

SECTOR ASSESSMENT (SUMMARY): FINANCE

Sector Road Map

A. Sector Performance, Problems, and Opportunities

1. Financial sector reform and development remain key priorities of the government by recognizing that a more efficient financial system will play an important role in private sector development through more efficient allocation of capital. Contributing to financial sector development is the government's commitment to fully liberalize interest rates and to expand economic reforms and broaden and deepen financial markets to ensure that the market will play a more decisive role in the allocation of resources. However, challenges to development remain particularly from the risks in shadow banking activities, use of wealth management products, and growth in the non-regulated financial sector that include online financing.

2. **Access to Finance.** As of 2014, micro, small, and medium-sized enterprises (MSMEs) account for about 80% of manufacturing jobs and of new job creation in urban areas. More importantly, MSMEs employ more low-income workers and socially vulnerable groups, and are sometimes the only source of employment in poorer regions. Although MSMEs are a major source of growth, access to finance continues to be a challenge. There are issues related to directed lending by the major banks. Many MSMEs are unable to satisfy the requirements of a formal credit decision process due to lack of collateral, proper accounting procedures, and sound business track records resulting in higher administrative costs for banks and higher perceived credit risk. Further, there are impediments due to legal obstacles including consistency in the regulation of credit, the use of collateral such as inventory, receivables, and land, and concerns with the bankruptcy process. Lack of coherent financial consumer and investor protection frameworks, underdeveloped credit rating and credit history industries, and weaknesses in financial literacy also impair access to various forms of finance. While a credit guarantee system exists, it is fragmented and operated at a sub-national level. Regardless, some key innovations have arisen in support of access to finance. There has been significant growth in e-payment platforms, crowd financing, and peer-to-peer (P2P) services. Numerous private sector internet companies are entering the market to create "over the top" financial services that bypass traditional financial channels. Steps are also being taken to further develop the financial consumer protection system.

3. **Micro and Rural finance.** Rural finance remains in need of further development particularly in the less developed central and western parts of the PRC. Concerns are characterized by a lack of competition, lack of motivation by investors to participate in the sector and establish rural micro finance institutions, and the need for an improved enabling operating environment. Regulation of microfinance institutions is inconsistent, market entry remains difficult, and the institutions are subject to many restrictive requirements that have unclear foundations in prudential policy. Alternative forms of rural finance have emerged, such as village and township banks (VTB), rural mutual finance societies, and loan corporations. As of 2014, there are about 2,000 country-level rural credit cooperatives, 147 rural cooperative banks, and 800 VTBs in operation. Microfinance has grown rapidly with over 8,590 microcredit cooperatives (MCCs) in existence as of 2014 having grown rapidly over the last 10 years. MCCs are crucial in supporting the development of rural finance yet; they remain constrained by strict capital controls, low access to credit reporting information for potential borrowers, lack of expertise, and limited capacity in raising funds. Yet, some of these constraints are moderating such as with the introduction of a rating concept to differentiate the relative strength of MCCs.

4. **Financial Stability, Regional Cooperation and Global Integration.** Legislation and an effective toolkit for financial stability are needed that include delineating responsibilities between the People's Bank of China (PBOC) and other regulators, and integrating finance sector oversight with higher-level strategies that manage monetary policy, interest rates and the Chinese yuan (yuan). Efforts continue to further create a pure market driven finance sector. Interest rate controls have been basically lifted and steps to full liberalization continue. The first licenses were granted in 2014 for 5 fully privately capitalized banks to begin establishment under a pilot program. A deposit insurance scheme was established on 1 May 2015 under the management of the PBOC as one component of a financial safety net and to support full liberalization of deposit interest rates. The scheme provides deposit protection up to 500,000 yuan. The rapid growth of lending via wealth management products is a concern given rising defaults in this unregulated segment that comprises a significant part of concerns with shadow banking activities. Proper regulation and control over alternative finance platforms through P2P and online portals are also a concern.

