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FINANCIAL SECTOR ASSESSMENT

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A joint IMF-World Bank mission visited China in multiple missions between October 2015 and June 2017, to update the findings of the Financial Sector Assessment Program (FSAP) conducted in 2011.[1] This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities and developmental challenges, and provides policy recommendations.

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GLOSSARY

ADBC	Agricultural Development Bank of China
AMC	Asset Management Company
AML/CFT	Anti-Money Laundering / Combating the Financing of Terrorism
AMP	Asset Management Plan
AUM	Assets Under Management
AQR	Asset quality review
BCP	Basel Core Principles for Effective Banking Supervision
CBRC	China Banking Regulatory Commission
CCB	City commercial bank
CCDC	China Clearing and Depositary Corporation
CCP	Central counterparty
CCyB	Counter-cyclical capital buffer
CDB	China Development Bank
CDS	Credit default swap
CET1	Common equity tier 1 capital
CIS	Collective Investment Schemes
CIPS	China's Cross-border Interbank Payment System
CIRC	China Insurance Regulatory Commission
CP	Commercial Paper
CRA	Credit rating agency
C-ROSS	China Risk Oriented Solvency System
CSDC	China Securities Depository and Clearing Corporation Limited
CSRC	China Securities Regulatory Commission
DIF	Deposit Insurance Fund
DSTI	Debt-service-to-income ratio
DTI	Debt-to-income ratio
DVP	Delivery versus payment
EXIM	Export-Import Bank of China
FATF	Financial Action Task Force
FCRG	Financial Crisis Response Group
FCP	Financial consumer protection
FHC	Financial holding company
FI	Financial institution
FMI	Financial Market Infrastructure
FPC	Financial Policy Committee
FSB	Financial Stability Board
FSDC	Financial Stability and Development Committee
GFC	Global Financial Crisis

G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
G-SII	Global Systemically Important Insurer
ICRE	Infrastructure, Construction, and Real Estate
ICOR	Incremental Capital-Output Ratio
JMC	Financial Regulatory Coordination Joint Ministerial Committee
JSB	Joint-Stock Bank
LCR	Liquidity coverage ratio
LGFV	Local Government Financing Vehicle
LOLR	Lender of Last Resort
LTV	Loan-to-value ratio
ML	Money laundering
MPA	Macroprudential Assessment
MSE	Micro- and small enterprise
MTN	Medium-Term Note
NBFI	Nonbank Financial Institution
NCD	Negotiable certificate of deposit
NDRC	National Development and Reform Commission
NPL	Nonperforming Loan
NSCA	Non-Standard Credit Asset
OTC	Over the counter
OCW	Out-of-court workout
PBC	Peoples' Bank of China
PFMI	CPSS-IOSCO Principles for FMIs
RCC	Rural credit cooperative
RMB	Renminbi
ROA	Return on assets
ROE	Return on equity
RFI	Rural financial institution
SHCH	Shanghai Clearing House
SMEs	Small and medium enterprises
SOE	State-Owned Enterprise
STR	Suspicious transaction report
TFP	Total factor productivity
TSF	Total Social Financing
WEO	World Economic Outlook
WMP	Wealth Management Product

PREFACE

A joint World Bank and IMF team visited China in multiple missions between October 2015 - June 2017 to conduct an update of the Financial Sector Assessment Program (FSAP) conducted in 2011. The mission assessed financial sector risks and vulnerabilities, the quality of financial sector supervision, and financial safety net arrangements, and examined the developmental challenges facing the financial sector.

The mission met with senior leaders and officials from a number of regulatory and government agencies, including the People's Bank of China (PBC), China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC), National Development and Reform Commission (NDRC), the Ministry of Finance (MOF), the Ministry of Human Resources and Social Security, State Administration of Foreign Exchange (SAFE), the Legislative Affairs Office of the State Council, and the National Bureau of Statistics. It also met with representatives from financial institutions, industry organizations, academics and the private sector.

The FSAP team would like to extend its deepest gratitude to the authorities for their impeccable preparation, constructive dialogue and excellent cooperation, and substantive contributions to the FSAP process. The PBC, CBRC, CIRC, and CSRC provided answers to hundreds of questions, translated innumerable pages of regulation and legislation, and patiently responded to questions and clarifications. Counterparts across the country were, without exception, well prepared. We would like to extend a special mention of appreciation to the FSAP offices of the PBC and the regulatory agencies for their responsiveness in efficiently organizing and facilitating many meetings. The challenge of understanding the complex Chinese financial system would have been impossible without the continued support of the Chinese authorities at the national level, but also at the regional level in Changchun, Chengdu, Chongqing, Fuzhou, Guangzhou, Hangzhou, Shanghai, Shenzhen, Shijiazhuang, Wenzhou, and Hong Kong SAR.

OVERALL ASSESSMENT AND SUMMARY OF MAIN RECOMMENDATIONS

Since the 2011 Financial Sector Assessment Program (FSAP), China's economic growth has remained strong, although a necessary economic transformation is underway. China now has the world's largest GDP in PPP terms, and poverty rates have fallen. However, medium-term growth prospects have moderated. The limits to the investment-driven growth strategy, combined with an aging population, waning dividends from past reforms, and a challenging external environment, have necessitated a transformation towards a more market-oriented economy that is more consumption-based, more services-driven, less credit-dependent and, especially, more efficient. This transformation has already started, as the Chinese authorities are increasingly emphasizing the quality of growth and have pushed structural reforms.

The economic transformation requires a fundamental change in the role of the financial system. Historically its role was to channel China's high savings at low cost to strategic sectors. China's economic rebalancing is multi-dimensional, and there is a need to significantly improve the financial sector's capital allocation to promote the rebalancing from investment to consumption; from heavy manufacturing to services; and from large to small enterprises. Looking ahead, the financial system will need to become more balanced, sustainable and inclusive, to facilitate China's economic transformation, where markets play an increasingly dominant role in resource allocation and where consequences of risk-taking are well-understood and accepted.

Although longer-term objectives are clear, policymakers continue to face challenges in balancing short-term growth concerns with long-term financial stability and sustainability. While liberalization has been extensive across banking, insurance, and securities markets, the government has tried to smooth the economic transition and minimize dislocations, and the financial sector has played an important role in the state's economic management. Expansionary monetary and credit policies have entailed the channeling of funds into public investments and declining sectors to sustain growth and reduce the short-run costs of transformation. These policies have proved increasingly ineffective in bolstering growth. They have also contributed to the rapid escalation in asset prices– notably equities and real estate in some areas – and leveraged exposures. The slow pace of state-owned enterprise (SOEs) reform and limited exit of weak firms have resulted in efficiency losses and reinforced the perception of implicit guarantees. Contingent fiscal liabilities have also grown rapidly.

Addressing these tensions is challenging in the context of the strong presence of the state in the financial sector. Despite notable progress with market-based reforms, the state continues to be involved as promoter, owner and regulator of the financial system. A high degree of government ownership and strategic control allow the state to influence the allocation of financial resources, to meet its economic and

social objectives. Incentive conflicts are particularly pronounced at the subnational level, where governments often fulfill conflicting roles as owners, and borrowers of financial institutions. The enduring presence of the state also reinforces perceptions of implicit guarantees, creating moral hazard, distorting risk pricing and weakening financial discipline. A realignment of the role of the state in the financial sector would help to better safeguard financial stability and promote sustainable financial development.

The evolution of the financial system reflects conflicts on key policy objectives, especially efforts to maintain economic growth while also containing risks. The financial system has grown dramatically in size and complexity since the previous FSAP. Bank assets now exceed three hundred percent of GDP; equity and bond markets have become the second and third largest in the world, and the insurance industry is expanding fast. Medium and smaller sized banks have grown particularly rapidly, as have wealth management products (WMPs), short-term wholesale funding and non-standard credit assets (NSCAs). There has been increased credit intermediation through nonbank channels, with increased interconnectedness between banks and non-bank lenders through funding arrangements, asset management channels, and common ownership. The authorities have tightened regulatory frameworks to reign in shadow banking and regulatory arbitrage, but the fundamental tensions between overall economic management and stability are left unaddressed.

The authorities recognize that a slower medium-term credit growth is required to put the economy on a more sustainable path. Credit growth has consistently outpaced GDP growth, leading to a large credit overhang. Much of the increase in leverage has occurred in the corporate sector, and strains have emerged in several highly-indebted sectors, that are resurfacing as pressures on asset quality in the banking sector. The deterioration of the financial condition of corporate borrowers has manifested itself in the banking sector in the form of an increase in NPLs, which remains low.

