

major commercial banks increased by 1.26 percentage points y-o-y, while the share of outstanding loans in total assets continuously rose, increasing by 1.62 percentage points y-o-y. the share of trade finance increased by 0.74 percentage points y-o-y, the share of interbank deposits declined by 0.16 percentage points y-o-y, the share of repurchase of assets declined by 0.27 percentage points y-o-y, the share of investment in total assets, which kept declining for 3 consecutive years, decreased by 2.13 percentage points in 2010 (Table B1.3).

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

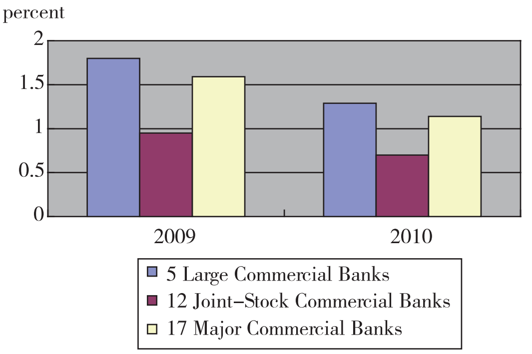
	Balance (RMB 100 milllion yuan)		As a percentage of total assets (percent)	
	2009	2010	2009	2010
Deposit in the central bank	72 946.91	93 423.88	13.86	15.12
Inter-bank deposits	9 376.38	15 819.61	1.78	2.56
Loans	246 998.56	300 073.85	46.94	48.56
Discount	16 647.5	7 686.39	3.16	1.24
Trade finance	9 849.38	16 149.52	1.87	2.61
Inter-bank lending	7 245.52	7 547.67	1.38	1.22
Investment	127 942.33	137 159.99	24.32	22.19
Repurchase of assets	28 330.51	31 572.83	5.38	5.11
Others	6 841.87	8 546.91	1.30	1.38
Total assets	526 178.96	617 980.65	100.0	100.00

The Scale and Quality of Loans

As of the end of 2010, outstanding loans of the major commercial banks reached RMB 32.39 trillion yuan, increased by RMB 5.04 trillion yuan or 18.43 percent y-o-y. In particular, outstanding loans of the large commercial banks rose by 17.68 percent to RMB 24.3 trillion yuan, and that of the JSCBs increased by 20.57 percent to RMB 8.09 trillion yuan.

As of the end of 2010, outstanding NPLs of the major commercial banks amounted to RMB 369.096 billion yuan, decreasing by RMB 66.7 billion yuan y-o-y. The NPL ratio registered 1.14 percent, down 0.45 percentage points y-o-y. In particular, the NPL ratio for the large commercial banks was 1.29 percent, down 0.51 percentage points, the NPL ratio for the JSCBs was 0.7 percent, down 0.25 percentage points (Figure B1.4).

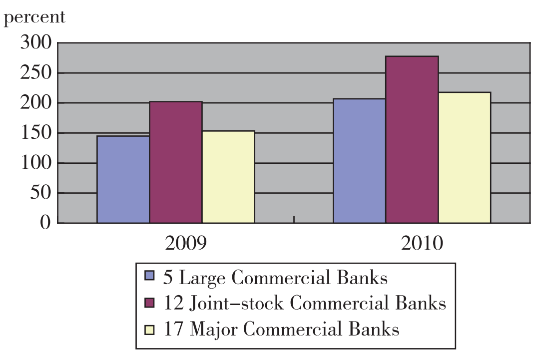
Figure B1.4 NPL Ratio of the 17 Major Commercial Banks



Provision Coverage Ratio[1]

In 2010, the provision coverage ratio of the major commercial banks maintained high level and kept growing, reached 217.66 percent at the end of 2010, up 64.41 percentage points y-o-y. In particular, the provision coverage ratio of the large commercial banks rose by 61.92 percentage points to 206.81 percent, and that of the JSCBs increased 75.6 percentage points to 277.6 percent (Figure B1.5).

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



Liabilities, Capital and Liquidity

The Scale and Structure of Liabilities

By the end of 2010, the total liabilities of the 17 major commercial banks totaled RMB 58.12 trillion yuan, increasing by 16.57 percent y-o-y, accounting for 64.96 percent of the total liabilities of financial institutions. In particular, the liabilities of the large commercial banks accounted for 49.21 percent, down 2.21 percentage points y-o-y, and that of the JSCBs accounted for 15.74 percent, up 0.75 percentage points y-o-y.

By the end of 2010, deposits of the major commercial banks totaled RMB 49.96 trillion yuan, increasing by 17.61 percentage y-o-y. In particular, corporate deposits rose by 19.06 percent, with a drop of 14.47 percentage points in the growth rate; household savings rose by 13.52 percent, with a drop of 6.64 percentage points in the growth rate. With the implementation of prudent monetary policy, although the growth rate of deposits and loans both gradually slowed down from the last year's high level, the growth rate of deposits declined, the enterprises had still sufficient funds as a whole. Corporate deposits and household savings accounted of the major commercial banks for 80 percent in the total liabilities, decreasing by 1.22 percentage points y-o-y.

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

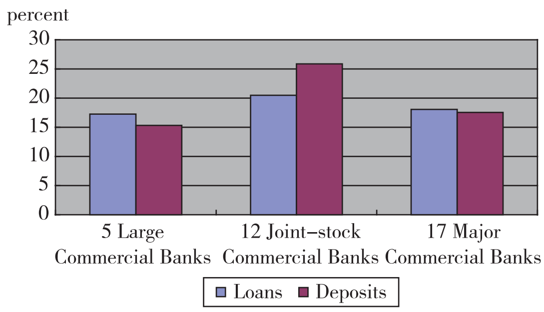
Capital and CAR

By the end of 2010, all the 17 major commercial banks had met the CAR requirement of CBRC. The overall CCAR and CAR of the major commercial banks were 9.62 and 11.8 percent, increasing by 0.91 and 0.8 percentage points. With the banks' growing scale of financing from stock and bond markets in 2010, the net capital of the major commercial banks increased substantially, by the end of 2010, the net capital of the major commercial banks amounted to RMB 4.08 trillion yuan, grew by RMB 0.94 trillion yuan or 30 percent y-o-y.

Liquidity

In 2010, loans of the large commercial banks grew faster than their deposits while deposits of the JSCBs grew faster than the loans (Figure B1.6). By the end of 2010, the loan/deposit ratio of the major commercial banks recorded 64.83 percent, keeping equivalent to the previous year. The liquidity ratio① was 41 percent, up 0.3 percentage points, RMB excess reserve ratio recorded 2.56 percent, down 0.57 percentage points, the overall liquidity was still sufficient.

