

China

Financial Stability Report

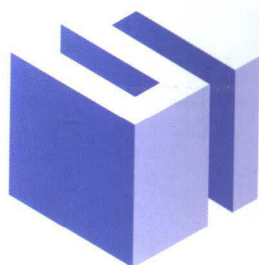
2006

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



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¹ The English edition is an unofficial translation of the *China Financial Stability Report 2006*. In case of any discrepancies, the Chinese version shall govern.

Preface

2005 was a groundbreaking year for China with impressive achievements in financial sector restructuring and wider opening up of financial sector, and the financial system has become more resilient to potential financial risks. *China Financial Stability Report 2006* aims to reflect the latest developments in a comprehensive manner and contributes to the PBC's effort to assess financial stability.

China Financial Stability Report 2006 is structured as follows: Chapter I provides an overview of financial stability in China; Chapter II analyses the impact of macroeconomic performance on financial stability; Chapter III to Chapter V respectively discusses reform and development of the banking, securities and insurance industries and their impacts on financial stability; Chapter VI focuses on the development of integrated financial services; Chapter VII discusses the relationship between financial market development and financial stability; Chapter VIII explores the needs to establish deposit insurance system in China; and Chapter IX analyses operation and risk management of the payment system. The Report contains 18 “boxes” that provide in-depth analysis of a number of significant issues that bear on financial stability. China Financial Publishing House contributed greatly to the Report.

Our aim is to present a dynamic and comprehensive picture of financial reform, development and stability in China over 2005. Yet given the limited knowledge of the authors and inadequate experience in evaluating financial stability, the report is certainly not perfect. We welcome suggestions from the relevant government bodies, academia and all sectors of the society to help us improve financial stability analysis and evaluation methodology in future editions.

Financial Stability Analysis Group of the PBC
October 8, 2006

Abbreviations and Acronyms

ABC	Agricultural Bank of China
ABS	Asset-backed Securitization
ADBC	Agricultural Development Bank of China
AMC	Asset Management Corporation
BIS	Bank for International Settlements
BOC	Bank of China
BOCOM	Bank of Communications
CAR	Capital Adequacy Ratio
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCPC	Prefecture City-level Clearing and Processing Center
CDB	China Development Bank
CHIBOR	China Inter-bank Borrowing Rate
CIRC	China Insurance Regulatory Commission
CITIC	China International Trust and Investment Corporation
CMB	China Merchant Bank
CNAPS	China National Automated Payment System
COFCO	China National Cereals, Oils and Foodstuffs Corporation
CPC	Communist Party of China
CPSS	Committee on Payment and Settlement System
CSRC	China Securities Regulatory Commission
DVP	Delivery versus Payment
ECB	European Central Bank
EPS	Earnings Per Share

FSAP	Financial Sector Assessment Program
HVPS	High Value Payment System
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPOs	Initial Public Offerings
JSCBs	Joint-Stock Commercial Banks
MBS	Mortgage-backed Securities
MOF	Ministry of Finance
NCCT	Non-Cooperative Countries and Territories
NDRC	National Development and Reform Commission
NPC	National Processing Center
NPA	Non-performing Assets
NPL	Non-performing Loans
OECD	Organization for Economic Cooperation and Development
OFIs	Other Financial Institutions
PBC	The People's Bank of China
QDIIs	Qualified Domestic Institutional Investors
QFIIs	Qualified Foreign Institutional Investors
RCCs	Rural Credit Cooperatives
RMB	Renminbi
RPS	Retail Payment System
SAC	Securities Association of China
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission
SCNPC	Standing Committee of the National People's Congress
SMEs	Small- and Medium-sized Enterprises
SOCBs	State-owned Commercial Banks

SSF	Social Securities Fund
TICs	Trust and Investment Companies
UCCs	Urban Credit Cooperatives
USD	US Dollar
WTO	World Trade Organization



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Chapter I

Overview

In 2005 the Chinese economy continued to grow in a healthy and sustained manner with breakthroughs in financial sector development. Reform of RMB exchange rate regime was well implemented. Restructuring of SOCBs into joint stock banks recorded gratifying results. Restructuring of RCCs went on smoothly. Restructuring of securities companies went into full swing. Non-tradable state share reform continued steadily. Headway was made in the integrated financial services pilot programmes for the insurance industry. Risks revealed in the banking and securities industries were properly dealt with. The long-term mechanism for financial risk management started to be established. The financial industry was more open to international participation. As a result, the financial system has become significantly stronger.

Breakthroughs in Financial Reform, Proper Management of Financial Risks, and Overall Financial Stability in China

In 2005 the CPC central committee and the State Council required that a proper balance among reform, development and stability be achieved within the framework of the concept of scientific development; that economic development remain the focus but with transformation of development concept, innovation in development models and improving quality of

growth, and that the historical legacy problems be resolved through development and reform to keep the economic development sustainable. These guidelines and policies have created a sound political, economic and social environment for financial stability. With breakthroughs in financial reform and risk management, stronger financial infrastructure and a healthier financial ecosystem as well as wider opening up of financial industry, China enjoyed overall financial stability.

Steady and Rapid Development of the National Economy Laid the Ground for Financial Stability

The economy demonstrated a sound momentum featuring rapid growth, greater efficiency and stable prices. As issues related to the macro economy were being closely monitored and structural problems began to ease, economic performance was enhanced with balanced development in different sectors. Breakthroughs were made in the reform of some key areas, which enhanced the government's ability to manage the macro economy. Healthy and stable performance of the macro economy helped to maintain financial stability.