The CBRC has given close attention to the pressures on asset quality, but additional measures may be necessary. For a variety of reasons, the NPL ratio may not capture the full extent of the credit quality problems. Some small- and medium-sized banks have significant amounts of loans that are 90 days past due, but that are not classified as NPLs. In addition, banks have moved loans into the investment book, and off-balance sheet. The authorities' supervisory approach is based on the "look-through" principle (whereby the nature and quality of the underlying assets are considered), but its effectiveness requires rigorous enforcement. There is scope for some further tightening of classification requirements and practices. Asset quality reviews (AQRs) for banks most at risk, considering their regional and credit exposures, would be an important step towards greater transparency. Targeted increases in bank capital buffers may be required, taking into account the risk profile and management capacity of banks and the potential impact of economic transition.

The magnitude of corporate over-indebtedness calls for a higher level of ambition in dealing with distressed corporate borrowers. The current set-up, with a central role for the four national Asset Management Companies (AMCs), favors rapid disposal over restructuring and resolution. Effective resolution of distressed corporate debt will require political willingness to restructure over-indebted sectors, including operational restructuring of viable corporates and exit of nonviable ones based on a rigorous viability assessment. This could be addressed through a multi-track strategy, with each track dealing with a different type of distressed debts. In this regard, the recent creation of creditor committees is a step in the right direction. Such a strategy would require high-level coordination among key ministries and regulatory agencies, and would need to be based on political consensus. Legal and regulatory frameworks need to be improved to facilitate a range of court-supervised and out-of-court restructuring options, including the development of framework agreements for the recently established creditor committees. A mapping exercise of distressed debtors could be conducted as preparation for differentiated workouts under the multitrack approach. Targeted social programs would help cushion the impact of operational restructuring of distressed corporates and reallocate resources to more dynamic sectors and enterprises.

Maintaining financial stability would also require that remaining gaps in regulatory frameworks be addressed. The standard assessments for the banking, insurance, and securities sectors show a high degree of compliance with international standards, but also point to critical gaps. Themes that cut across China’s regulatory agencies include a lack of independence, insufficient resources for supervising a large and increasingly complex financial sector, and inadequate interagency coordination and systemic risk analysis. The remaining priorities for financial market infrastructure oversight include the adoption of full delivery-versus-payment and a stronger legal basis for settlement finality.

Further enhancements to crisis management frameworks are needed to allow financial institutions to fail in a manner that minimizes the impact on financial stability and public resources. This would require amongst others greater emphasis on financial stability rather than social concerns in dealing with real and potential crisis situations, the introduction of a special resolution regime for failing banks, and a streamlining of the current system of financial safety nets.

Taking a longer-term perspective, the evolving needs of a rebalancing economy call for a continuation of existing efforts to build a more inclusive financial sector. Important progress has been made in expanding financial access, but remaining challenges include reaching the “last mile”, and widening the range of financial services for individuals and micro and small enterprises (MSEs). This requires a more market-based approach, wherein policymakers focus on creating the enabling environment for providers to serve the underserved in a commercially sustainable manner. Key actions include expanding credit infrastructure, developing a comprehensive legal framework for data protection,

expanding the functionality of rural cash withdrawal points, improving the legal environment for rural financial institutions (RFIs), and properly regulating and supervising digital finance while allowing for innovation and expansion. Promotional policies and programs should be employed in a more limited and targeted manner, and regular assessments should be undertaken to ensure efficiency and impact.

Rebalancing also involves an increasing role for capital markets. Well-regulated and developed capital markets could support large scale long-term financing and provide essential investable assets and hedging tools for long-term savings in the context of an ageing population. A more balanced financial sector structure would also help to unburden the banking system and enhance financial stability. A key priority for the further development of the bond market is the enhancement of its level of liquidity, including through harmonization of tax treatment across instruments and greater use of issuance techniques to reduce debt fragmentation. In addition, there is scope for further improvements in credit culture, which requires reliable credit ratings, internal risk management capacity to monitor and price risks, and reduced perceptions of implicit guarantees. Lastly, important market development challenges remain, including through the expansion of access to a greater variety of credits and types of issuers (public and private); increasing the variety and depth of structured and derivatives products; and the development of a larger and solid institutional investor base, including mutual funds, pension funds and insurance companies.

Further progress in the reform of CDB and the policy banks is needed to enhance their developmental impact. The broad mandates of CDB and the policy banks raise questions about their additionality vis-à-vis commercial sources of financing, especially in the context of vast domestic savings and a fast-developing financial system. In addition, the business scope, exposures to local government financing vehicles (LGFVs) as well as the overall credit risk profile of CDB and the policy banks warrant careful evaluation to ensure financial sustainability and fiscal discipline and to minimize long-term efficiency losses. The mandates of CDB and the policy banks need further clarification, and their toolkit needs upgrading to ensure that they supplement and catalyze commercial financing. This needs to be supplemented with enhancements to corporate governance, to impose strong accountability while ensuring the competencies and independence of the boards in carrying out their duties. The monitoring and evaluation framework, transparency and disclosure should also be improved to better assess impact and to ensure public accountability. Consideration could be given to conducting a comprehensive assessment of the mandates, governance and policies of CDB and policy banks, as well as a functional analysis of instruments and impact evaluation of main lending and investment programs to gauge the effectiveness of interventions and inform future reforms.

TABLE OF MAIN RECOMMENDATIONS

Recommendation	Priority[1/]
Macro-Financial Policy and Implicit Guarantees	
De-emphasize national and local growth projections and goals for GDP.	H, NT
Continue to diversify the ownership structure of state-owned financial institutions and enterprises, and easing restrictions on the entrance of domestic and foreign private financial institutions.	H, MT
Strengthening financial discipline, including expanding selective bond default.	H, MT
Systemic Risk and Macroprudential Policy	
Create a new Financial Stability Sub-Committee (FSS-C) with the sole function of preserving financial stability.	H, NT
Establish robust mechanisms for cooperation and information exchange with domestic and foreign safety-net participants.	H, NT
Trigger the countercyclical capital buffer, and review banks' capital requirements with a view to a targeted increase in capital.	H, NT
Address data gaps that impede systemic risk monitoring and effective financial regulation and supervision.	H, MT
Financial Regulation and Supervision	
Amend primary laws to strengthen operational and budgetary autonomy of the PBC and the regulatory agencies, and increase their resources.	H, MT
Review the legal and regulatory framework for the oversight of financial groups, financial holding companies (FHCs), and industrial groups with financial subsidiaries.	M
Banking	
Enhance group risk supervision and the ability to supervise banking and wider financial groups, as well as ownership structures including the identification of ultimate beneficial owners.	H, MT
Strengthen loan classification requirement for 90-day past due and restructured loans, and eliminate the use of collateral in loan classification.	H, MT
Strengthen enforcement of the "look-through" principle and enhance reporting requirements on banks' investment holdings and provisioning.	M
Securities Markets	
Harmonize the regulation of collective investment schemes (CIS), address weaknesses in disclosure, custody, bankruptcy remoteness and valuation of certain products.	H, NT
Introduce functional overlay to supervision that ensures that similar products issued by different types of financial firms are supervised and regulated similarly.	H, MT
Insurance	
Develop plan for risk-based supervision, bringing together all issues and actions of each insurer, including market conduct.	M
Establish plan to move valuation to a more market-consistent basis.	M
Financial Market Infrastructures	
Adopt full delivery-versus-payment (DVP) in the China Securities Depository and Clearing Corporation (CSDC).	H, NT
AML/CFT	
Mandate enhanced customer due diligence (CDD) for domestic publicly-exposed persons (PEPs) on a risk sensitive basis.	M
Crisis Management, resolution regime and financial safety nets	

Triggers for activating a government-led crisis response should be more clearly defined, and limited to systemic cases that may require public resources.	H, NT
Develop a special resolution regime for banks and systemically important insurance companies.	H, MT
Developmental Issues	
Resolution of Bad Debts	
Strengthen the collateral enforcement regime, including through the establishment of out of court collateral enforcement, and a unified movables registry.	H, MT
Introduce out of court workouts, including pre-pack arrangements.	H, MT
Introduce a personal insolvency framework.	H, MT
Conduct a mapping exercise of distressed debtors, as preparation for a multitrack approach.	H, NT
Establish a multitrack approach to promote operational restructuring of viable economic activity and efficient exit of unviable ones, coordinated at the State Council level and complemented with social programs to ease the impact of corporate restructuring.	H, MT
Financial Inclusion	
Revisit the role of the government by phasing out direct interventions and refocusing on strengthening the legal and regulatory framework and financial infrastructure so that providers can serve the underserved in a commercially sustainable manner.	H, NT
Further expand public credit registries; develop comprehensive legal framework for data protection; develop facilitated system to access public information on MSEs.	H, MT
Limit and target promotional fiscal and monetary policies; conduct regular assessments to ensure impact and improve design and publish results; improve M&E system.	M
Development of Capital Markets and Institutional Investors	
Enhance use of reopening and buybacks and improve the primary dealer system and trading architecture of government bonds to build a liquid yield curve.	H, MT
Improve collateral quality, market trading structure, legal certainty and structure of the repo instrument and the CCPs.	H, MT
Take further actions to harmonize regulations and reduce segmentation of issuers and investors in the interbank and exchange markets.	H, NT
Develop institutional investor base: harmonizing the regulation of WMPs and mutual funds, explore the developmental role of bancassurance, adopt new approach for pension fund sector based on automatic enrollment, default portfolio and contribution rates.	M
Enhancing the Role of CDB and the Policy Banks	
Precisely define the mandates of the policy banks by targeting specific market gaps where commercial banks and capital markets are unable or unwilling to fill.	H, NT
Improve the corporate governance arrangements for CDB and the Policy Banks to ensure the operational autonomy of the institutions, and the competencies and objectivity of the boards.	H, NT
Further develop other financial (e.g. credit guarantee, co-financing) and non-financial (e.g. advisory service) instruments to enhance impact.	M
1 Priority: Highest, near-term action (H, NT); Highest, medium-term action H, MT; Medium (M)	