5. Regional cooperation and global integration of the PRC finance sector is expanding rapidly, but still faces challenges with further internationalization of the yuan, full liberalization of interest rates and opening of the capital account for financial flows. Significant progress has been made with the use of the yuan for cross-border trade, in particular with regional partners whereby the yuan is now considered the second largest trade currency globally after the US dollar. However, improvements can be made with finance support to cross-border trade. In 2013, the first pilot project, the China (Shanghai) Pilot Free-Trade Zone, was put in place that also aims to expand and liberalize the finance sector. The zone allows free movement of interest rates and permits yuan convertibility and unrestricted foreign currency exchange and facilitates the management of capital accounts.

6. **Capital Markets and Green Finance.** Financing constraints limit the potential for innovation in finance, development of capital markets and green finance. With the continued dominance of banking in the PRC financial sector, capital markets remain relatively underdeveloped despite significant growth in stock and bond markets. Relative to the size of the economy and to total outstanding bank loans, the PRC's corporate bond market is still small. Although, steps have been taken to improved private access to the publicly traded equity market by SMEs, there has been only modest impact. Issues exist with restrictive regulations, lack of a legal framework, underdeveloped information and rating agency services, and the poor risk management capabilities of financial intermediaries. An institutional investor base is lacking in due in part to limited expertise in evaluating investments, risk aversion, and restrictions on investment options particularly for public sector pension, social, and insurance funds. There is a lack of a coherent investor protection framework. Legal, regulatory and tax impediments exist to formation of innovative financing structures; such as for securitizations, and with custody and trust functions that can support a full range of debt issuance.

7. A number of actions have taken place recently that further support deepening of the capital markets and internationalization. The Shanghai-Hong Kong Stock Connect was launched in November 2014 as a market access arrangement where investors in Hong Kong and the PRC can trade and settle shares listed on the other market respectively via the exchange and clearing house in their local markets. The scheme is an important step forward in opening the PRC's financial market and internationalization of the yuan. Steps have been taken to support development of the private equity industry by mitigating overlapping regulatory authorities by appointing the China Securities Regulatory Commission (CSRC) as the industry's primary regulator. Rules were also issued and clarified governing the registration and marketing of new funds, disclosure of fees, investment strategies and conflicts of interest, the oversight of

merger and acquisition (M&A) activity, and to simplify the review and approval process for foreign M&A transactions. A registration system for initial public offering of securities was adopted in 2014 in line with systems in place in developed financial markets. Steps have been taken to reform local government debt management to support development of a municipal bond market. For the first time, within limits, local governments can issue bonds with no central government guarantee. Bonds may comprise general obligation and hybrid revenue-type bonds. Further, the CSRC re-opened and clarified rules for issuance of securitizations.

8. Green finance pursues coordinated development between financial activities, environmental protection and ecological balance, thus realizing sustainable economic and social development. Development of green industries and restructuring of traditional industries towards more energy saving and environmentally friendly ones leads to large financial demands. Innovative financing platforms to meet the demands need to be explored and developed based on sound and efficient financial sector in PRC. The following issues among others are key challenges that need to be addressed to further promote green finance in PRC. First, there has been lack of favorable policy and legal framework. PRC's environmental policies and legal systems need to be further improved to support overall financial sector to provide green finance. Secondly, internal and external incentive structures need to be developed to increase private capital mobilization for green projects. While mobilizing private capital to fill the financing gap and to enable green transformation of PRC's economy is critical, policy instruments to establish a favorable investment environment for green projects have been insufficient. Various policy options to incentivize green finance need to be explored and assessed. Lastly, a longer term strategy and coordination mechanisms among policy makers and relevant authorities need to be established. Currently, green finance policy objectives of financial regulatory authorities are still limited to controlling loan provisions for energy-consuming, high-pollution and resource-based enterprises in order to realize short-term energy conservation and emission reduction targets.

B. Government's Sector Strategy

9. **Role of the Private Financial Sector.** The emphasis of the role of the private financial sector was highlighted by the government in November 2013 stipulating that the country will deepen its economic reforms to ensure that the market will play a more decisive role in the allocation of resources.¹ Further, in July 2013 ten measures were issued to serve as a guideline for the reform of the financial system.² The 12th Five-Year Plan for the Development³ and Reform of the Financial Industry detail seven key strategies for development and reform of the finance sector including: (i) improving macro adjustment and control and facilitating steady and sound economic development, (ii) optimizing deployment and establishing a modern financial

¹ 12 November 2013, *Communiqué of the Third Plenum of the 18th Central Committee of the Communist Party of China*, Beijing.