Breakthroughs in Financial Reform Improved the Competitiveness of the Financial Industry

Reform of RMB exchange rate regime was implemented smoothly: a managed floating exchange rate regime based on supply and demand with reference to a basket of currencies has taken shape. The market was playing an increasing role in the formation of exchange rate with greater flexibility. RMB exchange

rate remained stable at a reasonable and balanced level.

Reform of SOCBs went on smoothly. BOC, CCB and ICBC continued with shareholding reform. Having completed financial restructuring and established joint stock companies, BOC and CCB continued to improve corporate governance, internal control and risk management and pressed ahead with the introduction of strategic investors and IPOs subsequently. CCB was successfully listed on the Hong Kong Stock Exchange in October 2005. Reform of ICBC into a joint stock company with limited liability started in April 2005 and completed in October 2005. The corporate governance of ICBC is improving, and prepared for its IPOs. Reform of ABC is under active consideration within the framework of building a new socialist countryside and the overall strategy for rural financial reform. These reforms have proven effective with significant improvement in CAR, asset quality, profitability and financial sustainability of the restructured banks.

The pilot program of RCC reform has been extended to 29 provinces (autonomous regions and municipalities) with major breakthroughs. Firstly, with the implementation of various supportive policies, progress has been made to deal with legacy issues of the past. By end 2005, the PBC arranged the issuance of eight-year special bills valued at RMB 159.9 billion yuan to 2,263 counties (including county-level cities) to acquire NPLs and suspense accounts over previous years of RCCs. Secondly, property rights reform continued steadily,

particularly in the transformation of management practices. By end 2005, 72 rural banking institutions were formed together with 519 legal entities at the county level (including county-level city). Thirdly, pilot administrative reform has been undertaken, with regulatory responsibility of RCCs transferred to the provincial government and managerial duties of local governments for RCCs preliminarily identified. Fourthly, credit to agriculture sector continued to increase, contributing to the well being of farmers, agriculture and rural areas.

Non-tradable state share reform has begun to produce positive results. Under the overall plan of the State Council and in accordance with the concept of “centralized organization and decentralized decision-making” and operating procedure of “pilot program first, coordinated implementation and phased problem-solving”, non-tradable state share reform proceeded steadily. Based on their individual circumstances, listed companies adopted a variety of compensation schemes to minority tradable shareholders, including the granting of free shares with cash dividends (only to holders of tradable shares), warrants, restructuring and reverse stock split. Generally speaking, a win-win situation for owners of both tradable shares and non-tradable state shares has been achieved. Having removed a major overhang and structural deficiency of the capital market, non-tradable state share reform helps to protect the legitimate rights and interests of all stock market investors, in particular the minority tradable shareholders, and safeguards stability of the securities market.

Restructuring of securities companies achieved positive development. In collaboration with other government agencies, the PBC restructured eight securities companies including China Galaxy Securities, Shenyin & Wanguo Securities, Guotai Jun'an Securities, Huaxia Securities, Beijing Securities, Tiantong Securities, Southwest Securities and Xinjiang Securities, with China SAFE Investments Limited and China Jianyin Investment Co., Ltd. as platforms for restructuring. The means of restructuring has taken various forms, such as capital injection by shareholders, liquidity support and introduction of strategic investors. Smooth restructuring facilitated resources allocation in the securities market, and laying down a solid foundation for improving the international competitiveness of securities companies. Meanwhile, system development gained momentum during the process, with third party custodian of securities purchased by investors and transaction settlement fund first introduced to restructured securities companies.

Progress was made in the reform of insurance industry. Firstly, the scope of insurance services was expanded. With active development of agricultural insurance and involvement in rural medical insurance and pension insurance for farmers, the insurance industry restored the agricultural insurance, which was declining in recent years. Insurance companies have developed over 200 liability insurance products, contributing to social stability. Secondly, the insurance industry made breakthroughs in investing their funds and exploring a variety of investment channels. By end 2005, direct eq-

uities investment by insurance companies amounted to RMB 15.888 billion. Insurance companies have also become the second largest institutional investor groups in the bond market. Thirdly, the pilot program of comprehensive insurance business was carried out smoothly. In 2005 a number of insurance companies have set up subsidiaries for piloted comprehensive cross-sector business. Meanwhile cooperation between the banking and insurance industries is shifting from loose business alliance to equity shareholding relationship.

Financial Risks Were Dealt with Properly and Financial Safety Net Was Gradually Established

Led by the State Council and with close inter-departmental cooperation, risk management and restructuring of banks and securities companies have accelerated, effectively reducing financial system risks. Firstly, existing financial risks of SOCBs were effectively reduced. BOC, CCB and ICBC have reduced their non-performing asset ratios and brought CARs to international levels by restructuring efforts such as capital injection and market-based non-performing asset disposal. Their financial positions are thus significantly improved. Secondly, risks of small- and medium-sized banking institutions were preliminarily disposed. Restructuring and reform of China Everbright Bank and Guangdong Development Bank went on smoothly; 82 UCCs phased out quietly while RCCs reported significantly improved performance, with CAR rapidly improved as a result of replacement of non-performing assets