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



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

Appendix II

Statistics

Table B2.1 Selected Economic Indicators

(Year-end Balance)

Items	2006	2007	2008	2009	2010
Gross Domestic Product (100 million of RMB yuan)	211 923	249 530	300 670	335 353	397 983
Industrial Value Added	90 351.0	107 367.0	129 112.0	134 625.0	160 030.0
Fixed Asset Investment (100 million of RMB yuan)	109 998.2	137 239.0	172 291.0	224 846.0	278 140.0
Retail Sales of Consumer Goods (100 million of RMB yuan)	76 410.0	89 210.0	108 488.0	125 343.0	156 998.0
Urban	51 542.6	60 411.0	73 735.0	85 133.0	136 123.0
County & Below (Rural)	24 867.4	28 799.0	34 753.0	40 210.0	20 875.0
Export & Import (100 million of USD)	17 604.0	21 738.0	25 616.0	22 072.0	29 728.0
Export	9 689.4	12 180.0	14 285.0	12 017.0	15 779.0
Import	7 914.6	9 558.0	11 331.0	10 056.0	13 948.0
Balance	1 774.8	2 622.0	2 955.0	1 961.0	1 831.0
Foreign Direct Investment (100 million of USD)	694.7	748.0	924.0	900.0	1 057.0
Foreign Exchange Reserve (100 million of USD)	10 663.4	15 282.5	19 460.3	23 991.5	28 473.4
Consumer Price Index (previous year = 100)	101.5	104.8	105.9	99.3	103.3
Fiscal Revenue(100 million of RMB yuan)	38 760.2	51 304.0	61 316.9	68 476.9	83 080.3
Fiscal Expenditure(100 million of RMB yuan)	40 422.7	49 565.4	62 427.0	75 873.6	89 575.4
Fiscal Balance(100 million of RMB yuan)	–2 162.5	1 738.6	–1 110.1	–7 396.7	–6 495.1
Per Capita Urban Residents Dispensable Income (yuan)	11 759.0	13 786.0	15 781.0	17 175.0	19 109.0
Per Capita Rural Residents Net Income (yuan)	3 587.0	4 140.0	4 761.0	5 153.0	5 919.0
Number of Employed Persons in Urban Area (million)	283.10	293.50	302.10	311.20	—
Registered Unemployment Rate in Urban Area (percent)	4.1	4.0	4.2	4.3	4.1
Total Population (million)	1 314.48	1 321.29	1 328.02	1 334.74	1 339.72

Note: Since 2010, the new grouping method is adopted by NBS on the Ratail Sales of Consumer Goods: according to the location of outlets, groups "urban" and "county & below" change to "urban" and "rural".

Source: ① Calculated based on data from "China Statistical Yearbook", "Statistical Communique of The People's Republic of China on the National Economic and Social Development" and other related materials.

② Data of 2010 was from "Statistical Communique of the People's Republic of China on the 2010 National Economic and Social Development", "Report on the Implementation of the Central and Local Budgets for 2010 and on the Draft of Central and Local Budgets for 2011" and "2010 Sixth National population census data Gazette".

Table B2.2 Selected Financial Indicators (1)

(Year-end Balance)

(100 million of RMB yuan)

Items	2006	2007	2008	2009	2010
Money & Quasi-money (M_2)	345 603.6	403 442.2	475 166.6	606 225.0	725 851.8
Money (M_1)	126 035.1	152 560.1	166 217.1	220 001.5	266 621.5
Currency in Circulation (M_0)	27 072.6	30 375.2	34 219.0	38 246.0	44 628.2
Total Deposits with Financial Institutions	335 459.8	389 371.2	466 203.3	597 741.1	718 237.9
Urban & Rural Household Deposits	161 587.3	172 534.2	217 885.4	260 771.7	303 302.5
Enterprise Deposits	113 239.0	138 673.7	157 632.2	217 110.0	244 495.6
Total Lending by Financial Institutions	225 347.2	261 690.9	303 394.6	399 684.8	479 195.6

Source: PBC.

Table B2.3 Selected Financial Indicators (2)

(Growth Rates)

(percent)

Items	2006	2007	2008	2009	2010
Money & Quasi-money (M_2)	16.95	16.74	17.82	27.68	19.73
Money (M_1)	17.49	21.05	9.06	32.35	21.19
Currency in Circulation (M_0)	12.65	12.20	12.65	11.77	16.69
Total Deposits with Financial Institutions	16.83	16.07	19.73	28.21	20.16
Urban & Rural Household Deposits	14.56	6.77	26.29	19.68	16.31
Enterprise Deposits	17.78	22.46	13.67	37.73	12.61
Total Lending by Financial Institutions	15.10	16.10	18.73	31.74	19.89

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

Source: PBC.

Table B2.4 International Liquidity

(millions of USD)

Items	2006	2007	2008	2009	2010
Total Reserves (minus gold)	1 068 538	1 530 279.24	1 949 260	2 414 131	2 862 276
Special Drawing Rights (SDRs)	1 113	1 191	1 199	12 510	12 345
Reserve Positions in IMF	1 081	839	2 031	2 469	2 593
Foreign Exchange	1 066 344	1 528 249	1 946 030	2 399 152	2 847 338
Gold (millions of ounce)	19.29	19.29	19.29	33.89	33.89
Gold (national valuation)	4 074	4 074	4 074	9 815	9 815
Foreign Liabilities of Other Depository Companies	531 724	82 676	75 255	88 146	108 406

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

Source: PBC.

Table B2.5 Gold and Foreign Exchange Reserves

Year	Gold Reserves (10 thousand of ounce)	Foreign Exchange Reserves (100 million of USD)	Change in Foreign Exchange Reserves (percent)
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

Note: PBC made adjustment to data of gold reserves in December 2001, December 2002 and April 2009.

Source: PBC.

Table B2.6 Assets of China's Financial Sector

(Including foreign currencies)

(December 31, 2010)

(trillions of RMB yuan)

Items	Balance
Financial Sector	128.25
Central Bank	25.93
Banking Financial Institutions	95.30
Securities Financial Institutions	1.97
Insurance Financial Institutions	5.05

Note：Securities Financial Institutions only include securities companies.

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

Table B2.7 Depository Corporations Survey in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter4
Net Foreign Assets	202 280.0	207 272.6	215 974.1	226 045.0
Domestic Credit	521 017.5	540 682.5	559 825.4	587 324.0
Claims on Governments (net)	29 318.3	23 749.3	24 892.0	34 604.3
Claims on Non-financial Sectors	463 375.4	485 821.5	504 410.5	521 658.5
Claims on other Financial Sectors	28 323.9	31 111.7	30 522.9	31 061.3
Money & Quasi-money	649 947.5	673 921.7	696 471.5	725 851.8
Money	229 397.9	240 580.0	243 821.9	266 621.5
Currency in Circulation	39 080.6	38 904.9	41 854.4	44 628.2
Demand Deposits	190 317.4	201 675.2	201 967.5	221 993.4
Quasi-money	420 549.5	433 341.7	452 649.6	459 230.3
Time Deposits	122 943.7	131 674.0	142 865.5	143 232.1
Savings Deposits	280 350.3	287 474.1	299 136.4	303 093.0
Other Deposits	17 255.5	14 193.7	10 647.8	12 905.2
Deposits not Included in Broad Money	12 389.6	12 721.9	13 641.3	13 566.1
Bonds	53 417.6	55 230.3	58 304.8	59 105.2
Paid-in Capital	23 524.9	24 061.7	25 393.6	26 726.5
Other Items (net)	-15 982.0	-17 980.6	-18 011.7	-11 880.7

Notes: ① PBC began to compile Depository Corporations Survey since 2006. Depository Corporations Survey does not cover Trust Investment Company and Financial Lease Company, compared with former Banking Survey.

