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Building A Safe and Sound Banking Sector In China

LIU Mingkang

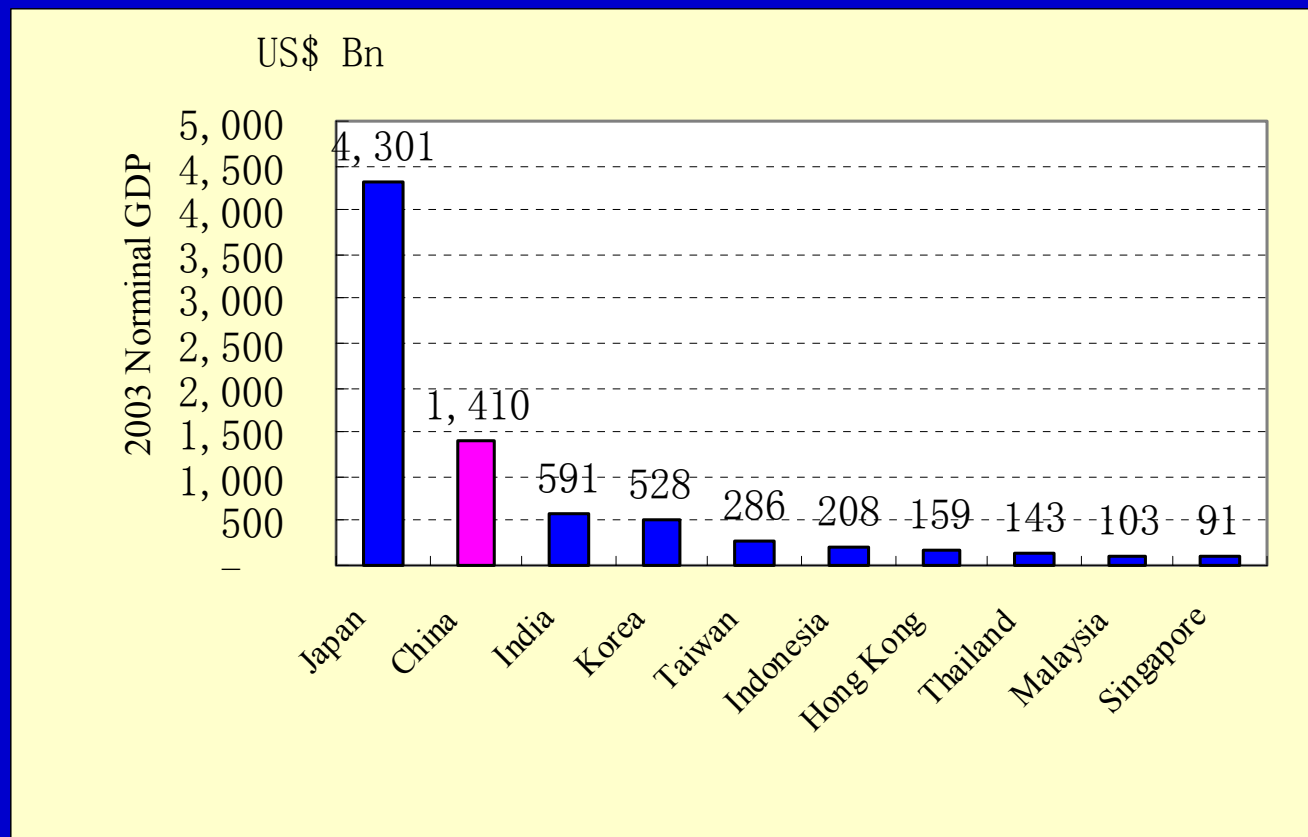
Chairman, China Banking Regulatory Commission

May 16, 2004, Jeju, Korea

- *Economic underpinnings to the banking sector*
- Three battles to fight in building a safe and sound banking sector
- Four undertakings to assist the construction of a safe and sound banking sector
- Process to manage reform