MACROFINANCIAL CONTEXT

A. Macroeconomic Context

1. **Since the last FSAP in 2011, China's economic performance has remained strong but a much-needed economic transformation is now underway.** In dollar terms, GDP has grown by more than 60 percent, and in PPP terms, China's GDP is now the world's largest. Poverty rates have fallen, and financial inclusion has improved. However, limits to the investment-driven growth strategy, an aging population, waning dividends from past reforms, and a challenging external environment, have affected the viability of a wide range of firms. The transformation towards a more market-oriented economy that is more consumption-based, more services-driven, less credit-dependent and, especially, more efficient, will involve difficult policy choices, and may impact the pace of economic activity, before growth takes place on a sustainable basis. This transformation has already started, as the Chinese authorities are increasingly emphasizing the quality of growth and have pushed structural reforms to reduce overcapacity, deleverage the corporate sector, and promote the exit of zombie companies.

2. **Reforming the financial sector is part of this transformation.** The Chinese leadership is committed to deepening financial reform and has recognized the need to increase the market's role in resource allocation. The government set out an ambitious reform program at the Third Plenum of the Central Committee of the 18th Party Congress of the Communist Party of China (CPC) in November 2013, with the objective of reducing the direct intervention of the government in resource allocation while promoting the market's role. Financial reform is a key component of the broader reform agenda, and the authorities have been pressing with the implementation of reforms, as illustrated in Table 1. The 19th Party Congress in November 2017 further reaffirmed the government's commitment to deepen reforms.

Table 1: Key financial sector reforms since the last FSAP

Reform areas	Description
Interest rate liberalization	Liberalization of lending rates; removal of the ceiling on deposit rates
Exchange rate liberalization	Daily trading band of USD/RMB widened; Exchange rate regime modified to allow a greater role for the market in setting the daily opening reference rate of the RMB
Banking sector	Private bank pilot program launched; Cap on loan-to-deposit ratio of 75 percent removed Deposit insurance system introduced A new round of policy bank reform started
Capital market	Shanghai–Hong Kong and Shenzhen-Hong Kong Stock Connect, and Bond Connect (north-bound) programs launched Foreign access to domestic interbank bond market eased
Insurance sector	Interest rates for life products liberalized Risk-based solvency regime introduced and investment regime relaxed
Local government debt	New Budget Law passed, with efforts to strengthen the supervision and management of local government debts

Source: World Bank staff, based on official government documents.

3. Despite progress, policymakers still face challenges to balance short-term growth concerns with long-term financial stability and sustainability. While liberalization has been extensive across banking, insurance, and equity and bond markets, the state also views its role as smoothing the transition and minimizing dislocations. Accordingly, accommodative monetary and credit policies have facilitated the channeling of funds into public investments and sectors with low productivity and over-capacity. However, these policies have proved increasingly ineffective to sustain growth. They have also contributed to the rapid escalation of asset prices– notably equities and real estate in some areas – and leveraged exposures. Despite several rounds of State Owned Enterprise (SOE) reform, a significant number of SOEs continues to underperform, while limited exit of weak firms have reinforced the market perception of implicit guarantees and weakened financial discipline. Contingent fiscal liabilities, including through various forms of local government financing vehicles/structures, have also grown.

4. The combination of swift liberalization of domestic financial markets, rapid credit growth, and high savings rates has spurred financial innovation and a buildup of leverage and risks. Credit growth has consistently exceeded GDP growth (Annex 3 Figure 1), and the "credit gap" has increased to about 25 percent of GDP according to the Bank for International Settlements (BIS)—very high by international comparison and above levels consistent with a high probability of financial distress. Likewise, corporate debt has reached 165 percent of GDP, also a very high ratio by international standards. There is a significant debt overhang from borrowing by weak corporates and local government entities. Household debt, while still low, has risen by 15 percentage points of GDP over the past five years and is partly driven by the expectation of increasing real estate prices. Financial innovation in channeling funds has led to a buildup of risks in the financial system.

B. The Financial System

5. China's financial system has grown dramatically in size and complexity since 2011. Total financial assets have expanded rapidly, from 263 percent of GDP in 2011 to 467 percent in 2016 (Annex 2). Bank assets exceed 300 percent of GDP or 68 percent of the financial system assets. Within the banking sector, growth has been driven by small and medium commercial banks (joint stock, city and rural commercial banks), while the assets of the four large state-owned banks have remained stable as a share of GDP (Annex 3 Figure 1).[2] NBFIs, including trust, insurance, securities, and asset management companies have grown rapidly and gained market share. However, banks continue to dominate in terms of size and connectivity, including through on- and off-balance sheet channels of intermediation, which

[2] The four large banks are International Commercial Bank of China (ICBC), Bank of China, China Construction Bank, and Agricultural Bank of China. All are state-owned G-SIFIs, and are collectively referred to as the Big 4.

involve asset management activities entailing strong connections within the banking system and between banks and other NBFIs.

6. **The evolution of the financial system since 2011 reflects conflicts on key policy objectives in particular, maintaining high growth rates while containing risks.** As mentioned above, during this period the authorities were frequently engaged in a difficult balancing act, promoting credit activity to preserve high growth, proceeding with financial liberalization (including the relaxation of interest rate controls), and clamping down on products and sectors perceived to be risky. The market has spawned successive rounds of regulatory arbitrage designed to circumvent interest rate, credit, and prudential controls. The system has grown in size, interconnectedness, and complexity.

7. **Liability structures of banks and NBFIs are increasingly intricate and funding maturities have shortened considerably.** While the four large nationwide banks still enjoy a solid deposit base, the rapid growth of small- and medium-sized banks and NBFIs has to an important extent been financed by short-term borrowing on the interbank market.

8. **Asset structures have also become more complex and banks are at the core of a large system of indirect lending through NBFIs, with smaller banks more exposed.** Bank loans account for only 46 percent of bank assets, and only 38 percent among city commercial banks (Annex 3 Figure 1). Banks met savers' search for yield pioneering wealth management products (WMPs), where funds raised were reinvested in debt securities, deposits, as well as non-standard credit assets (NSCAs) such as trust loans, entrusted loans, and bankers' acceptance. In 2013, the CBRC imposed a limit on the share of NSCAs to the lower of 35 percent of total WMPs or 4 percent of total assets of a bank. However, this spurred the development of new instruments, including trust beneficiary receipts and asset management plans (AMPs) by a range of NBFIs. Banks hold these products in their investment portfolios, which in the case of many medium-sized banks account for half of total assets. The regulatory tightening starting in early 2017 has resulted in a decline in the outstanding amount of these products.

9. **The expansion of credit has provided an extended life to the old investment driven growth model, with bond issuance and non-bank credit becoming important sources of finance**. Productivity growth has continued to decline after the global financial crisis and credit intensity has increased (Annex 3 Figure 2). [3] In addition to the misallocation of credit and the efficiency losses, pressures to sustain public investment and the slow adjustment of overcapacity industries have led to regulatory arbitrage and accumulation of risks and contingent liabilities. While bank credit to infrastructure, construction and real estate (ICRE) sectors seems to have declined as a share of total bank lending due to more stringent

[3] The analysis and figures are drawn from the forthcoming World Bank report (2017), *The New Drivers of Growth*.

prudential requirements, this seems to have been compensated for by credit through other channels, including trusts, WMPs, and bonds (Annex 3 Figure 2).

10. Benchmarking China's financial development also shows that China remains a bank-dominated system and that its path to financial diversification has been different from other countries'. [4] The ratio of private credit to GDP exceeds the benchmarks by wide margins (Annex 3 Figure 3). In fact, in absolute terms China already has the largest banking system in the world. By contrast, the ratios of assets to GDP of traditional NBFIs such as insurance companies have only recently surpassed the relevant benchmarks, while mutual funds and especially pension funds are still under the benchmarks, despite China's very high savings rate. This reflects the fast growth of non-traditional pools of savings including trusts and WMPs (which cannot be benchmarked given their unique nature to China). Securities markets have grown significantly, surpassing the benchmarks by wide margins, and in volume terms are among the top three markets in the world. However, these markets are dominated by financials and large SOEs, and are not yet significant sources of finance for the private corporate sector.