② Data of Other Deposits does not include margin deposits of Non-financial Companies since 2006.

Source: PBC.

Table B2.8 Balance Sheet of Monetary Authority in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	192 119.0	198 356.3	204 810.6	215 419.6
Foreign Exchange	182 310.8	188 704.0	195 222.5	206 766.7
Money Gold	669.8	669.8	669.8	669.8
Other Foreign Assets	9 138.3	8 982.5	8 918.3	7 983.1
Claims on Governments	15 625.9	15 621.2	15 551.9	15 421.1
Of Which: Central Government	15 625.9	15 621.2	15 551.9	15 421.1
Claims on Other Depository Corporations	8 618.2	8 966.5	9 136.4	9 485.7
Claims on Other Financial Corporations	11 514.6	11 498.5	11 465.8	11 325.8
Claims on Non-financial Corporations	44.0	44.0	44.0	25.0
Other Assets	8 169.1	8 445.5	7 675.3	7 597.7
Total Assets	**236 090.7**	**242 932.0**	**248 683.9**	**259 274.9**
Reserve Money	150 032.8	154 234.5	161 320.3	185 311.1
Currency Issuance	42 836.1	42 566.9	46 219.8	48 646.0
Deposits of Financial Corporations	107 196.8	111 667.6	115 100.5	136 665.1
Other Depository Corporations	107 057.7	111 506.4	114 945.7	136 480.9
Other Financial Corporations	139.1	161.2	154.8	184.2
Deposits of Non-financial Corporations	—	—	—	—
Demand Deposits	—	—	—	—
Deposits of Financial Corporations not Included in Reserve Money	649.6	612.4	639.6	657.2
Bond Issuance	43 442.3	46 975.2	44 005.2	40 497.2
Foreign Liabilities	746.7	719.1	715.7	720.1
Deposits of Government	23 251.0	31 023.0	32 458.8	24 277.3
Own Capital	219.8	219.8	219.8	219.8
Other Liabilities	17 748.5	9 148.1	9 324.5	7 592.2
Total Liabilities	**236 090.7**	**242 932.0**	**248 683.9**	**259 274.9**

Note: The category of Deposits of Financial Corporations not included in Reserve Money was added since 2008, meanwhile the category of Deposits of Non-financial Corporations and Demand Deposits was cancelled.

Source: PBC.

Table B2.9 Balance Sheet of Other Depository Corporations in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	16 958.0	16 310.3	18 575.3	18 524.8
Reserve Assets	109 344.9	114 018.8	117 271.5	136 835.0
Deposits with Central Bank	105 589.4	110 356.7	112 906.1	132 817.1
Cash in Vault	3 755.5	3 662.1	4 365.4	4 017.9
Claims on Governments	36 943.4	39 151.1	41 798.9	43 460.5
Of Which: Central Government	36 943.4	39 151.1	41 798.9	43 460.5
Claims on Central Bank	52 990.7	47 761.7	45 570.8	40 274.2
Claims on Other Depository Corporations	119 775.9	122 930.0	132 375.6	134 452.8
Claims on Other Financial Corporations	16 809.3	19 613.2	19 057.1	19 735.5
Claims on Non-financial Corporations	370 545.6	384 817.3	397 254.5	409 539.1
Claims on Other Resident Sectors	92 785.8	100 960.2	107 112.1	112 094.4
Other Assets	51 415.9	50 855.6	53 942.4	46 692.4
Total Assets	**867 569.5**	**896 418.2**	**932 958.1**	**961 608.6**
Liabilities to Non-financial Institutions and Households	608 534.8	636 131.7	660 345.9	684 857.8
Deposits Included in Broad Money	593 611.4	620 823.2	643 969.3	668 318.5
Enterprise Demand Deposits	190 317.4	201 675.2	201 967.5	221 993.4
Enterprise Time Deposits	122 943.7	131 674.0	142 865.5	143 232.1
Household Savings Deposits	280 350.3	287 474.1	299 136.4	303 093.0
Deposits not Included in Broad Money	12 389.6	12 721.9	13 641.3	13 566.1
Transferable Deposits	5 371.7	5 509.8	5 493.7	6 081.9
Other Deposits	7 017.9	7 212.1	8 147.7	7 484.2
Other Liabilities	2 533.9	2 586.5	2 735.2	2 973.2
Liabilities to Central Bank	5 569.6	5 215.4	5 328.5	5 629.0
Liabilities to Other Depository Corporations	52 270.0	51 927.4	55 221.1	55 748.4
Liabilities to Other Financial Corporations	44 984.1	43 373.1	40 139.8	44 255.2
Of Which: Deposits Included in Broad Money	17 255.5	14 193.7	10 647.8	12 905.2
Foreign Liabilities	6 050.2	6 675.0	6 696.0	7 179.4
Bond Issuance	53 417.6	55 230.3	58 304.8	59 105.2
Paid-in Capital	23 305.2	23 842.0	25 173.8	26 506.8
Other Liabilities	73 438.0	74 023.4	81 748.2	78 326.9
Total Liabilities	**867 569.5**	**896 418.2**	**932 958.1**	**961 608.6**

Source: PBC.