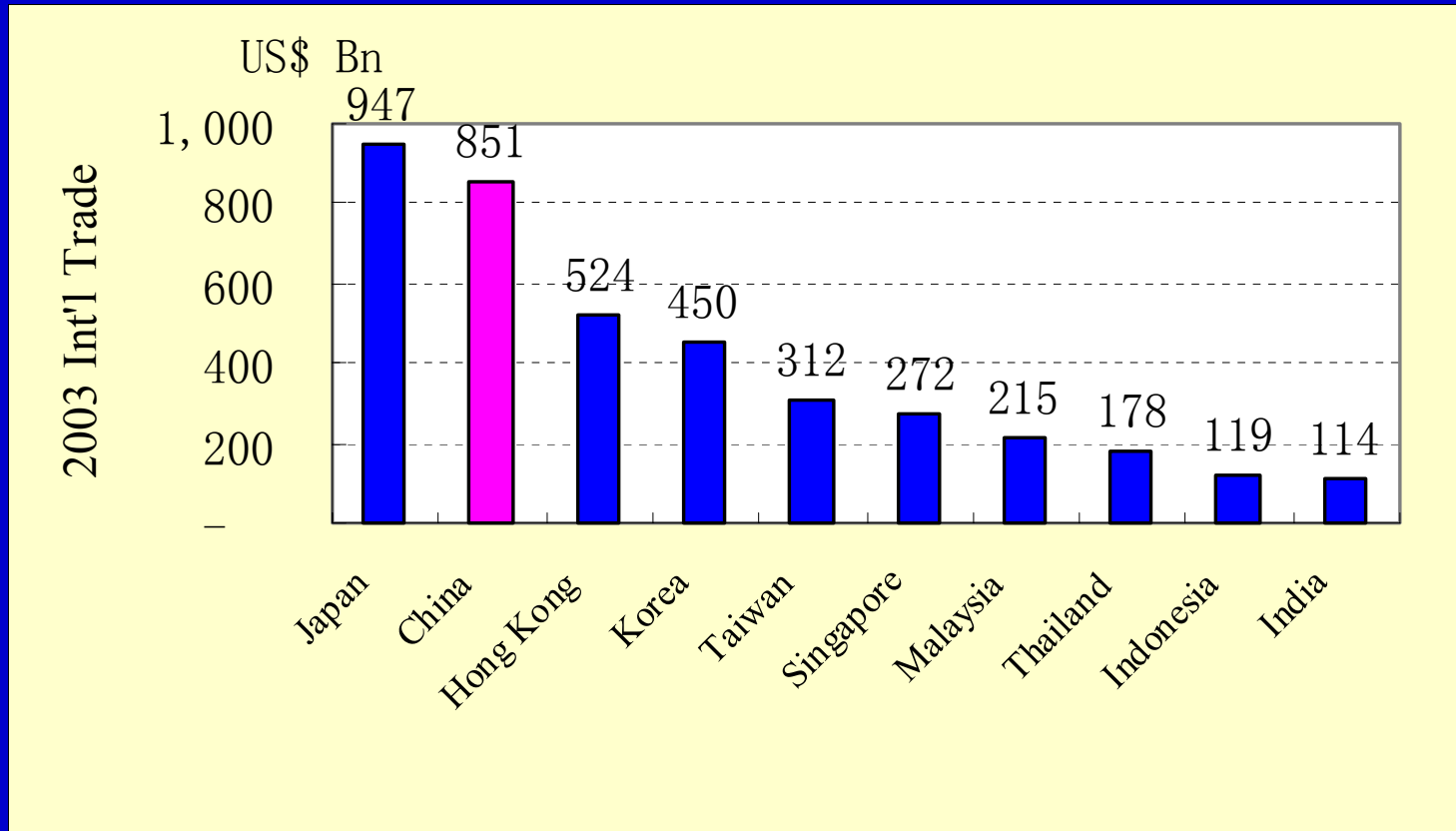
China is the second largest economy in Asia in terms of GDP and trade, only behind Japan.