11. The insurance industry has been growing rapidly and has a strong potential for further development. The sector has been growing by over 20 percent a year, driven by price liberalization, new entrants, products, and distribution channels, and already exceeds all the relevant benchmarks (Figure 3). Despite the recent development of the bond market, asset and liability management has been hampered by the insufficiency of longer duration instruments and hedging instruments such as swaps. As a result, many companies reduced the duration of their liabilities by selling short-term products with limited insurance content and similar to WMPs. This is not sustainable and has already triggered regulatory reactions.

12. Mutual funds and pension funds are still undeveloped. China's open mutual fund industry has recently grown at faster rates but remains undeveloped relative to the relevant benchmarks (Annex 3 Figure 3). Money market funds account for half of assets under management. Their growth is hindered, however, by competition from WMPs. Despite similarities in the eyes of investors, WMPs enjoy regulatory advantages, such as the right to offer expected returns in their prospectus and marketing material. Pension funds (enterprise annuities) remain the smallest traditional NBFI in the financial system, despite the tax incentives and China's aging demographic profile.

13. China's bond market is the world's third largest but remains a limited source of finance for the private corporate sector. The bond market is already the world's third largest with an outstanding stock in 2016 of US$8.5 trillion or 85 percent of GDP. The size of the non-government market is relatively large by international comparison (Annex 3 Figure 3), but financials (including policy banks)

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[4] China's financial development is benchmarked against peer groups of middle income G20 countries, a broader sample of upper middle income countries, and the predicted median values generated by a large panel of countries, following the World Bank's FinStats methodology (Beck, Feyen, Ize, and Moizeszowicz 2008).

and highly rated and large SOEs account for the bulk of the stock. Risk pricing in the bond market has been hampered by a widespread perception of implicit guarantees for LGFVs and SOEs, although spreads between local government bonds and LGFV and SOE debt has widened considerably in 2016 and 2017. The bond market also includes an active short-term interbank market dominated by repos. Much of this activity is between banks, but NBFIs are also involved.

14. China's equity market is also large, with a high level of participation of retail investors. After the US, China has the world's largest stock markets by capitalization, and also exceeds all the relevant benchmarks when measured relative to GDP (Annex 3 Figure 3). However, retail investors contribute to 80 percent of turnover in China. This, combined with a relatively small free float, raises questions about the quality of price discovery and has also led to high volatility. Stability concerns have motivated the authorities to intervene in markets at times, with an adverse impact on risk pricing and market discipline. The development of the equity market is considered by the authorities as a helpful deleveraging tool, as companies should be able to issue equity to pay off debt. However, given the volatility in summer 2015 and early 2016, and concerns about the progress of reform on initial public offerings (IPOs), its potential is not yet being fully realized.

15. Finally, the prominent presence of the state is a unique feature of China's financial sector. Despite the progress with reforms, the state still plays multiple roles as promoter, owner and regulator of the financial system. Many governments worldwide also promote financial development but in China the promoter role has frequently entailed direct interference in prices such as in the equity market episode of 2015 and in the allocation of resources in the form of pressures to sustain funding to investment and overcapacity industries. The state also continues to own or exercise de facto control over most of the banking sector (in contrast with trends worldwide in recent decades)[5], a large share of other financial institutions (such as insurance companies, trusts, and securities companies), as well as SOEs, which are some of the financial sector's largest borrowers. The very high degree of government ownership and strategic control implies direct and significant influence over the allocation of financial resources, although the government has allowed the establishment of a number of domestic private banks since 2014 and is taking steps to ease restrictions on the market access of foreign firms in financial services.[6]

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[5] See the 2013 Global Financial Development Report: "Rethinking the Role of the State in Finance".

[6] At the time of finalization of this report, an easing of the limits of foreign ownership in the financial sector was announced. Under the new policy, foreign investors would be allowed to acquire 51 percent of Chinese securities firms, fund managers and futures companies and would allow them to own up to a 100 percent three years from now. The limits on foreign investment in insurance companies would be raised from 50 percent to 100 percent within five years. China also plans to eliminate the 25 percent cap on foreign ownership in banks, although no specific timelines have been set.

16. The multiple policy objectives associated with the state's roles in finance can impair the authorities' efforts to regulate and supervise a large and complex financial system. In addition to the pursuit of safety and soundness objectives, prudential policies and supervision tend to accommodate the government's economic and industrial policies, as well as market development and social objectives. The tensions between the ownership and regulatory roles are particularly strong at the subnational level. Subnational governments continue to control local banks and NBFIs, including through local SOEs, and are caught in conflicting roles as owners, regulators and debtors/borrowers of these financial institutions.

17. The enduring presence of the state also reinforces perceptions of implicit guarantees, creating moral hazard, weakening financial discipline, and distorting resource allocation. There is a widespread perception that the government back-stops weak enterprises and financial institutions, as well as asset markets, due to various economic and social considerations. This creates moral hazard, builds incentives for risk-taking, and distorts risk pricing. Within China's macroeconomic context, which is characterized by high savings, ample aggregate liquidity, constant search for yield, and financial liberalization, such dynamics have contributed to the misallocation of resources and the buildup of risks. Under these circumstances, removing market perceptions of implicit guarantees remains one of the most difficult challenges faced by policy makers.

RISK ASSESSMENT

A. Overview of Risks

Complexity, interconnectedness, and liquidity risk

18. The financial system is becoming increasingly complex, interconnected, and reliant on wholesale funding. The increasingly complex asset and liability structures reflect regulatory arbitrage, with banks transferring credit risk from the loan book to the investment book and NBFIs to reduce capital charges or to circumvent provisioning requirements or credit controls. Increased credit intermediation by NBFIs has been accompanied by a significant share of wholesale funding and increasing exposure of banks to funding and contagion risks, especially smaller banks.[7] The ratio of interbank funding to total funding has increased from 11 percent in 2010 to 17 percent in 2016, and 22 percent among joint stock banks (JSB) and city commercial banks (CCBs). Deposits now account for only 60 percent of bank liabilities. Repos are the main wholesale funding instrument. Collateral is predominantly in the form of government bonds, although non-government assets are also used. In addition, average repo maturities are shortening, particularly among smaller banks. Intermediation chains—with larger, more creditworthy

[7] Claims of banks on NBFIs have increased from 2 percent of banking assets at the end of 2010 to 12 percent at the end of March 2017.

institutions on-lending to smaller bank or nonbank counterparts—are lengthening with increasing opacity about liquidity and credit risks along the chain.

19. **Fast growth of off-balance sheet WMPs and maturity mismatches between shadow banking investment assets and investors' expectations for liquidity raise the risk of liquidity shocks.** While off-balance sheet WMPs are not formally guaranteed by banks, in practice non-contractual support by the originating bank is likely to occur due to reputational risks. Maturity mismatches between investors' expectations for liquidity on WMPs and the underlying assets leave the sponsoring bank exposed to the risk of investor runs. Although the CBRC is compliant with Basel Committee's liquidity coverage ratio (LCR) requirements, it is not clear that banks, particularly medium-sized ones, have sufficient buffers to compensate for potential runs on banks' investment products. Liquidity pressures could also come from redemption of other asset management products offering on-demand liquidity (e.g. open-ended collective trusts or funds) by NBFIs, many of which have funding or ownership connections with banks.

20. **While several factors could help mitigate the impact of liquidity shocks, the availability of buffers could delay timely policy adjustments in the face of rising risks.** Banks hold significant amounts of cash, reserves, and securities that could be liquidated under stress, and the PBC accepts a broad range of securities for collateral, offering generous access to liquidity under moderate haircuts and no pre-established quantitative limits. There is fiscal space to smooth the economy through the transition and the international reserves position remains strong. In addition, the Chinese authorities have a formidable array of administrative levers that could be used in a crisis. However, the very availability of these buffers may breed complacency about rising risks and moral hazard, and some of these buffers are already shrinking.

21. **Fast development of financial holding companies and deficiencies in the regulatory and supervisory framework for such groups have increased systemic risk**. There are a large number of banking and insurance groups, as well as financial companies owned by central and local SOEs, private companies (including internet companies owning various financial institutions). Group-wide supervision and supervision of cross-sectoral activities need to be strengthened. Some FHCs (e.g. financial holding platforms established by internet companies) may need to be brought under regulatory purview.

Asset quality and credit risk

22. **Against the backdrop of a slowing economy and the aftermath of the post-crisis credit boom, the authorities are increasingly focused on asset quality.** To a moderate extent, the strains in the corporate sector are reflected in reported non-performing loans (NPLs), which increased from 1.0 percent of total loans at the end of 2013 to 1.8 percent as of Q3 2016 and has since plateaued, while special mention loans peaked at 4.1 percent of total loans in Q3 2016. Compared to the NPL outstanding of

RMB1.6 trillion, banks have disposed of RMB3.7 trillion of NPLs between 2011 and 2016, primarily to the four national AMCs, which are then mostly offloaded through resales (see para 76). Banks' provisions for NPLs remain high at 179 percent, but have decreased from 290 percent in early 2013.