Table B2.10 Balance Sheet of Chinese-funded Large Banks in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	12 787.89	12 307.15	14 366.21	14 033.96
Reserve Assets	70 747.89	72 707.20	75 199.09	82 875.61
Deposits with Central Bank	68 655.47	70 710.92	72 723.53	80 573.48
Cash in Vault	2 092.42	1 996.28	2 475.56	2 302.12
Claims on Governments	25 018.31	26 379.19	28 154.28	29 350.00
Of Which: Central Government	25 018.31	26 379.19	28 154.28	29 350.00
Claims on Central Bank	48 580.77	43 469.42	41 438.10	36 484.06
Claims on Other Depository Corporations	59 848.63	59 333.79	63 047.25	62 085.65
Claims on Other Financial Corporations	11 484.97	12 697.02	11 878.57	12 056.74
Claims on Non-financial Corporations	217 133.58	223 910.50	230 665.53	236 938.25
Claims on Other Resident Sectors	49 753.73	54 177.36	57 538.19	60 572.72
Other Assets	36 074.07	34 527.37	38 313.67	31 055.00
Total Assets	**531 429.84**	**539 509.00**	**560 600.90**	**565 451.99**
Liabilities to Non-financial Institutions and Households	379 411.73	389 902.02	402 775.08	409 775.68
Deposits Included in Broad Money	369 316.54	379 653.83	392 069.96	399 275.42
Enterprise Demand Deposits	112 972.86	117 787.93	117 644.72	125 919.75
Enterprise Time Deposits	61 699.50	64 084.03	68 454.54	66 650.50
Household Savings Deposits	194 644.18	197 781.88	205 970.69	206 705.16
Deposits not Included in Broad Money	7 993.68	8 189.43	8 558.92	8 180.90
Transferable Deposits	3 221.77	3 246.54	3 014.89	3 306.31
Other Deposits	4 771.90	4 942.89	5 544.03	4 874.58
Other Liabilities	2 101.52	2 058.76	2 146.20	2 319.37
Liabilities to Central Bank	1 206.18	625.88	660.88	898.10
Liabilities to Other Depository Corporations	19 190.42	19 273.88	20 155.93	19 677.92
Liabilities to Other Financial Corporations	30 441.77	28 234.11	25 620.64	27 722.69
Of Which: Deposits Included in Broad Money	12 221.35	9 866.25	7 595.82	8 774.55
Foreign Liabilities	2 228.50	2 553.23	2 437.33	2 557.88
Bond Issuance	37 204.36	38 313.53	40 874.77	41 058.61
Paid-in Capital	14 196.13	14 326.77	15 190.12	15 849.59
Other Liabilities	47 550.73	46 279.59	52 886.14	47 911.51
Total Liabilities	**531 429.84**	**539 509.00**	**560 600.90**	**565 451.99**

Source: PBC.

Table B2.11 Balance Sheet of Chinese-funded Medium-sized Banks in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	2 652.91	2 745.06	2 799.86	3 002.18
Reserve Assets	17 000.82	18 391.56	18 391.31	22 243.69
Deposits with Central Bank	16 687.38	18 067.89	18 017.18	21 871.47
Cash in Vault	313.44	323.67	374.12	372.22
Claims on Governments	5 592.09	6 287.05	6 568.44	6 888.04
Of Which: Central Government	5 592.09	6 287.05	6 568.44	6 888.04
Claims on Central Bank	3 372.76	3 103.18	2 887.10	2 562.48
Claims on Other Depository Corporations	29 119.17	29 877.28	32 393.38	30 820.03
Claims on Other Financial Corporations	2 573.60	3 924.27	3 686.60	3 931.70
Claims on Non-financial Corporations	82 792.97	86 425.24	89 536.81	93 795.25
Claims on Other Resident Sectors	15 775.13	17 334.18	18 515.54	19 963.28
Other Assets	6 090.58	6 665.08	5 141.31	4 654.02
Total Assets	**164 970.02**	**174 752.91**	**179 920.34**	**187 860.66**
Liabilities to Non-financial Institutions and Households	96 455.68	105 559.82	109 470.96	115 141.33
Deposits Included in Broad Money	93 894.01	102 873.13	106 466.36	112 158.22
Enterprise Demand Deposits	38 076.94	41 579.26	40 148.41	45 372.86
Enterprise Time Deposits	36 757.87	40 268.44	43 701.90	43 772.83
Household Savings Deposits	19 059.20	21 025.43	22 616.05	23 012.53
Deposits not Included in Broad Money	2 246.75	2 317.64	2 600.07	2 582.98
Transferable Deposits	953.28	1 000.52	1 056.24	1 161.61
Other Deposits	1 293.47	1 317.12	1 543.83	1 421.37
Other Liabilities	314.92	369.05	404.54	400.13
Liabilities to Central Bank	3 662.09	3 680.01	3 708.72	3 727.42
Liabilities to Other Depository Corporations	20 239.77	18 740.66	19 872.04	19 590.93
Liabilities to Other Financial Corporations	12 531.58	12 918.89	12 637.29	14 221.19
Of Which: Deposits Included in Broad Money	4 919.62	4 240.42	2 997.35	4 027.38
Foreign Liabilities	928.74	1 079.29	1 097.95	1 218.59
Bond Issuance	15 448.10	16 135.17	16 638.67	17 247.21
Paid-in Capital	1 926.02	1 993.11	2 132.42	2 160.92
Other Liabilities	13 778.04	14 645.95	14 362.29	14 553.07
Total Liabilities	**164 970.02**	**174 752.91**	**179 920.34**	**187 860.66**

Source: PBC.

Table B2.12 Balance Sheet of Chinese-funded Small Banks in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	92.29	104.87	104.40	134.57
Reserve Assets	11 773.19	12 924.90	13 442.89	17 920.42
Deposits with Central Bank	11 278.90	12 424.21	12 834.27	17 287.35
Cash in Vault	494.29	500.70	608.62	633.06
Claims on Governments	4 457.68	4 489.67	4 983.06	5 267.40
Of Which: Central Government	4 457.68	4 489.67	4 983.06	5 267.40
Claims on Central Bank	921.35	1 059.26	1 054.63	1 094.95
Claims on Other Depository Corporations	15 185.50	17 825.18	19 727.46	24 197.48
Claims on Other Financial Corporations	1 613.13	1 800.80	2 197.25	2 048.11
Claims on Non-financial Corporations	39 837.06	42 553.33	44 521.13	45 570.74
Claims on Other Resident Sectors	9 435.71	10 612.37	11 641.32	12 465.35
Other Assets	4 032.95	4 276.18	4 796.67	4 719.48
Total Assets	**87 348.86**	**95 646.57**	**102 468.80**	**113 418.50**
Liabilities to Non-financial Institutions and Households	68 644.71	74 690.94	79 363.08	87 198.85
Deposits Included in Broad Money	68 382.23	74 344.34	78 927.84	86 639.78
Enterprise Demand Deposits	24 153.34	26 584.62	27 564.72	31 951.51
Enterprise Time Deposits	14 952.09	16 701.06	18 877.21	20 345.26
Household Savings Deposits	29 276.81	31 058.66	32 485.91	34 343.02
Deposits not Included in Broad Money	178.27	228.82	295.52	369.10
Transferable Deposits	104.54	138.08	195.31	273.54
Other Deposits	73.73	90.74	100.21	95.56
Other Liabilities	84.21	117.79	139.72	189.96
Liabilities to Central Bank	120.63	169.73	186.34	215.49
Liabilities to Other Depository Corporations	8 452.41	9 579.43	10 854.50	12 398.41
Liabilities to Other Financial Corporations	894.78	1 206.08	1 019.94	1 508.71
Of Which: Deposits Included in Broad Money	110.91	83.67	53.67	102.10
Foreign Liabilities	16.76	23.14	27.42	36.71
Bond Issuance	390.77	408.10	417.07	477.92
Paid-in Capital	2 851.65	3 093.58	3 282.49	3 627.13
Other Liabilities	5 977.14	6 475.56	7 317.97	7 955.29
Total Liabilities	**87 348.86**	**95 646.57**	**102 468.80**	**113 418.50**

Source: PBC.