² July 2013, State Council of the People's Republic of China measures to serve as a guideline for the reform of the financial system: (i) maintain prudent monetary policy and a reasonable money and credit supply to support economic restructuring; (ii) use credit flows to guide the country's economic restructuring, supporting emerging strategic industries, the information technology industry, the service sector, and other labor-intensive industries, and curbing sectors with overcapacity; (iii) integrate financial resources to support the development of small and microenterprises, and increase financial support to technology and innovation-oriented small and medium enterprises; (iv) increase credit support for agriculture and expand financial services in rural areas; (v) boost domestic consumption by improving the environment for consumer finance; (vi) support companies that are seeking overseas expansion by providing various financing channels; (vii) develop a multilevel and mature capital market; (viii) expand insurance coverage in agriculture and for those companies with global plans, among others; (ix) encourage private capital to invest in the finance sector, such as private banks, financial leasing firms, and consumer finance companies; and (x) guard against financial risks, especially those associated with local government debt and property financing.

³ 2011-2015

system, (iii) encouraging innovation and speeding up the development of a multi-tiered financial market, (iv) continuously improving financial operations through reform, (v) deepening and further opening up the financial system, (vi) enhancing regulation for financial stability and security; and, (vii) optimizing the environment for financial development.

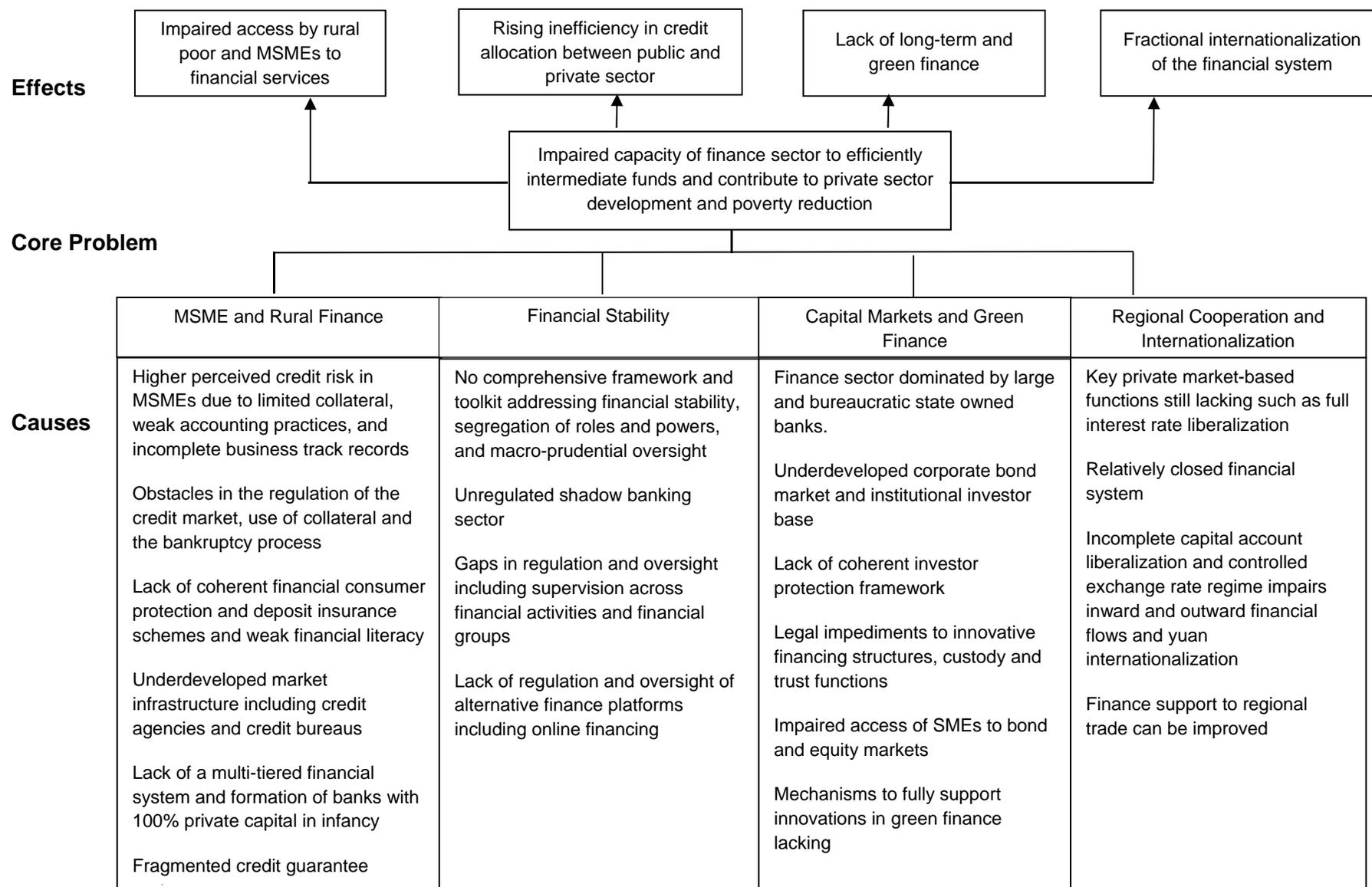
C. ADB's Sector Experience and Assistance Program