23. For a variety of reasons, the reported NPL ratio does not capture the full extent of China's asset quality challenges, some of which the authorities have tried to address through regulatory tightening and intensified supervision since early this year.

- Loan book. Some banks carry loans that are 90-day past due (dpd) but are not classified as NPLs. This is in line with loan classification guidelines that allow collateralized loans to SMEs that are 90 – 180 dpd but with qualified collateral or guarantees to be classified in the special mention category. For commercial banks as a whole, 90 dpd loans not classified as NPLs represent 0.4 percent of total loans. For small- and medium-sized banks, the share is 0.8 percent. The rollover of past due loans (within certain constraints) and repayments through loans by other lenders are also observed in practice, although reliable data are not available.
- Investment book. Some banks have moved credit assets into their investment book to circumvent credit quotas and restrictions, or to reduce capital charges and provisions.
- Off-balance sheet exposures. There are indications that some banks have transferred assets off balance sheet but retained credit risk.

24. Medium- and small-sized banks are particularly exposed given the fast expansion of assets and exposures to non-standard credit assets. Joint stock banks and city and rural commercial banks have been expanding their balance sheet aggressively and gaining market share, amid fierce market competition and pressure to support local industries and public investments. Compared to the big 4 banks, smaller banks also have a much larger share of nonstandard credit assets in the investment book and off-balance sheet WMPs, presumably with a riskier lending profile.

25. Stress tests point to widespread undercapitalization of banks other than the big 4 under a severely adverse scenario in which real annual GDP growth falls to 2.9 percent, and deleveraging and other second-round effects could amplify costs.[8] Under this scenario combining both domestic and external shocks, real GDP growth declines by two standard deviations relative to the baseline over a two-year horizon (a cumulative 7.3 percentage points over 2017–18). Under these macroeconomic conditions and assuming partial migration of special-mention loans (SMLs), the NPL ratio would rise sharply to 9.1 percent in 2018. Due to credit and market losses, and reduced net interest income, the common equity tier 1 (CET1) capital ratio in the system would decline to 7.2 from 10.3 percent—even though the

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[8] The FSAP team carried out the stress tests using as input supervisory data provided in a data room at the PBC. However, only part of the data available for supervisory purposes was made available to the team.

assumed relaxation of the required provisioning coverage ratio (from 150 percent to 50 percent in the severe scenario, a typical level of provisioning coverage in other economies) offsets a significant part of the credit losses. The impact of the shocks is highly uneven across banks – while capital at the big 4 banks remains adequate under a severely adverse scenario, 27 out of 33 banks included in the tests are undercapitalized relative to at least one of the thresholds (total capital of 10.5 percent, Tier 1 capital of 8.5 percent, and CET1 capital of 7 percent, all of which include the capital conservation buffer), and the number of banks that fall below the 7 percent CET1 capital threshold is 23. Under a severely adverse scenario, the capital shortfall for the 33 tested banks amounts to 2.5 percent of GDP. Moreover, the significant reduction in capital buffers and provisioning coverage under the adverse scenario would trigger deleveraging and second-round effects, with fiscal costs possibly exceeding the recapitalization needs for the banking system by a wide margin.

Local government off-budget borrowing/contingent liabilities

26. Risks associated with local government finances warrant close monitoring. Borrowing by local governments and their associated local government financing vehicles (LGFV) has grown by around 25 percent a year since 2007—2.5 times as fast as central government borrowing—driven by local imperatives to meet growth and social welfare objectives. As local governments had no authority to borrow directly until 2015, they used LGFVs for debt-financing of public investment projects, with local control over land revenues providing implicit collateral. A 2015 Budget Law aims at preventing LGFVs from engaging in non-commercial borrowing for public investment. It also includes other measures for swapping legacy government debt out of LGFVs into explicit government bonds, and for improving the transparency and accountability of local government finances. However, in the context of a public investment-driven fiscal stimulus in 2015 and 2016, LGFV borrowing continued at a rapid pace. A clamp-down by the central government on LGFV borrowing for public investment shifted attention to some other off-budget vehicles such as PPPs and so-called Government Guided Funds. The central government has recently further strengthened the investigation and punishment of local government borrowings that are not allowed by the relevant laws and regulations, and issued policy guidelines to enhance the management of PPPs and Government Guided Funds.

Fintech

27. China is the epicenter of global fintech and has begun drawing it within the regulatory perimeter. During 2016, the stock of peer-to-peer lending doubled (though only around 0.5 percent of the banking sector assets) while Alibaba, China's largest internet retailer and effectively a competitor to the payments system, allows customers to invest money held in its escrow accounts in financial assets. China's ubiquitous smartphone app WeChat has moved into lending with WeBank, exerting competitive

pressure on the banking system. These developments do not yet appear to raise systemic risks, and the authorities are already working to strengthen oversight, by requiring lending products sold by internet firms to be supervised by CBRC and securities products by the CSRC. To promote the healthy development of internet finance, the State Council launched the special rectification program on internet finance, which aims to strengthen regulation for various internet finance products and services, create a healthy market competition environment, and promote the sound and sustainable development of the industry.

B. Implications and Overall Policy Recommendations

28. Continued focus on growth targets, both at the national and at the regional level, has required a fast expansion of credit that is increasingly intermediated by the more opaque shadow banking system. Pressures remain to maintain a high level of public investment, but the returns on investments are in decline against a backdrop of an overall decline in productivity. In addition, the needed operational restructuring of the corporate sector (SOEs and excessive capacity sectors) has been hampered by concerns about employment and social stability.

29. Regulatory tightening over regulatory arbitrage and shadow banking is a welcome step and must continue. Further efforts are needed to steer the financial system towards an orderly unwinding of complex financing structures. The authorities have made efforts to unify the rules on asset management products to reduce regulatory arbitrage. The latest regulatory tightening aimed strengthening banks' risk controls and eliminating the scope for regulatory arbitrage is also welcome. In addition, a rigorous and consistent implementation of the "look-through" principle, including through more intrusive and frequent on-site supervision is called for.

30. It is equally important to address the fundamental tensions between short-term growth objectives and financial stability. Growth targets would need to be de-emphasized or eliminated to reduce the economy's reliance on excessive credit growth. At the local level, expectations for public investment would need to be aligned with revenue and financing capacity, in order to phase out off-budget borrowing by local governments. In addition, incentives for local governments to implement the Budget Reform would need to be strengthened. A slower pace of credit growth will also require a more vigorous restructuring of distressed but viable enterprises (particularly SOEs) and the exit of non-viable ones.

31. Dismantling implicit guarantees will be a necessary component of reform. The new growth strategy entails less reliance on credit expansion and greater emphasis on credit allocation and economic efficiency, which will depend inter alia, on progress in removing implicit guarantees and tightening financial discipline. This will require in turn credible policies as expectations of guarantees are

entrenched. These expectations will be revised only to the extent that more defaults and insolvencies are allowed (including of SOEs). Strengthening financial and social safety nets with budgetary support would not only mitigate the risks and costs of adjustment but also show the Government commitment to restructuring, thereby also contributing to a revision of expectations. Finally, progress in recasting the role of the state, diversifying the ownership structure of financial institutions and SOEs and allowing greater participation of private institutions, would contribute to a revision of market expectations, improve incentives for efficient credit allocation and strengthen the enforcement of financial discipline.

32. Tightening of regulatory standards on credit risk and asset quality reviews could provide greater clarity about problem exposures and prevent recurring problems in the future. The authorities should tighten the regulatory standards on credit risk (particularly on 90 dpd loans and restructured loans) and remove the consideration of collateral in loan classification. A review of credit quality at banks most at risk would be an important step towards greater transparency. AQRs should take a comprehensive and independent assessment including the investment book, as well as whether transfers of assets have been conducted at arms' length. Targeted examinations and stress tests on credit risk, which the CBRC already conducts, can provide a useful indication of the financial institutions that are most exposed. The AQRs should be conducted promptly to provide inputs to the ongoing restructuring efforts, including those led by creditor committees.

33. Addressing effectively the problems of over-indebted and unviable borrowers will prove key to the success of the reforms. Effective NPL resolution will require resolve to restructure over-indebted sectors, including the operational restructuring of viable corporates and the exit of nonviable ones (see the development section).