Table B2.13 Balance Sheet of Foreign-funded Banks in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	1 246.53	1 109.53	1 253.90	1 280.40
Reserve Assets	1 324.19	1 421.09	1 570.46	2 023.68
Deposits with Central Bank	1 315.90	1 413.35	1 560.90	2 014.56
Cash in Vault	8.29	7.74	9.55	9.12
Claims on Governments	987.71	1 074.68	1 106.28	1 004.47
Of Which: Central Government	987.71	1 074.68	1 106.28	1 004.47
Claims on Central Bank	0.00	0.00	0.00	0.00
Claims on Other Depository Corporations	2 624.39	2 841.09	2 908.98	3 630.10
Claims on Other Financial Corporations	101.76	140.52	189.60	244.95
Claims on Non-financial Corporations	7 112.40	7 494.01	7 818.87	8 236.27
Claims on Other Resident Sectors	296.43	344.33	366.48	408.97
Other Assets	1 539.50	1 718.19	1 897.60	2 187.31
Total Assets	**15 232.92**	**16 143.44**	**17 112.18**	**19 016.15**
Liabilities to Non-financial Institutions and Households	6 689.25	7 300.62	8 125.14	9 677.71
Deposits Included in Broad Money	5 198.91	5 777.51	6 483.11	7 808.77
Enterprise Demand Deposits	1 672.93	1 836.25	1 749.82	2 272.77
Enterprise Time Deposits	3 087.42	3 468.01	4 215.86	4 962.52
Household Savings Deposits	438.56	473.25	517.44	573.48
Deposits not Included in Broad Money	1 490.34	1 523.11	1 642.03	1 868.93
Transferable Deposits	885.90	882.89	916.49	999.48
Other Deposits	604.45	640.22	725.53	869.46
Other Liabilities	0.00	0.00	0.00	0.00
Liabilities to Central Bank	0.00	0.00	0.00	0.00
Liabilities to Other Depository Corporations	1 673.47	1 533.10	1 388.30	1 212.89
Liabilities to Other Financial Corporations	532.37	597.79	506.31	531.51
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	2 861.69	2 996.81	3 109.44	3 341.68
Bond Issuance	0.00	0.00	0.00	0.00
Paid-in Capital	1 425.16	1 430.25	1 482.66	1 515.15
Other Liabilities	2 050.98	2 284.86	2 500.34	2 737.21
Total Liabilities	**15 232.92**	**16 143.44**	**17 112.18**	**19 016.15**

Source: PBC.

Table B2.14 Balance Sheet of Urban Credit Cooperatives in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter1	Quarter2	Quarter3	Quarter4
Foreign Assets	0.00	0.00	0.00	0.00
Reserve Assets	43.54	33.25	18.76	11.90
Deposits with Central Bank	40.94	31.68	17.59	10.92
Cash in Vault	2.61	1.57	1.17	0.98
Claims on Governments	8.51	4.34	5.27	4.03
Of Which: Central Government	8.51	4.34	5.27	4.03
Claims on Central Bank	0.51	0.51	3.21	3.21
Claims on Other Depository Corporations	42.67	37.77	32.26	17.77
Claims on Other Financial Corporations	0.21	0.01	0.98	0.00
Claims on Non-financial Corporations	139.76	104.71	68.44	50.89
Claims on Other Resident Sectors	48.92	33.18	31.43	16.91
Other Assets	58.49	45.81	23.56	11.26
Total Assets	**342.61**	**259.58**	**183.90**	**115.97**
Liabilities to Non-financial Institutions and Households	297.76	227.44	152.07	96.75
Deposits Included in Broad Money	297.74	227.43	152.04	96.73
Enterprise Demand Deposits	72.21	64.01	38.09	16.45
Enterprise Time Deposits	19.41	16.88	14.16	8.98
Household Savings Deposits	206.12	146.54	99.79	71.31
Deposits not Included in Broad Money	0.00	0.00	0.00	0.00
Transferable Deposits	0.00	0.00	0.00	0.00
Other Deposits	0.00	0.00	0.00	0.00
Other Liabilities	0.02	0.01	0.04	0.01
Liabilities to Central Bank	0.00	0.00	0.00	0.00
Liabilities to Other Depository Corporations	14.00	6.44	11.56	6.21
Liabilities to Other Financial Corporations	1.11	1.27	0.70	0.54
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	0.00	0.00	0.00	0.00
Bond Issuance	0.00	0.00	0.00	0.00
Paid-in Capital	11.61	10.95	8.88	5.75
Other Liabilities	18.13	13.47	10.68	6.73
Total Liabilities	**342.61**	**259.58**	**183.90**	**115.97**

Source: PBC.

Table B2.15 Balance Sheet of Rural Credit Cooperatives in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	1.29	1.74	2.18	1.89
Reserve Assets	7 352.95	7 278.17	7 318.47	10 191.25
Deposits with Central Bank	6 497.38	6 434.61	6 406.93	9 474.45
Cash in Vault	855.57	843.56	911.54	716.80
Claims on Governments	670.05	721.34	771.42	742.99
Of Which: Central Government	670.05	721.34	771.42	742.99
Claims on Central Bank	113.29	129.32	187.24	128.51
Claims on Other Depository Corporations	8 372.24	8 288.71	8 813.04	8 353.12
Claims on Other Financial Corporations	836.54	858.55	880.85	1 164.34
Claims on Non-financial Corporations	17 216.29	17 567.10	17 730.33	17 511.84
Claims on Other Resident Sectors	17 364.24	18 326.09	18 870.25	18 504.48
Other Assets	3 181.71	3 202.39	3 330.08	3 607.90
Total Assets	**55 108.61**	**56 373.41**	**57 903.85**	**60 206.32**
Liabilities to Non-financial Institutions and Households	46 955.76	47 695.33	48 862.40	50 563.73
Deposits Included in Broad Money	46 925.60	47 655.81	48 818.88	50 500.49
Enterprise Demand Deposits	8 370.06	8 751.32	9 325.70	10 083.20
Enterprise Time Deposits	1 830.07	1 916.15	2 046.73	2 029.78
Household Savings Deposits	36 725.47	36 988.34	37 446.46	38 387.51
Deposits not Included in Broad Money	3.46	4.62	4.89	6.13
Transferable Deposits	0.73	1.10	1.01	1.32
Other Deposits	2.73	3.52	3.88	4.81
Other Liabilities	26.70	34.89	38.62	57.11
Liabilities to Central Bank	577.18	732.03	766.76	780.80
Liabilities to Other Depository Corporations	2 156.23	2 318.39	2 428.46	2 403.10
Liabilities to Other Financial Corporations	350.68	327.18	262.44	204.94
Of Which: Deposits Included in Broad Money	0.00	0.00	0.00	0.00
Foreign Liabilities	0.00	0.00	0.00	0.30
Bond Issuance	0.10	0.10	0.10	0.10
Paid-in Capital	1 916.89	1 936.89	1 959.16	2 152.07
Other Liabilities	3 151.75	3 363.48	3 624.53	4 101.28
Total Liabilities	**55 108.61**	**56 373.41**	**57 903.85**	**60 206.32**

Source: PBC.