2003 Nominal GDP



Source: CEIC, IFS, Various Central Banks

2003 Exports & Imports

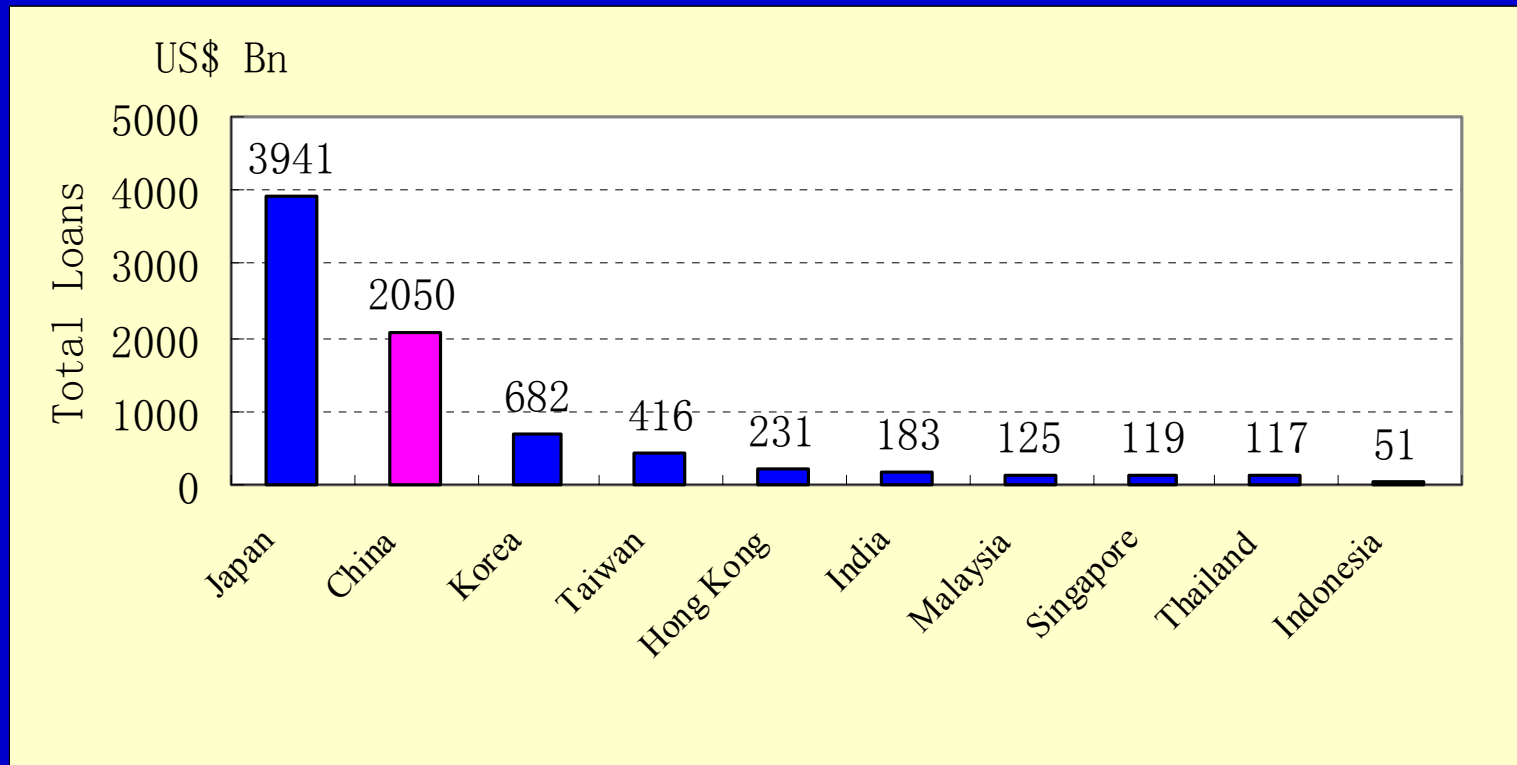


Source: CEIC, IFS, Various Central Banks

China has an enormous banking sector.

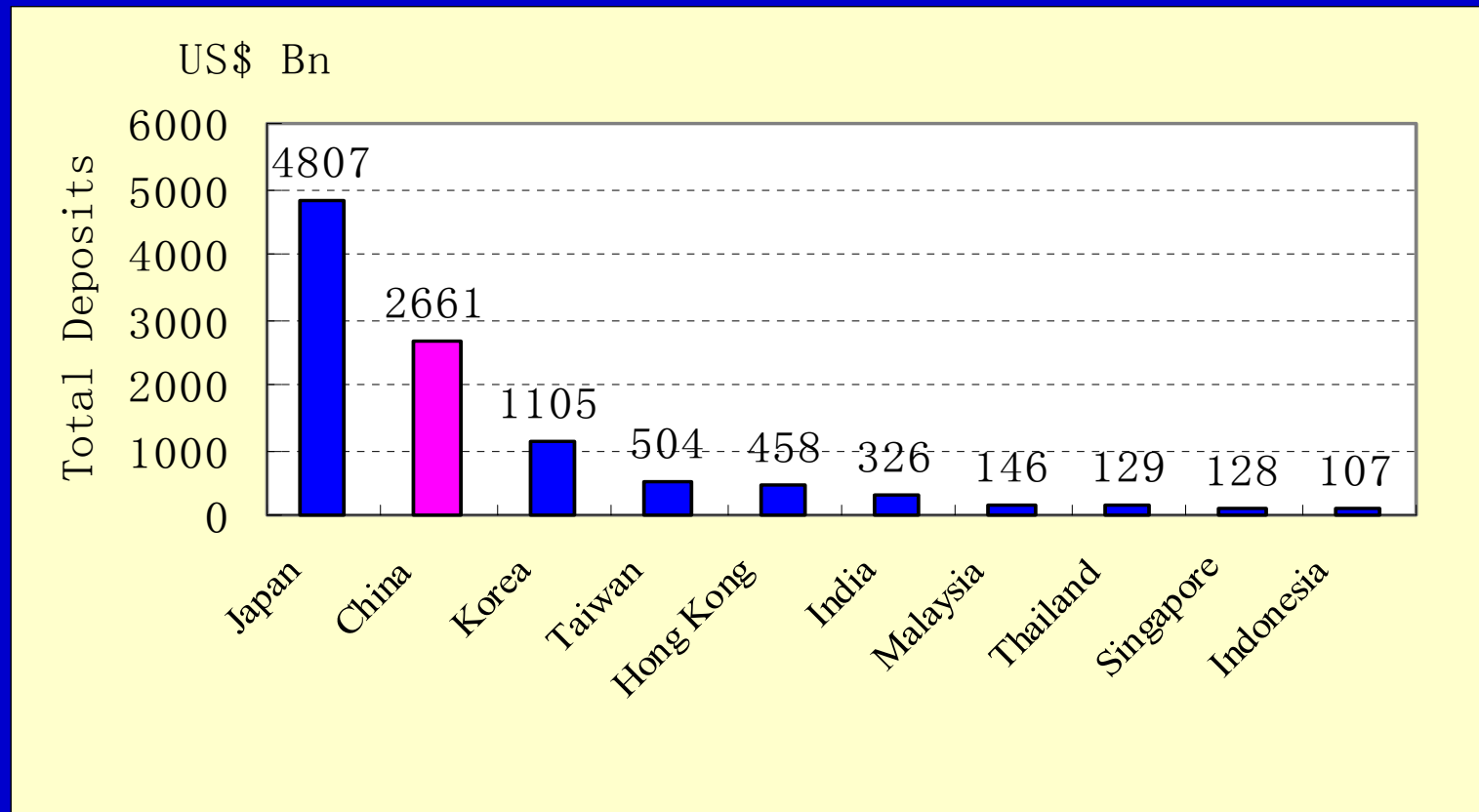
- China has one of the largest banking markets in Asia, as measured by system-wide loans and deposits.