10. Asian Development Bank's (ADB) finance sector operations in the PRC are focused on: (i) financial inclusion; (ii) financial innovation in such areas as structured finance, local government finance, public-private partnerships, and climate-change finance; (iii) financial stability through supporting financial system frameworks and supervision; and (iv) regional financial integration and financial stability through regional surveillance, the implementation of legal and regulatory frameworks, and developing capacity, among other actions. To improve access to finance, advisory assistance in the financial sector has encouraged rural financial reforms, support for rural financial statistics, microfinance development, and credit guarantees for small and medium-sized enterprises (SMEs). To deepen the financial markets, technical assistance has been provided for risk management, financial market supervision, cooperation among financial regulators, and bond market development in Asia and the Pacific.

11. Support focuses on finance sector policy, legal, and regulatory reforms to encourage the private sector's continuing development. ADB has also supported SMEs finance through various private equity funds' investments, including an environment fund. ADB also supported creation of a rating system for MCCs to enhance their access to finance in support of financial inclusion. ADB's nonsovereign operations will continue to help improve access to finance and financing projects with high development and demonstration impacts. ADB helps develop financial solutions with innovative contractual and financial structures to encourage private participation, enhance management expertise, and improve corporate governance. ADB's nonsovereign operations will continue to help commercial banks and nonbank financial institutions mobilize resources and manage risks, and promote access to finance in rural areas. Through equity investments and loans to financial institutions, ADB promotes finance sector development and institutional reform (corporate governance and internal controls). ADB also assists SMEs through support to financial intermediaries and continues to explore new financial products and mechanisms to expand the flexibility and availability of financing for SMEs. ADB is also working to promote private participation to support energy efficiency and clean energy, transport, and urban environmental services, particularly wastewater treatment and district heating. ADB's equity investments help catalyze foreign investment and promote sound corporate governance and internal risk controls.

12. ADB has previously supported green finance in line with the Government's shift towards a model of economic growth with environmental management. Emission trading mechanism was developed and tested under pilot scheme, and ADB will further assist in establishing a national emission trading system. Recognizing the difficulties faced by SMEs in securing sufficient funds to implement energy efficiency and emission reduction projects, ADB supports energy service company (ESCO) financing model and will assist in establishing ESCO guarantee funds. In terms of debt instrument, ADB will facilitate green bond market development through policy and regulatory improvement that address any existing barriers. Furthermore, ADB supports establishing green funds through fund of funds to leverage public and private capital for climate change finance.

Problem Tree for Finance Sector



MSME = micro, small, and medium-sized enterprises, SME = small and medium-sized enterprise

Source: Asian Development Bank