Table B2.16 Balance Sheet of Finance Companies in 2010

(Quarter-end Balance)

(100 million of RMB yuan)

Items	Quarter 1	Quarter 2	Quarter 3	Quarter 4
Foreign Assets	177.05	41.99	48.70	71.81
Reserve Assets	1 113.42	1 274.09	1 345.74	1 584.91
Deposits with Central Bank	1 113.38	1 274.05	1 345.70	1 584.89
Cash in Vault	0.04	0.04	0.04	0.03
Claims on Governments	209.06	194.88	210.19	203.53
Of Which: Central Government	209.06	194.88	210.19	203.53
Claims on Central Bank	2.05	0.00	0.50	0.97
Claims on Other Depository Corporations	4 583.36	4 726.11	5 453.24	5 348.66
Claims on Other Financial Corporations	199.14	191.98	223.23	289.67
Claims on Non-financial Corporations	6 313.53	6 762.40	6 913.34	7 435.88
Claims on Other Resident Sectors	111.62	132.73	148.89	162.65
Other Assets	427.43	409.06	424.33	440.95
Total Assets	**13 136.65**	**13 733.24**	**14 768.17**	**15 539.04**
Liabilities to Non-financial Institutions and Households	10 079.95	10 755.48	11 597.14	12 403.74
Deposits Included in Broad Money	9 596.38	10 291.17	11 051.15	11 839.05
Enterprise Demand Deposits	4 999.02	5 071.77	5 496.04	6 376.84
Enterprise Time Deposits	4 597.36	5 219.40	5 555.11	5 462.22
Household Savings Deposits	0.00	0.00	0.00	0.00
Deposits not Included in Broad Money	477.08	458.29	539.91	558.06
Transferable Deposits	205.43	240.70	309.71	339.68
Other Deposits	271.65	217.60	230.20	218.38
Other Liabilities	6.49	6.02	6.08	6.63
Liabilities to Central Bank	3.48	7.79	5.79	7.20
Liabilities to Other Depository Corporations	543.67	475.44	510.29	458.94
Liabilities to Other Financial Corporations	231.83	87.75	92.50	65.59
Of Which: Deposits Included in Broad Money	3.60	3.32	0.92	1.12
Foreign Liabilities	14.53	22.50	23.90	24.23
Bond Issuance	374.27	373.41	374.22	321.40
Paid-in Capital	977.71	1 050.42	1 118.09	1 196.17
Other Liabilities	911.22	960.44	1 046.23	1 061.77
Total Liabilities	**13 136.65**	**13 733.24**	**14 768.17**	**15 539.04**

Source: PBC.

Table B2.17 Statistics of Securities Market

Year	2004	2005	2006	2007	2008	2009	2010
Number of Domestic Listed Companies (A share B share)	1 377	1 381	1 434	1 550	1 625	1 718	2 063
Number of Domestic Listed Foreign Companies (B share)	110	109	109	109	109	108	108
Number of Overseas Listed Companies (H share)	111	122	143	148	153	159	165
Number of Shares Issued (100 million of shares)	7 149.43	7 629.51	14 897.57	22 416.85	24 522.85	26 162.85	33 184.35
Of Which: Negotiable Shares (100 million of shares)	2 577.18	2 914.77	5 637.79	10 331.52	12 578.91	19 759.53	19 442.15
Total Market Value of Shares (100 million of RMB yuan)	37 055.57	32 430.28	89 403.90	327 140.89	121 366.44	243 939.12	265 422.59
Of Which:Negotiable Shares (100 million of RMB yuan)	11 688.64	10 630.51	25 003.64	93 064.35	45 213.90	151 258.65	193 110.41
Trade Volume of Shares(100 million of shares)	5 827.73	6 623.73	16 145.22	45 038.71	24 131.38	51 106.99	42 151.99
Turnover of Shares(100 million of RMB yuan)	42 333.95	31 664.78	90 468.91	460 556.20	267 112.64	535 986.74	545 633.54
Shanghai Composite Index (close)	1 266.50	1 161.06	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08
Shenzhen Composite Index (close)	315.81	278.75	550.59	1 447.02	553.30	1 201.34	1 290.87
Number of Investor Accounts (10 thousand)	7 215.74	7 336.07	7 854.00	13 887.02	12 363.89	14 027.88	15 454.03
Average P/E							
Shanghai	24.23	16.33	33.38	59.24	14.86	28.73	21.61
Shenzhen	24.63	16.36	33.61	72.11	17.13	46.01	44.69
Average Turnover Rate (percent)							
Shanghai	288.71	274.37	46.31	37.77	392.52	499.41	197.61
Shenzhen	288.29	316.43	55.95	42.35	469.11	793.27	557.46
Treasury Bonds Issue (100 million of RMB yuan)	6 923.90	7 042.00	8 883.00	23 139.10	8 558.20	17 927.24	19 778.30
Corporate Bonds Issue (100 million of RMB yuan)	327.00	2 046.50	3 938.00	5 181.00	8 723.40	16 599.30	16 094.45
Trade Volume of Bonds(10 thousand of units)	504 218.50	283 714.36					
Turnover of Bonds(100 million of RMB yuan)	50 323.50	28 367.85					
Turnover of Outright Treasury Bonds Purchase (100 million of RMB yuan)	2 966.46	2 780.63	1 540.71	1 200.59	2 122.52	2 085.10	1 661.64
Turnover of Treasury Bonds Repo (100 million of RMB yuan)	44 086.61	23 621.17	9 092.77	18 345.08	24 268.65	35 475.87	65 877.79
Number of Securities Investment Funds	161	218	301	346	439	557	704
Number of Shares of Securities Investment Funds (100 million of shares)	3 308.79	4 714.18	6 020.09	22 339.84	19 403.25	26 767.05	25 200.75
Turnover of Securities Investment Funds (100 million of RMB yuan)	728.58	773.15	1 909.68	8 620.10	5 831.06	10 249.58	8 996.43
Trading Volume of Futures(10 thousand lots)	30 569.76	32 287.41	272 098.56	71 565.57	136 396.00	215 751.76	313 368.83
Turnover of Futures (100 million of RMB yuan)	146 935.32	134 463.38	209 533.78	400 733.30	719 173.35	1 305 142.92	3 080 592.40

Source: CSRC.

Table B2.18 Ratio of Stock Market Capitalization to GDP

(100 million of RMB yuan unless otherwise noted)

Year	GDP	Market Capitalization	Ratio (percent)	GDP	Negotiable Market Capitalization	Ratio (percent)
1994	48 198	3 691	7.66	48 198	965	2.00
1995	60 794	3 474	5.71	60 794	938	1.54
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	13 179	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

Source: Calculated based on data from CSRC and NBS.