Total Loans in 2003



Source: CEIC, IFS, Various Central Banks

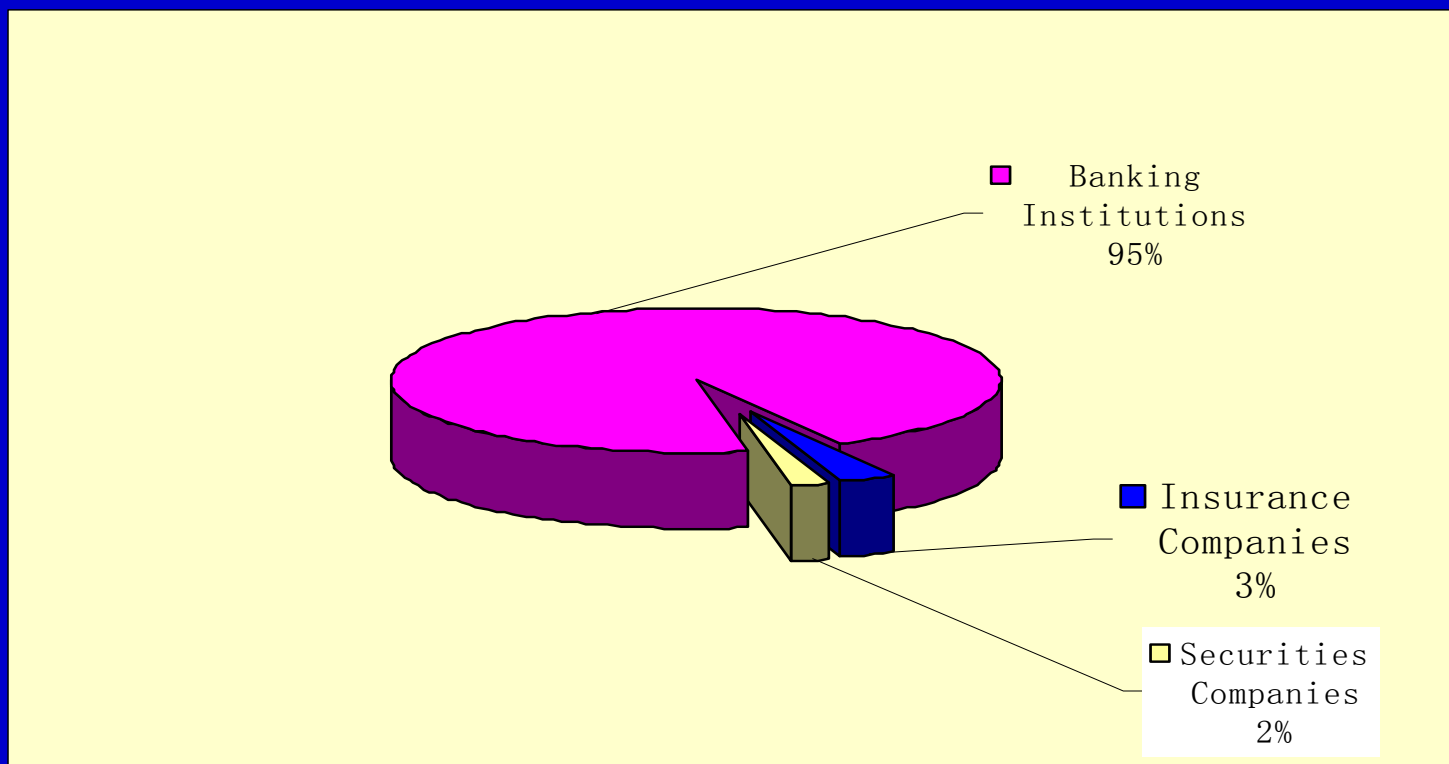
Total Deposits in 2003



Source: CEIC, IFS, Various Central Banks

- The assets of the banking sector account for around 95 per cent of the total assets of all financial institutions in China.