34. Targeted increases in bank capital may be required taking into account the risk profile of banks and the impact of economic transition and financial restructuring. Capital is a critical component of the macro-and micro-prudential tool-kit. While the banking system meets Basel III minimum requirements (and in some areas China is 'super-equivalent') risks in the sector are high and uncertain, supporting the case for building additional buffers. In particular, countercyclical capital buffers and D-SIB surcharge should be activated, to enhance the credibility of the financial system and reassure markets that an additional line of defense has been established protecting the highly-interconnected core of the financial system, even though not all risks are on banks' balance sheets and problems may originate elsewhere. Capital adequacy requirements should be ascertained through enhanced supervisory review process (Pillar 2) to ensure individual banks hold capital reflecting their risk profile and management capacity. The implementation of a multi-track restructuring program (ideally preceded by AQRs for banks most at risk) would entail loss write-offs and reveal with even greater accuracy the need for more capital in the banking system.

35. Liquidity management also needs to be strengthened to preserve financial stability. With the above measures to reduce regulatory arbitrage, strengthen credit risk management and increase capital buffers, liquidity risks associated with abrupt unwinding of financing chains would already be reduced. In addition, LCR requirement for banks should be strengthened by raising the run-off rates for WMPs to levels commensurate with other retail products. Liquidity standards for asset management products (other than money market funds) offering on-demand redemption should also be reviewed. Repo market reform would also help reduce systemic risk, for example through strengthened eligibility criteria for collaterals, increasing haircuts based on the difficulties in liquidating collaterals, and gradually excluding retail investors in the exchange repo market.

SUPERVISORY OVERSIGHT

A. Legal Framework for the Financial Sector and Supervisory Governance

36. Despite substantial progress, the legal framework for the financial sector has not kept pace with the rapid development of the financial sector. There is an urgent need to make the primary laws more substantive, operational, and also flexible to accommodate market developments. The legal framework should become more coherent to support supervision and to minimize regulatory arbitrage. A general legislative review would be appropriate at this juncture.

37. Institutional arrangements for financial supervision should be grounded on a sound legal basis set out in primary legislation. Several primary financial laws contain objectives to promote financial development and support economic and social development. It is imperative to reinforce the primary objective of financial stability, both de jure and de facto. The operational autonomy of the financial authorities should be strengthened by providing for budgetary autonomy and specifying the circumstances, criteria, and procedures for the involvement of the State Council in operational supervisory matters. Primary laws should stipulate the basic governance mechanisms for the financial authorities, including the criteria for appointment, disqualification, dismissal procedures of members of decision-making bodies, and disclosure of reasons for dismissal. The legal regimes for supervisory cooperation and information sharing (including the exchange of granular financial data) with domestic and foreign safety-net-participants should be more specifically laid out in primary legislation.

38. Some urgent reforms of financial sector laws are needed. The legal basis for supervision of financial groups and industrial groups with financial subsidiaries should be reviewed. The promulgation of a unified standard on asset management products and other cross-sectoral products should be accelerated, preferably through a unified primary law to ensure regulatory consistency in the treatment of these products. Regarding P2P-lending, there is an urgent need to put in place fundamental primary legal

protection relating to client data protection and confidentiality. Lastly, while the Financial Consumer Protection (FCP) framework has been strengthened since 2013, a more comprehensive legal framework for FCP is needed to address remaining gaps and challenges.

B. Systemic Risk Oversight and Macroprudential Policy

39. Since the last FSAP, China has improved its systemic risk monitoring and response capacity, but challenges remain. The PBC and the regulatory agencies have collaborated to monitor WMPs and other financial products, and the Joint Ministerial Committee (JMC) was created in 2013 to facilitate policy coordination among the PBC and three regulatory commissions. The authorities are creating a uniform data platform to facilitate information sharing. At the individual agency level, various efforts have been made to improve financial monitoring and assessments, including creation of new macroprudential tools. Nonetheless, the authorities face many challenges in containing systemic risk**:**

- **Regulatory gaps.** Understanding of systemic risks may be weak in instances where each regulator supervises products under its jurisdiction and ambiguity arises regarding the mandate to supervise new or cross-sectoral products.
- **Inadequate coordination mechanism.** The JMC focuses on coordination of specific regulatory policies rather than collaborating on systemic risk analysis. The JMC's mandate and responsibilities are not legally defined, and decision-making is based on consensus of participating agencies, which can lead to delayed responses.
- **Conflicting objectives.** Regulators in principle give priority to their stability mandate over sectoral development goals, but gaps in coordination may mean that insufficient account is taken of the impact of growth on financial stability in areas that fall under another regulator or outside the regulatory perimeter.

40. A more effective macroprudential policy-making structure is needed. A recently-announced high-level interagency committee under the State Council—the Financial Stability and Development Committee (FSDC)—is a positive step.[9] The FSDC includes a both a financial stability and a development mandate. To ensure well-informed decision-making, a separate body should be created with the sole mandate of ensuring financial stability (and similar for development). Such a body might be a Financial Stability sub-committee (FSS-C). The FSS-C members should have joint accountability to the FSDC and thus to the State Council to ensure effective work.

41. Several requirements need to be met to operationalize the FSS-C as an effective macroprudential body. The FSS-C should be a permanent body and meet regularly and frequently (at

[9] The FSDC held its first meeting early November.

least quarterly). It would be supported by interagency working groups, set up at technical level. Regular systemic risk analysis should be undertaken on a collaborative, cross-agency basis between relevant experts of the PBC and regulatory agencies. The FSS-C and sub-groups work should be facilitated by interagency communication at all levels, including full access to internal systemic risk analysis of members' reports. The FSS-C should be an advisory rather than an executive body: macroprudential tools should remain in the hands of PBC and relevant supervisory agencies, which take into consideration the recommendations of the FSS-C in formulating and activating polices.

42. The authorities should implement stress tests in a coordinated framework for the purpose of joint systemic risk assessments and macroprudential policy decision-making. More granular information should be collected, and data and information sharing across financial sector regulators needs to be substantially enhanced. The coverage of the stress testing exercises should be expanded to include NBFIs, integrated into the broader risk assessment framework. Lastly, analytical capacity within the stress testing teams should be enhanced significantly to ensure that key sources of systemic risks are properly quantified.

C. Supervisory Oversight – Cross-Cutting Issues

43. The assessments of banking, insurance, and securities supervision confirmed that regulatory and supervisory frameworks have been reinforced since the last FSAP. Some areas of common strength emerged, such as the adequacy of supervisory powers, rule-making abilities, and efforts to align rules with international standards. The authorities have been able to act quickly in the event of market dislocations.

44. However, there are key weaknesses, which affect the ability and capacity of regulators to respond to challenges and their ability to work together in a complex system:

- **Unambiguous safety and soundness mandates and operational independence of the financial regulatory authorities needs to be strengthened** (see previous section on legal framework).
- **Resources and organizational flexibility should be increased**. Despite the rapid growth and increasing complexity of the financial system, the staff count at headquarters of the three regulatory agencies has not risen in 10 years, and budgets have not risen accordingly. Maintaining adequate intensity of on-site supervision, effective supervision of complex groups and innovative products, and keeping pace with international regulatory reform have become increasingly difficult. The regulators cannot reallocate staff resources to priority areas without prior government approval, and have experienced – together with the PBC – increasing difficulties in retaining qualified staff.

- **Coordination among financial sector regulators should be strengthened.** It should shift from an ex post exchange of information, discussion of developments, and crisis management, toward an ex ante collaboration on sharing data, assessing risks, curtailing regulatory arbitrage, and crisis prevention and preparedness. Unified rules and functional oversight of "like" products are needed. Coordination should also be improved within supervisors, across functional units and local bureaus.

45. Complex groups undertaking cross-sectoral activities present significant challenges and the regulatory framework for FHCs is lacking. There is no standard approach to the structure or regulation of FHCs, as acknowledged by the authorities. Despite efforts to improve coordination through the JMC, exchange of information and cooperation at the level of groups and institutions have been insufficient. This has opened room for abuses of financial services and prevented a better understanding of the risks arising from complex groups. There is a framework for consolidated supervision of banking groups, but the overall regulatory framework for FHCs is still lacking and some types of FHCs (e.g. internet based conglomerates) fall entirely out of regulatory purview. Recent policy initiatives, aimed at designing the overall framework for FHCs supervision, risk monitoring and analysis, and consolidated supervision on financial conglomerates at the group level are a step in the right direction, and could be further expanded through the FSDC.

D. Banking Supervision

46. The CBRC has responded decisively to the dual challenge of rapid industry development and the demands of the international regulatory reform agenda. Continuous efforts have been made to upgrade banking regulation and supervision, and organizational reforms in 2015, building on other internal reforms, will serve the CBRC well in delivering its supervisory mandate.