Table B2.19 Ratio of Domestic Stock Financing to Bank Loan Increment

(100 million of RMB yuan unless otherwise noted)

Year	Domestic Stock Financing	Loan Increment	Ratio (percent)
1994	138.05	7 216.62	1.91
1995	118.86	9 339.82	1.27
1996	341.52	10 683.33	3.20
1997	933.82	10 712.47	8.72
1998	803.57	11 490.94	6.99
1999	897.39	10 846.36	8.27
2000	1 541.02	13 346.61	11.55
2001	1 182.13	12 439.41	9.50
2002	779.75	18 979.20	4.11
2003	823.10	27 702.30	2.97
2004	862.67	19 201.60	4.49
2005	338.13	16 492.60	2.05
2006	1 231.89	31 441.30	3.92
2007	8 431.86	36 322.51	23.21
2008	3 308.16	49 854.00	6.64
2009	3 923.52	96 290.18	4.07
2010	9 672.20	79 510.73	12.16

Note: Domestic stock financing includes financing through A share and B share.

Source: Calculated based on data from PBC and CSRC.

Table B2.20 Statistics of Stock Market

Year		2004	2005	2006	2007	2008	2009	2010
Number of Domestic Listed Companies (A share, B share)		1 377	1 381	1 434	1 550	1 625	1 718	2 063
Of Which: ST Companies		135	115			140	142	153
Medium/ Small-sized Companies		38	50	102	202	273	327	531
Growth Enterprises Board							36	153
Number of Domestic Listed Foreign Companies (B share)		110	109	109	109	109	108	108
Of Which: ST Companies		20	15			20		
Number of Shares Issued (100 million of shares)		7 149.43	7 629.51	14 897.57	22 416.85	24 522.85	26 162.85	33 184.35
Of Which: Medium/ Small-sized Companies		32.23	56.14	143.21	339.64	591.60	794.13	1 366.74
Growth Enterprises Board							34.60	175.06
Total Market Capitalization of Shares (100 million of RMB yuan)		37 055.57	32 430.28	89 403.90	327 140.89	121 366.44	243 939.12	265 422.59
Of Which: Medium/ Small-sized Companies		413.43	481.15	2 015.30	10 646.84	6 269.68	16 872.55	35 364.61
Growth Enterprises Board							1 610.08	7 365.22
Market Capitalization of Negotiable Shares (100 million of RMB yuan)		11 688.64	10 630.51	25 003.64	93 064.35	45 213.90	151 258.65	193 110.41
Of Which: Medium/ Small-sized Companies		119.96	185.29	723.63	3 823.66	2 672.68	7 503.57	16 150.32
Growth Enterprises Board							298.97	2 005.64
Volume (100 million of shares)	Total	5 827.73	6 623.73	16 145.22	45 038.71	24 131.38	51 106.99	42 151.99
	Daily Average	23.98	27.37	66.99	186.11	98.10	209.45	174.18
	Medium/ Small-sized	59.16	130.30	296.78		1 189.26		4 055.35
	Growth Enterprises Board	—	—	—	—	—	—	400.53
Turnover (100 million of RMB yuan)	Total	42 333.95	31 664.78	90 468.91	460 556.22	267 112.64	535 986.74	545 633.54
	Daily Average	174.21	130.85	375.39	1 903.12	1 085.82	2 196.67	2 254.68
	Medium/ Small-sized	822.63	1 203.92	3 071.55	16 173.66	16 637.28	48 273.52	85 832.42
	Growth Enterprises Board	—	—	—	—	—	1 828.11	15 717.88

(concluded)

Year		2004	2005	2006	2007	2008	2009	2010
Average Turnover Rate(percent)	Shanghai	288.71	274.37	46.31	37.77	392.52	499.41	197.61
	Shenzhen	288.29	316.43	55.95	42.35	469.11	793.27	557.46
Average P/E	Shanghai	24.23	16.33	33.38	59.24	14.86	28.73	21.61
	Shenzhen	24.63	16.36	33.61	72.11	17.13	46.01	44.69
	Medium/ Small-sized	31.33	24.49	42.03	85.07	24.96	51.01	56.93
	Growth Enterprises Board						105.38	78.53
Shanghai Composite Index	Open	1 492.72	1 260.78	1 163.88	2 728.19	5 265.00	1 849.02	3 289.75
	Highest	1 783.01	1 328.53	2 698.90	6 124.04	5 522.78	3 478.01	3 306.75
	Date	2004-4-7	2005-2-25	2006-12-29	2007-10-16	2008-1-14	2009-8-4	2010-1-11
	Lowest	1 259.43	998.23	1 161.91	2 617.02	1 664.92	1 844.09	2 319.74
	Date	2004-9-13	2005-6-6	2006-1-4	2007-1-5	2008-10-28	2009-1-5	2010-7-2
	Average	1 482.85	1 153.55	2 302.94	4 797.17	2 707.32	2 969.10	2 810.66
	Close	1 266.50	1 161.06	2 675.47	5 261.56	1 820.81	3 277.14	2 808.08
Shenzhen Composite Index	Open	377.93	313.81	278.99	555.26	1 450.33	560.10	1 207.33
	Highest	470.55	333.28	552.93	1 567.74	1 584.40	1 240.64	1 414.64
	Date	2004-4-7	2005-3-9	2006-12-29	2007-10-8	2008-1-15	2009-12-4	2010-11-11
	Lowest	315.17	237.18	278.99	547.89	452.33	557.69	890.24
	Date	2004-9-13	2005-7-18	2006-1-4	2007-1-5	2008-11-4	2009-1-5	2010-7-2
	Average	379.43	282.64	483.28	1 252.42	785.83	1 050.25	1 221.15
	Close	315.81	278.75	550.59	1 447.02	553.30	1 201.34	1 290.87

Source: Shanghai Stock Exchange and Shenzhen Stock Exchange.

Table B2.21 Summary of China's Bond Issuance

(100 million of RMB yuan)

Year	Treasury Bonds			Policy Financial Bonds			Subordinated Bonds			Enterprise Bonds		
	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance	Issuance	Redemption	Outstanding Balance
1992	460.78	238.05	1 282.72	55.00	30.00	143.12	—	—	—	683.71	192.76	822.04
1993	381.31	123.29	1 540.74	—	34.29	108.83	—	—	—	235.84	255.48	802.40
1994	1 137.55	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	2 746.00	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

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

② The data of Enterprise Bonds covers Enterprise Bonds, Coporate Bonds, Short-term Financial Bills, Middle-term Notes and SME Collective Notes.

Source: PBC.