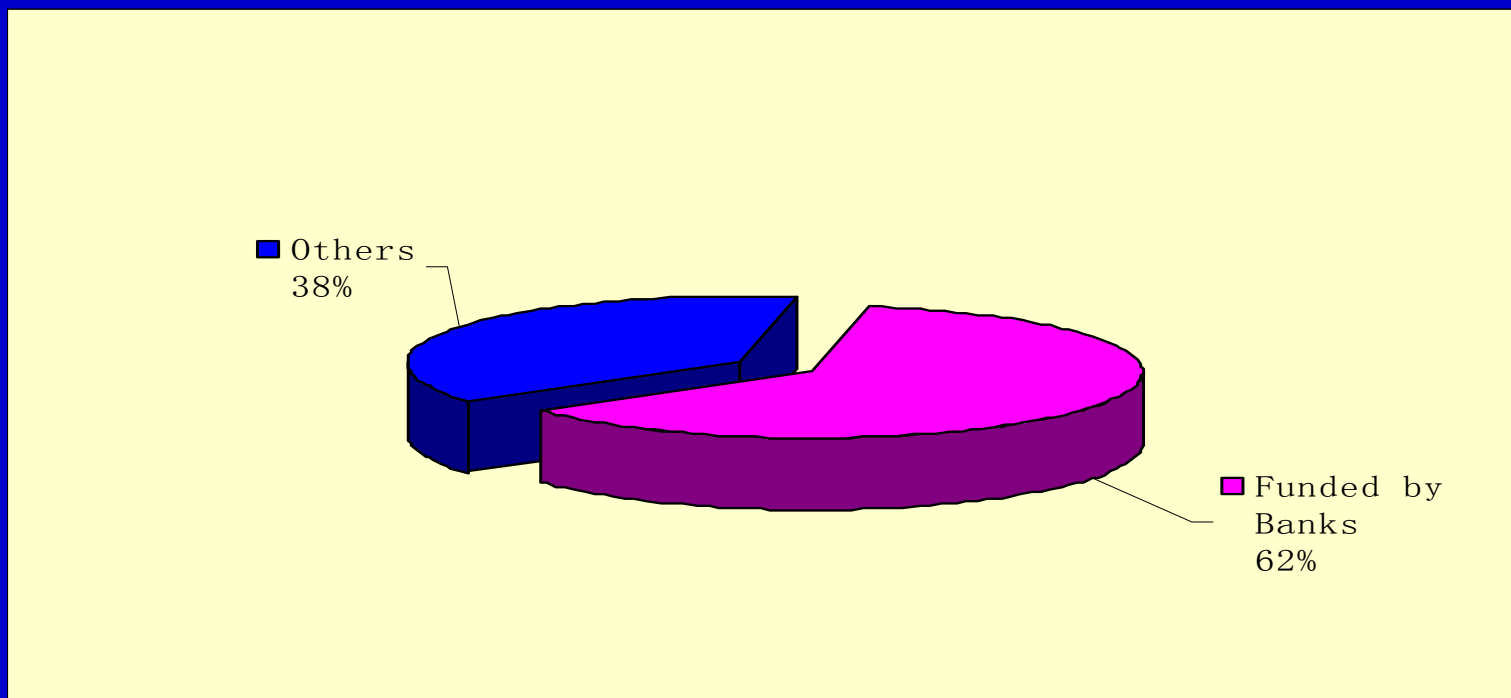
■ Financial Assets Distribution



Source: PBC, CBRC

- 62 per cent of the fixed-asset investments in China are funded by the banking sector.

Fixed-asset Investments Composition

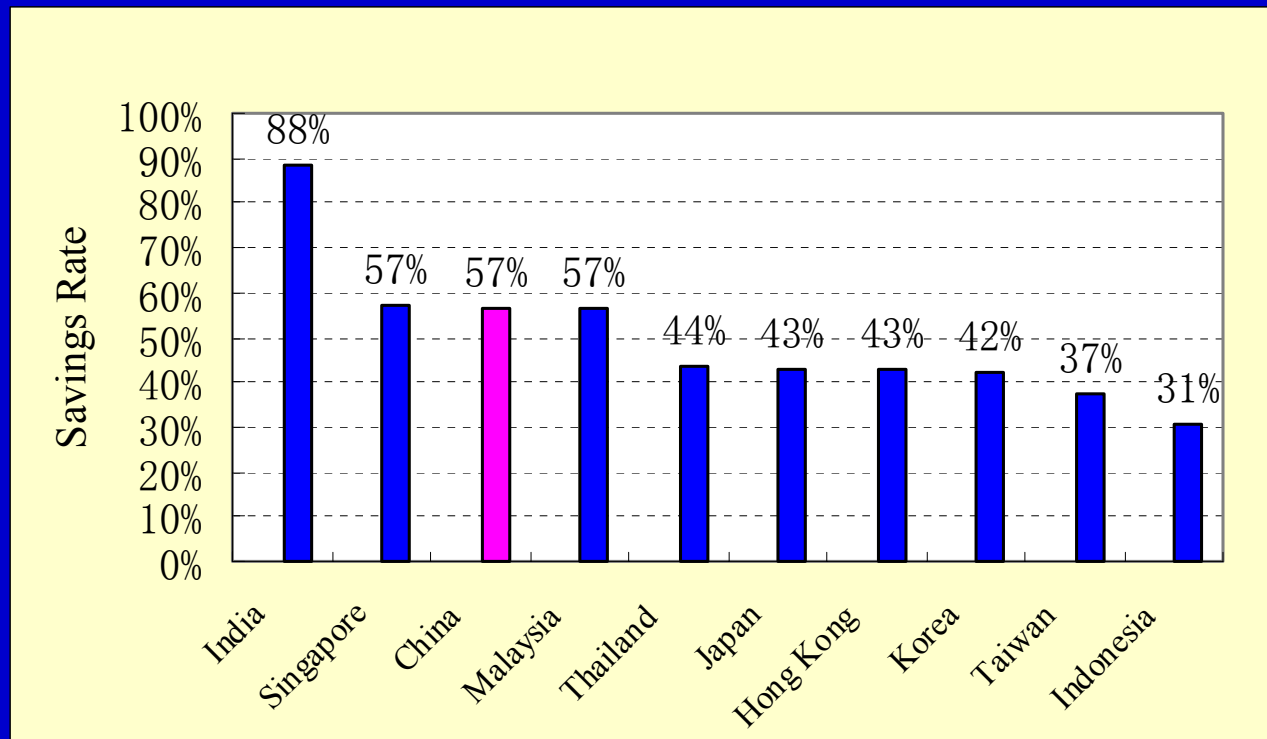


Source: PBC, CBRC

China has unique fundamentals well-suited to consumer banking.