47. Nevertheless, there are weaknesses in some key areas that must be addressed if financial sector vulnerabilities are to be reduced:

- **Group supervision.** The CBRC must ensure banks have enterprise-wide risk management approaches and are capable of fully identifying and managing risky interactions across complex groups. Disclosure of ultimate beneficial ownership is deficient, complicating compliance with capital adequacy, large exposure and related party transaction rules. In addition, the lack of powers of approval, or even pre-notification of changes of control or structure of groups including banks is a major shortcoming.
- **Risk concentrations.** As noted in the previous FSAP, regulations on large exposures and related party exposures need to be strengthened – an urgent reform as conglomerates grow. Exemptions allowed when there are relationships between entities with common local government ownership

represent significant sources of concentration risk, as well as potential for undermining bank governance standards.

- **Loan classification and credit risks.** Loan classification standards appear insufficiently robust considering the mounting challenges of many borrowers in traditional and overcapacity industries.

48. Strengthening supervisory approaches across the sector is a complex challenge. The CBRC meets most international standards that apply to the largest and complex banks, but its work on the Domestic Systemically Important Banks needs to be given a higher priority. Also, certain smaller banks receive inadequate oversight despite often presenting riskier profiles, due to resource constraints and in some cases, lower regulatory or supervisory standards than might be appropriate.

E. Supervision of Securities Markets

49. In the last three years, the CSRC has enhanced the protection of retail investors, improved systemic risk monitoring, and strengthened enforcement. The CBRC has strengthened the regulatory framework for WMPs in several aspects, including stronger distribution and sales rules, full segregation and separate accounting for each WMP, and stricter rules on eligible investments. Overall, the regulatory framework and supervisory program for the securities markets is largely compliant with the International Organization of Securities Commissions (IOSCO) Principles.

50. Harmonizing the regulation of similar products is a key challenge, with asset management services being a priority area. Rapid industry development has resulted in many products fulfilling similar economic or investor needs being offered by entities that are supervised by different agencies. Existing agreements on harmonizing the regulation of activities and products under more than one regulatory regime and supervisory authority should be implemented. Uniform regulations are being developed for asset management products, as well as for credit rating services. The authorities should also develop harmonized regulations for asset-backed securities.

51. The recent strengthening in enforcement policy should be deepened further. The CSRC has adopted a more vigorous approach to sanctions through imposing larger monetary penalties and bans on market participation. Gaps in the descriptions of some types of misconduct should be eliminated and the penalties increased for administrative sanctions and criminal offenses (including terms of imprisonment).

52. Systemic risk monitoring should ensure a holistic view of securities markets and their interconnectedness with the financial sector. The CSRC has made impressive progress in improving its tools and processes for systemic risk identification and monitoring. These efforts should continue, to ensure that the CSRC continues to have effective tools and expertise to monitor all relevant markets.

Given the existence of multiple regulators for key products and markets, it is critical that information sharing, identification, and monitoring of systemic risk are implemented by the proposed FSS-C.

F. Insurance Supervision

53. **Rapid growth of the insurance industry poses challenges to effective supervision.** The sector has expanded rapidly, and market entry, new products and distribution channels and price liberalization have increased competition. However, slower economic growth and lower investment returns have exposed life insurers to increased risk. Many non-life companies are moving into new lines as margins on established lines erode. There are risks to business models, performance and solvency and risks of mistreatment of customers that have to be managed.

54. **CIRC has undertaken far-reaching reforms in recent years, resulting in a high level of compliance with the Insurance Core Principles.** There are extensive requirements on governance, reinsurance, disclosure and conduct. The China-Risk Oriented Solvency Standards (C-ROSS) implemented in 2016 draw on international practices and Chinese experience to create both risk-based solvency standards and a framework for in-depth assessment of insurers' risk management. CIRC is the lead supervisor for a global systemically important insurer, and is preparing a regime for domestic systemically important insurers. Enforcement powers are extensive, and there are full legal provisions and a funded insurance guarantee scheme to support orderly exit and policyholder protection.

55. **Regulatory and supervisory practices can be strengthened further, including:**

- **The further development of C-ROSS.** CIRC can plan for a more market-oriented valuation basis. It could expand the role of supervisory judgment. It should continue to keep investment limits under review while it seeks to improve standards on insurance sector risk management.
- **Solvency control levels.** These should be reviewed by CIRC and communicated to insurers, including the point where it will intervene above the minimum requirement and the point below which no insurer may continue in business.
- **Crisis management and preparedness.** Frameworks should be enhanced for the larger insurance groups, building on recovery and resolution planning for the one G-SII.
- **Cooperation with other regulators.** Cooperation could be strengthened, including with CSRC on asset management issues and with foreign regulators as well.
- **Market conduct**. The CIRC should review consumer protection risks, including risks of misselling of more complex products, and fill gaps of disclosure requirements in the supervision of intermediaries.

G. AML/CFT

56. China was removed from the Financial Action Task Force (FATF) enhanced follow-up process in 2012, following a substantial reform effort. Since the 2007 Mutual Evaluation Report, money laundering (ML) has been criminalized, and all terrorist financing offenses are now covered. The securities and insurance sectors were brought into China's AML/CFT regime. Measures required to bring the legal framework into compliance with international standards include mandating the enhanced customer due diligence (CDD) for domestic PEPs on a risk sensitive basis.

57. While China has taken steps to align its anti-corruption initiatives with its AML/CFT framework, there is room for improvement. China participates in international anti-corruption efforts. As concealing the proceeds of one's own crime is viewed as an extension of the predicate offense, self-laundering is not sanctioned as an independent action. Full and comprehensive availability of information on ownership and control of legal persons in line with the FATF Recommendations is needed.

58. Developing group-wide supervision and cooperation mechanisms are priorities in supervision, and stronger sanctions should be considered. The PBC is developing a risk-based approach to AML/CFT supervision by requiring institutions to undertake self-assessments and by developing its own methodology for prioritizing institutions. An increased focus on group-wide risk should be a priority. Stronger sanctions for breaches of AML/CFT obligations should be considered.

H. Supervision of Financial Market Infrastructures

59. The supervision of China's large and complex network of FMIs has been strengthened, but additional steps are needed in ensuring FMIs' compliance with international standards. China's landscape for FMIs is one of the largest and most complex in the world, which consists of a range of payment, clearing and settlement systems, including several interbank payment systems, securities settlement systems and CCPs. The landscape is evolving quickly, with the emergence of innovative products for internet payments, and the establishment of a cross-border interbank payment system (CIPS) and a CCP for over-the-counter derivatives.

60. The adoption of the CPSS-IOSCO Principles for FMIs (PFMIs), and the establishment of an interagency platform to assess FMIs (the 'PFMI Office') are important achievements. Full implementation of the principles by FMIs is the next step. The level of implementation of the requirements varies greatly among FMIs. A key priority is the adoption of full delivery versus payment and the modernization of credit and liquidity risk management by CSDC.

61. Although various initiatives are underway to strengthen the legal basis for FMI supervision, some weaknesses remain in the legal framework. The various legislative initiatives will strengthen the

supervisory framework and enhance clarity. The establishment of a statutory framework for futures markets is an important priority.

62. **A comprehensive statute, or otherwise statutory provisions, should provide legal certainty regarding finality and netting of transactions, for all relevant material aspects covering all FMIs.** This should provide for recognition of settlement finality in the event of insolvency of a participant; recognition of multi-lateral netting; provisions for bankruptcy remoteness of pledged collateral; and prescriptions to overcome any zero hour rules.

63. **Cyber risk has been identified by authorities as an important supervisory topic in relation to FMIs.** A cyber security law was issued in 2016 and will come into effect in June 2017. Joint crisis coordination mechanisms and testing of crisis communication protocols can further improve the management and monitoring of these risks.

64. **Finally, resilience of FMIs can be strengthened through the provision of central bank services to all solvent, systemically important FMIs.**[10] The PBC currently provides settlement services to CCDC and SHCH. In extreme circumstances, the CSDC and other CCPs could be faced with insufficient liquidity. Under these circumstances, they may strengthen liquidity by expanding collateral eligibility. Special financing arrangements could be made by the central bank for the above circumstances.

CRISIS MANAGEMENT, RESOLUTION REGIME AND FINANCIAL SAFETY NETS

65. **While China has successfully managed weak FIs, significant reforms are needed to support a more market-oriented system and promote financial stability in the longer term.** The authorities have relied on official financial support to manage failing FIs regardless of the systemic importance of the firm. While this approach addresses any immediate risks, it encourages moral hazard which undermines financial stability in the longer term. Moreover, the size of the financial sector suggests this approach may no longer be viable, as the resources needed would be much larger than in the past. Establishing a framework that allows FIs to fail, and that requires shareholders, creditors and investors to bear the costs of those failures while mitigating financial stability risks, is a key part of the transition. Reforms are needed to repurpose the existing crisis management framework, and to accommodate a special resolution regime.

[10] This would require legislative changes or specific State Council approval.

A. Crisis Prevention and Preparedness

66. Some elements of an effective institutional framework for crisis management are in place. The regulatory agencies and the PBC have developed emergency response frameworks that include early warning systems, indicator-based action plans, and reporting rule that provide for timely communication between local and head offices, and with local government, regarding emerging risks. At the discretion of the relevant regulatory commission or the PBC, serious matters are escalated to the State Council, which can activate the Financial Crisis Response Group (FCRG) to facilitate decision-making, inter-agency coordination and crisis management.