Table B2.22 Statistics of China's Insurance Development

(100 million of RMB yuan unless otherwise noted)

Items	2004	Increase y-o-y (percent)	2005	Increase y-o-y (percent)	2006	Increase y-o-y (percent)	2007	Increase y-o-y (percent)	2008	Increase y-o-y (percent)	2009	Increase y-o-y (percent)	2010	Increase y-o-y (percent)
Premium Income	4 318.13	11.28	4 927.34	14.11	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
1. Property Insurance	1 089.89	25.36	1 229.86	12.84	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
2. Personal Accident Insurance	117.07	17.56	140.89	20.35	162.47	15.31	190.11	17.01	203.56	7.08	230.05	13.02	275.35	19.69
3. Health Insurance	259.88	7.42	312.30	20.17	376.90	20.69	384.17	1.93	585.46	52.40	573.98	-1.96	677.47	18.03
4. Life Insurance	2 851.30	6.81	3 244.28	13.78	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
Claim Payment	1 004.44	19.43	1 129.67	12.47	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
1. Property Insurance	567.52	19.15	671.75	18.36	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. Personal Accident Insurance	39.42	28.63	43.51	10.37	51.67	18.75	63.43	22.76	62.57	-1.35	63.92	2.15	71.39	11.69
3.Health Insurance	89.10	27.47	107.92	21.11	125.10	15.92	116.86	-6.58	175.28	49.99	217.03	23.82	264.02	21.65
4.Life Insurance	308.39	16.75	306.50	-0.62	465.41	51.85	1 064.45	128.71	1 314.98	23.54	1 268.74	-3.52	1 108.99	-12.59
Operating Expenses	435.82	20.65	525.96	20.68	667.06	26.83	947.62	42.06	1 079.52	13.92	1 234.06	14.32	1 538.35	24.66
Bank Deposits	4 968.78	9.21	5 241.43	5.49	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
Investment	5 711.94	49.18	8 894.41	55.72	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
Of Which: Treasury Bonds	2 651.71	88.48	3 588.29	35.32	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
Securities Investment Funds	673.17	45.30	1 099.21	63.29	912.08	-17.02	2 530.46	177.44	1 646.46	-34.93	2 758.78	67.56	2 620.73	-5.00
Total Assets	11 853.55	29.93	15 225.97	28.45	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

Note: ①Data of premium income, claim payment and operating expenses are data for the year.

②Data of bank deposits, investment and total assets are data of year-end balance.

Source: Calculated based on data from CIRC Website.

Table B2.23 The Structure of Non-life Insurance Premium Income

(100 million of RMB yuan unless otherwise noted)

Insurance Lines	2007	Ratio (percent)	2008	Ratio (percent)	2009	Ratio (percent)	2010	Ratio (percent)
Automobile Insurance	1 484.28	71.14	1 702.52	56.89	2 155.61	72.02	3 004.15	74.60
Enterprise Property Insurance	186.83	8.95	209.63	7.00	221.43	7.40	271.61	6.74
Cargo Transportation Insurance	63.11	3.02	70.97	2.37	61.27	2.05	78.74	1.96
Accident Insurance	74.31	3.56	72.71	2.43	73.92	2.47	85.53	2.12
Liability Insurance	66.60	3.19	81.75	2.73	92.21	3.08	115.88	2.88
Others	211.35	10.13	308.67	10.31	388.46	12.98	470.98	11.70
Total	2 086.48	100.00	2 446.25	100.00	2 992.90	100.00	4 026.89	100.00

Source: CIRC.

Table B2.24 The Structure of Life Insurance Premium Income

(100 million of RMB yuan unless otherwise noted)

Insurance Lines	2007	Ratio (percent)	2008	Ratio (percent)	2009	Ratio (percent)	2010	Ratio (percent)
Life Insurance	4 463.44	90.19	6 658.09	90.74	7 457.22	91.57	9 679.31	92.18
Of Which: Common Life Insurance	1 002.71	20.26	983.66	13.41	961.56	11.81	948.17	9.03
Participating Insurance	2 221.23	44.88	3 798.87	51.77	5 292.56	64.99	7 454.77	70.99
Unit-linked Insurance	393.83	7.96	425.03	5.79	147.90	1.82	152.82	1.46
Accident Insurance	115.80	2.34	130.85	1.78	156.13	1.92	189.83	1.81
Health Insurance	369.73	7.47	548.63	7.48	530.83	6.52	631.74	6.02
Total	4 948.97	100.00	7 337.57	100.00	8 144.18	100.00	10 500.88	100.00

Source: CIRC.

Table B2.25 Insurance Premium Income of China's Different Regions in 2010

(100 million of RMB yuan)

Regions	Insurance Premium Income	Property Insurance	Life Insurance	Accident Insurance	Health Insurance
Total	14 527.97	3 895.64	9 679.51	275.35	677.47
Guangdong	1 231.76	309.06	840.15	24.08	58.48
Jiangsu	1 162.67	311.91	780.41	25.96	44.39
Beijing	966.46	212.30	676.49	13.70	63.97
Shanghai	883.86	189.22	630.61	14.98	49.04
Shandong	876.22	241.57	569.50	18.55	46.59
Henan	793.28	134.72	618.34	9.19	31.03
Sichuan	765.77	191.56	522.64	17.28	34.29
Hebei	746.40	192.91	513.59	10.38	29.52
Zhejiang	690.34	259.47	386.58	17.29	27.00
Hubei	500.33	98.21	372.26	8.93	20.93
Liaoning	453.81	118.58	306.04	6.18	23.02
Hunan	438.53	100.70	305.70	9.83	22.31
Anhui	438.25	119.62	295.51	5.74	17.37
Shanxi	365.30	92.94	253.59	4.93	13.83
Shenzhen	361.49	120.57	216.55	7.93	16.45
Fujian	346.07	99.89	217.89	7.79	20.49
Heilongjiang	343.22	71.86	254.49	4.93	11.95
Shaanxi	333.81	85.42	228.65	6.10	13.64
Chongqing	321.08	65.96	235.77	7.72	11.63
Jiangxi	253.26	69.24	169.21	4.41	10.40
Jilin	239.25	60.89	165.93	2.85	9.59
Yunnan	235.68	94.22	117.41	8.10	15.95
Inner Mongolia	215.54	96.27	106.59	4.50	8.18
Tianjin	214.01	65.13	133.91	3.38	11.59
Guangxi	190.94	65.76	110.08	5.96	9.13
Xinjiang	190.92	63.00	108.60	4.93	14.39
Qingdao	153.85	49.55	92.85	2.28	9.18
Dalian	151.05	43.56	97.40	2.62	7.46
Gansu	146.34	38.82	98.98	2.66	5.88
Ningbo	144.06	66.20	70.99	3.05	3.82
Guizhou	122.63	46.92	67.70	3.72	4.29
Xiamen	77.55	28.20	43.74	1.59	4.02
Ningxia	52.75	17.50	29.46	1.42	4.36
Hainan	47.95	17.85	27.25	1.09	1.76
Qinghai	25.70	10.38	13.42	0.74	1.15
Tibet	5.06	4.11	0.43	0.31	0.21
Group and Head Office Level	42.81	41.58	0.82	0.26	0.15

Note: Data of “Group and Head Office Level” refers to the premium income earned by the group and head office, which is not included in regional data.

Source: CIRC.

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