- China has large savings.

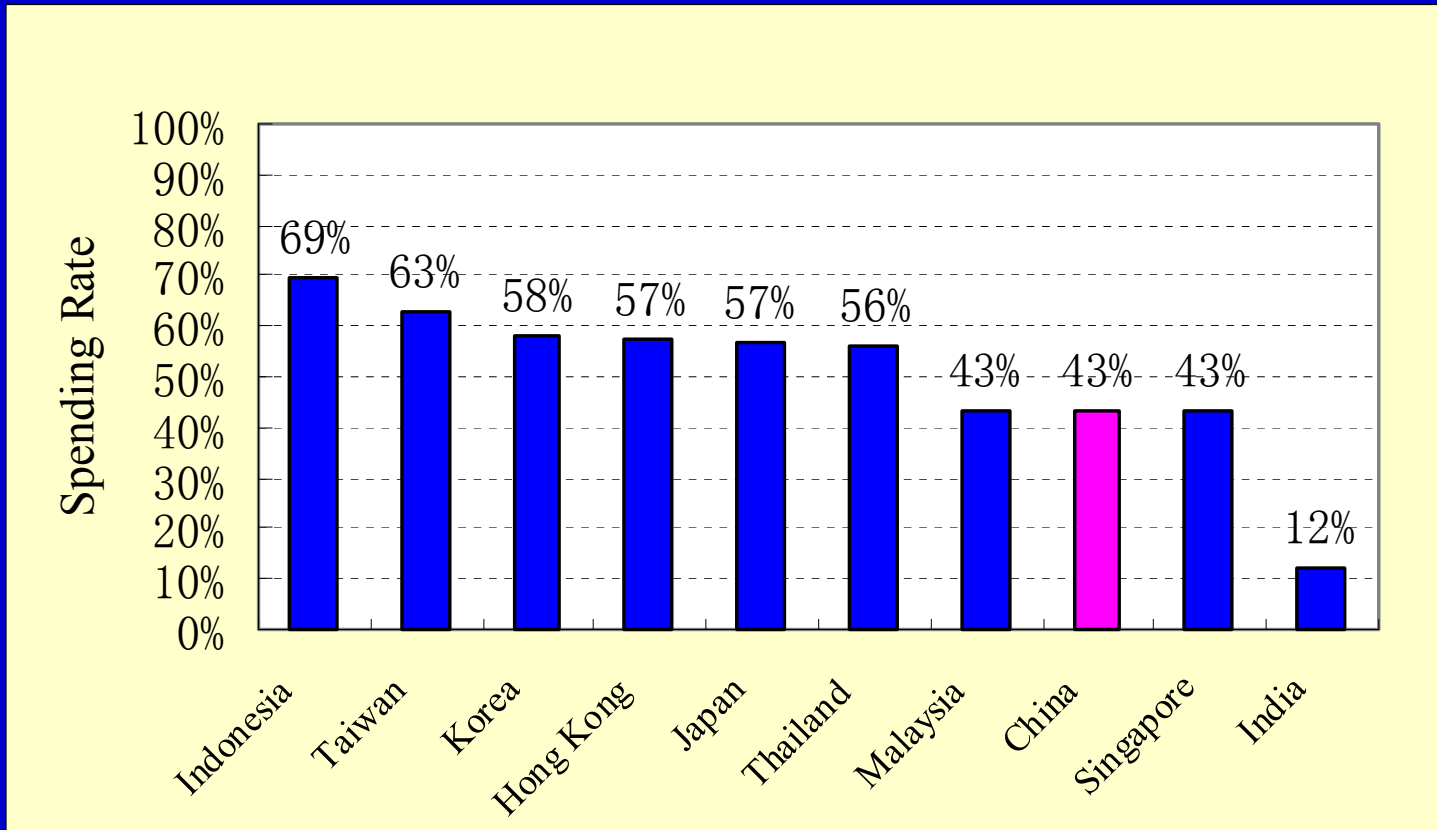
Savings as % of GDP



Source: CEIC, IFS, Various Central Banks

- China sees large consumer spending.

Spending as % of GDP

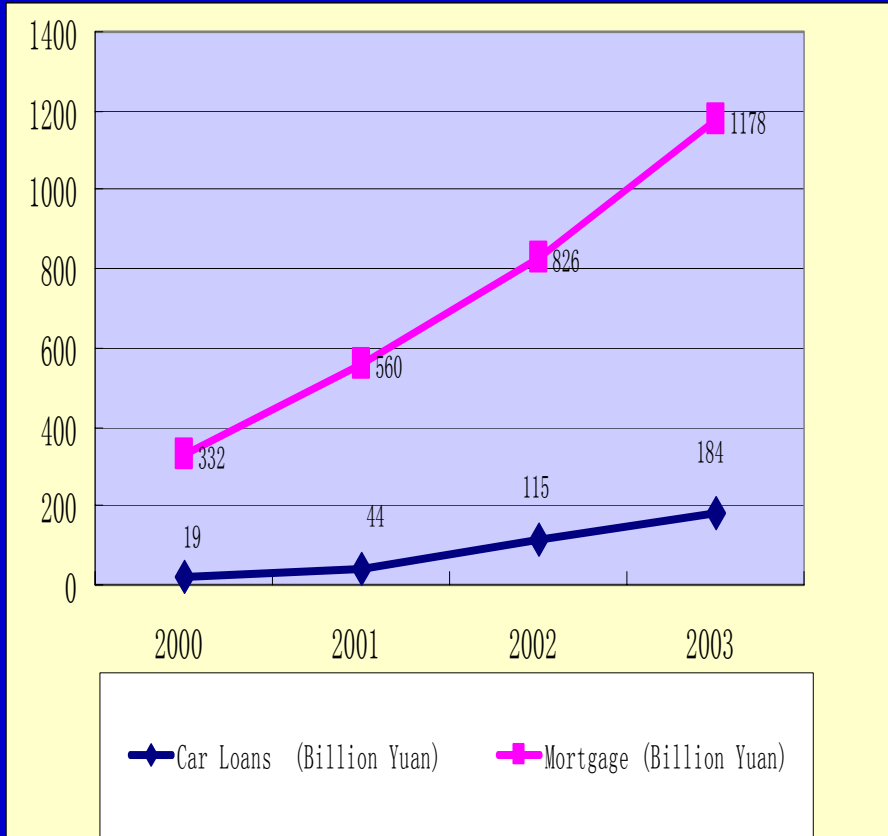


Source: CEIC, IFS, Various Central Banks

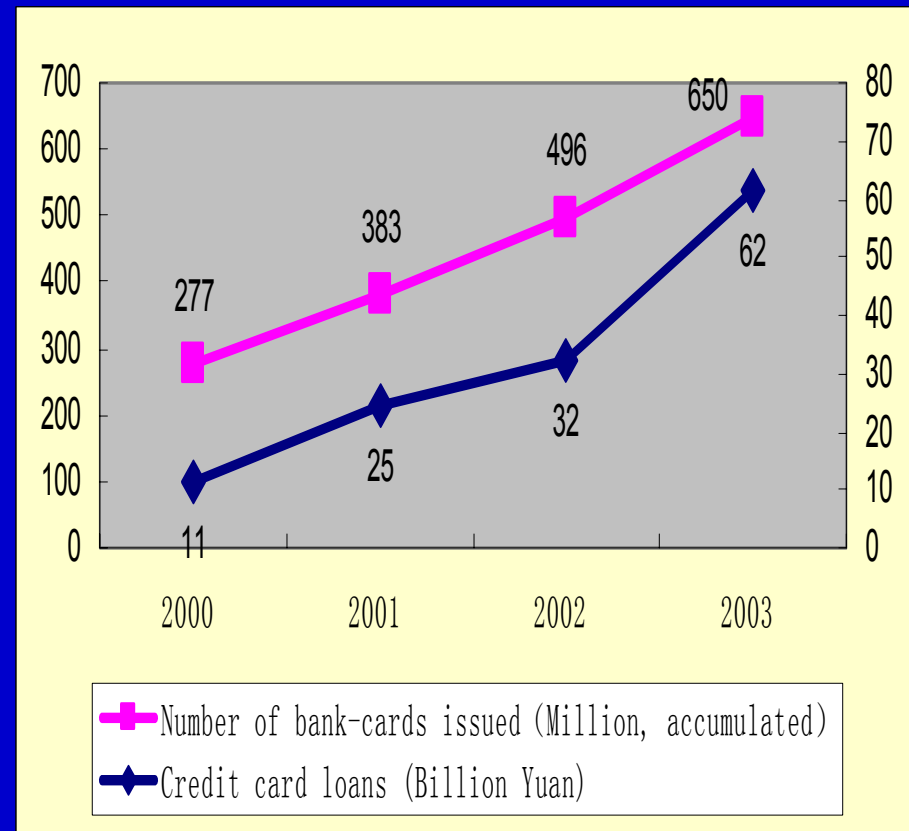
China's consumer banking grows by leaps and bounds.

Over two decades of economic reforms and growth have laid a foundation for private capital formation and wealth accumulation. China's GDP per capita has exceeded the threshold of US\$1,100. These in turn form the basis for the growth of consumer banking business.

Car & Housing Loans



Bank-card Business



China has abundant opportunities in wealth management...

As consumers become increasingly sophisticated and economy increasingly matured, the bank customers are migrating away from traditional bank deposits towards such products as funds, insurance, pension, etc.

Example of Dis-intermediation in China

Alternative Saving Products	Drivers for Demand
Mutual Funds Investment-Linked Insurance	Customer demand for a more risk/return balanced product as compared with securities versus savings
Pension	An aging population
Investment in Cars, Home and Other Personal Assets	Increasingly affluent population more able to afford large fixed assets
Life insurance	Customer demand for retirement products

- Economic underpinnings to the banking sector
- *Three battles to fight in building a safe and sound banking sector*
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- Process to manage reform

The first battle refers to the reforms of the big 4 banks.

- The big four SOE banks are the major players in the Chinese financial market, with their assets accounting for almost 55 per cent of the total bank assets in China. Crucial as it is, the reform of the big four is not an easy job.
- The ultimate success of the reforms lies in diversification of the banks' ownership and fundamental transformation of their operating mechanisms.

- We have chosen the BOC and the CCB to carry out the reforms on a pilot basis.
- We set ten guidelines requiring better corporate governance, including:
 1. Having a clear corporate governance structure comprising the general shareholders meeting, a board of directors, a board of supervisors and an executive management, with all the necessary checks and balances
 2. Selecting domestic and foreign strategic investors to form synergy

3. Setting out clear-cut strategies
4. Establishing sound decision-making process, internal controls and risk management system
5. Adopting reduced layers of hierarchy and streamlined business structure
6. Introducing accountability and motivation
7. Having in place the prudent accounting practices and transparency
8. Building up an up-to-date management information system

9. Underpinning staff training plus talents recruiting

10. Giving a full play to the professional consulting services

■ On the way for their restructuring and IPO, we recommend the following seven benchmarks to measure the banks' progress, many of which already represent the level of international best practice.

1. Net ROA (Return on Assets) ratio will reach 0.6 per cent by 2005, and will be further increased to the level of the best international banks by 2007.

2. Net ROE (Return on Equity) ratio will reach 11 per cent or above by 2005, and be further increased to 13 per cent or above by 2007.
3. Cost/income ratio will be controlled within the range of 35 to 45 per cent starting from 2005.
4. Non-performing asset ratio will be controlled within the range of 3 to 5 per cent.
5. The largest exposure to a single borrower will be no more than 10 per cent of the total capital.

6. Capital adequacy ratio (CAR) will be above 8% all the time.
 7. NPL provisioning coverage ratio will reach 60-80 per cent by 2005 and try to reach 100 per cent by 2007.
- The other two SOE banks' reform will be following and they are required to move quickly, too.

The second battle has been waged to the reforms of rural credit cooperatives (RCCs).

- As China's urban economy grows faster, hopes are now being pinned on the vast rural hinterland as the next source of growth. It depends how the financial things are done.
- Since the second half of 2003, the State Council has launched the pilot reforms of RCCs in eight provinces and municipalities, which will be further expanded this year.
- The reforms of RCCs will focus on ownership change, management and operating mechanisms improvement.
- The number will be dramatically reduced from 35500 to more than 3000.

The third battle refers to the restructurings of small and difficult banks.

- A comprehensive and mandatory evaluation process is a must.
- An orderly plan of liquidation and restructuring over 3 to 5 years requires coordination with high level policy objectives and constraints.
- Moving too fast is destructive, moving too slow is expensive.
- Enhanced corporate governance and credit culture should be a by-product.

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The first undertaking is to introduce private capital and foreign strategic investors.

- At present, no legal obstacles exist to prohibit Chinese commercial banks from introducing private capital and international strategic investors.
- A single overseas investor is now allowed to hold up to 20 per cent stake of a Chinese bank.
- The experience of Bank of Shanghai and Shanghai Pudong Development Bank shows that such practice has both improved their corporate governance and enhanced their management and innovation capacity.
- Relevant policies and procedures need to be developed for investor's qualification review, corporate governance evaluation and foreign exchange management.

The second undertaking is to accelerate the cultivation of a credit culture and market discipline.

- To speed up the construction of a nationwide database to provide both individual and corporate credit information
- To promote the development of commercialized and professional credit information agencies and set industry standards for credit information services

- To strengthen the transparency and set relevant standards and rules
- To further improve the legal and institutional environment for NPL disposal. Such a framework will incorporate bankruptcy laws, arbitration procedures, judicial process, etc.

The third undertaking is to promote fair competition and financial innovations by exercising sound and efficient supervision.

- To promote financial stability and facilitate financial innovations at the same time
- To enhance the international competitiveness of the Chinese banking sector
- To set appropriate supervisory and regulatory boundaries and refrain from unnecessary controls

- To encourage fair and orderly competition
- To clearly define the accountability of both the supervisor and the supervised institutions
- To employ supervisory resources in an efficient and cost-effective manner

The fourth undertaking is to put into place effective market exit mechanisms and an efficient financial safety net.

- We must underpin the market competition mechanisms to highlight the role of market discipline.
- We must build a financial safety net, which contains, among other things, the lender of last resort function performed by the central bank, financial bailout mechanisms and a deposit insurance system.
- However, we must be careful not to create moral hazards, and undermine the role of market discipline.

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Process to manage reform

- Reform is a process and we need to manage the reform process so that it stays the course and any departures from path can be put back on track through set procedures.
- Reform needs change of ownership.
- Reform requires a mindset change.

“If you wish to succeed, you should use persistence as your good friend, experience as your reference, prudence as your brother and hope as your sentry.”

--- Thomas Edison

THANK YOU