67. But triggers for activating a government-led crisis response should be limited to systemic cases where public resources may be required. Since problems are elevated rapidly to government level, policy decisions may not be made on technical grounds, and be skewed towards addressing social—rather than financial—stability. At the national level, until the FCRG is activated (or the State Council intervenes directly), the regulatory commissions and the PBC may, in principle, act within the full scope of their authority to respond to emerging risks. While only serious matters are reported to the State Council, at the local level, other non-systemic incidents are reported to local governments as they have explicit statutory responsibilities to resolve risks posed by FIs operating in their jurisdiction. Many countries include a role for government in crisis management; but good practice[11] is for this role to be limited to incidents that have implications for the use of public funds.

68. To enhance their ability to respond to emerging risks, regulators should be able to request corrective actions based on forward-looking assessments. The regulatory commissions have comprehensive systems of early warning indicators and powers to request corrective actions and to impose sanctions. However, there is limited scope for any supervisor to act based on a forward-looking assessment, which may lead to worsening conditions of the weak FI and reduce recovery value in resolution. The authorities have requested recovery plans for the 5 G-SIFIs to ensure that the burden is placed on FIs to restore their financial condition in the event of distress; and they plan to extend these requirements to domestic systemically-important banks and insurance companies.

B. Resolution Powers and Approaches

69. Further work is needed to align approaches to resolving weak FIs with the Key Attributes of Effective Resolution Regimes. Although the bankruptcy law applies to FIs, typically a local government will lead negotiations on the restructuring of a weak FI with its shareholders, creditors and potential new investors, and sometimes it will also use fiscal resources. By contrast, international good

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[11] For example, as per the Key Attributes of Effective Resolution Regimes for Financial Institutions.

practice points to imposing losses on shareholders and unprotected creditors; facilitating the orderly exit of failed firms; relying on deposit insurance to protect depositors up to the insured limit; and minimizing the use of public funds. Establishment of the deposit insurance system is a welcome step, but further progress is needed to ensure alignment with best practices.

70. Work to expand administrative powers to resolve banks and insurance companies should be accelerated, and a special resolution regime put in place for banks and systemic NBFIs. For the G-SIFIs, crisis management groups have been established, and resolution planning and resolvability assessments are underway. However, legal changes are needed to put in place a special resolution regime, and empower an administrative authority to require the recognition of losses in accordance with a clearly established hierarchy of claims and apply a broad set of resolution powers, including the ability to transfer part of the business or shares to a healthy firm or bridge institution, and bail-in powers.

C. Financial Safety Nets

71. An overly-broad system of financial safety nets is in place, which poses a challenge for limiting moral hazard. The formal financial safety nets consist of: (i) the DIF; (ii) the insurance protection fund; (iii) the securities investor protection fund; (iv) the recently established protection fund for trust companies; and (v) PBC liquidity assistance. Beyond this, state financial assets have been used to provide market support in response to the 2015 equity market disruptions. Use of the safety net does not currently require a distinction to be made between insolvency and illiquidity; there is no clear test of systemic importance; and there is no means to ensure shareholders and unprotected creditors bear losses before the safety nets are used, or that costs to the safety nets are minimized.

72. The resources of the protection funds should be used only after licenses are withdrawn, and to provide an appropriate level of protection for selected classes of creditors. This would prevent the use of protection fund resources for rehabilitating failing firms and protecting shareholders. A clear distinction between protected deposits and other investments must be clearly disclosed to all bank customers, and enforced. This will help erode perceptions of implicit guarantees. Protections in the trust and securities sector should be limited to cases of fraud or misappropriation of assets, and not used for recapitalization or to provide liquidity support.

73. Funding for commercial banks outside normal monetary operations should be available only under a specific emergency liquidity arrangement, subject to strict conditions. A much stronger procedural framework is required, based on key principles including: (i) support is provided at the discretion of the PBC; (ii) to solvent, viable institutions only; (iii) against collateral and at penalty rates; (iv) triggering intensified supervisory measures and (v) on provision of a clear repayment plan.

DEVELOPMENT AND ACCESS

A. Resolution of Bad Debts

74. **After a sustained buildup in credit and corporate indebtedness, borrower distress is on the increase, resurfacing in the financial system in the form of pressures on asset quality.** Since the last FSAP, the total credit-to-GDP ratio has continued to edge up. Much of the increase in leverage is concentrated in the corporate sector. Credit intensity has increased, particularly in regions where traditional and declining industries are concentrated, and many indebted sectors (construction, steel and cement, solar panels, utilities and mining) suffer from excess capacity.

75. **The slowdown has led to the emergence of strains in several highly-indebted sectors, and pressures on asset quality in the banking sector, although reported NPLs remain low.** Banks have kept reported NPL ratios low due inter alia to transfers and write-offs, government-designed mechanisms to broaden disposal channels, and continued strong loan growth, despite the economic slowdown. Also, as discussed above (paragraph 23) the NPL ratio does not capture the full extent of the asset quality challenges as banks have moved considerable amounts of problematic credit exposures into the investment book or off-balance sheet.

76. **The current set-up, with a dominant role for the four nationwide AMCs, promotes rapid disposal of problem assets, but restructuring activity seems limited.** Banks perceive regulatory pressure to keep the reported NPL ratio below certain ceilings, and are therefore keen to rid their balance sheets of non-performing assets. China's four nationwide AMCs were created in 1999 and have absorbed significant amounts of bad assets from banks. Between 2011 and 2016, banks have disposed RMB 3.7 trillion of NPLs, mostly through the AMCs. AMCs bid for the loans and mostly offload NPLs through resales. The presence of AMCs has created a relatively well-functioning channel for the disposal of bad debt, but the presence of multiple entities has also contributed to a fragmentation of the creditor base. Moreover, the availability of a purchaser of NPLs may discourage banks from engaging in complex restructurings, and could skew banks' incentives towards origination of fresh loans. The AMCs have resold most of the acquired NPLs. There appears to be a general dearth of operational restructuring of distressed corporate borrowers (either by originating banks, AMCs or third party investors), and few borrowers exit the system through bankruptcy procedures.

77. **In response to the current challenges, the authorities have taken steps to improve the functioning of the AMC-based disposal channel, and to diversify the range of disposal options.** In a bid to enhance competition among AMCs and to facilitate disposal of NPLs at the local level, many provinces have established local AMCs recently, although the big four continue to dominate the market.

Initiatives have also been taken to expand the range of resolution options, including pilots for NPL securitization and debt-to-equity swaps. In addition, the authorities have issued regulation for creditor committees[12], wherein creditors on a case-by-case basis negotiate debt restructuring with distressed borrowers. In May 2017 the CBRC reported the creation of 12,836 creditor committees covering 14.9 trillion yuan in bank loans, more than 10 percent of outstanding loans.

78. The multiple challenges emanating from a structural slowdown and the rebalancing of the economy call for a rethink of current approaches that favor rapid disposal over restructuring. The problems of over-indebted corporate borrowers are unlikely to get resolved with time, as medium-term growth prospects have moderated. In absence of thorough operational restructuring[13] for distressed but potentially viable borrowers and a timely exit for unviable ones, losses will mount and salvageable economic activity will erode. Besides the loss in economic efficiency, these losses also burden the financial system, and can hinder intermediation as banks' capacity to finance promising investment projects is "locked in" in chronically loss-making sectors.

79. Debt recovery and restructurings are currently discouraged by some aspects of the legal and regulatory framework and its implementation. While reportedly working well in large cities, the enforcement of collateral in other parts of the country has been reported to hit roadblocks in the local judiciary system, sometimes due to social implications. There are very few formal re-organization and liquidation cases[14], and experience with the implementation of bankruptcy procedures is limited. The legal bankruptcy framework could be improved by clarifying the commencement test (including provisions that encourage debtors to file on time)[15], and creating a personal insolvency framework.

80. Further enhancements could be made to promote out of court workouts (OCWs) and pre-packaged restructurings. Although Chinese law does not include specific provisions incentivizing workouts, CBRC has encouraged multi-creditor OCWs by promoting creditors' committees through a set of guidelines and a circular. It would be helpful to add further specificity to the guidelines and to set out a general framework for the functioning of such creditor committees. As a complement to OCWs it would be helpful to establish pre-packaged restructurings that permit a rapid court approval of agreements reached out of court, and to address remaining legal and tax disincentives for successful workouts.

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[12] CBRC Notice on the Banking Sector Financial Institutions—Notice of the work of the creditors' committee 1196 of July 6, 2016. The notice contains guidelines on the operation of such committees and recommends the use of inter-creditor agreements to document terms that are agreed as part of an out of court workout.

[13] Operational restructuring involves fundamental changes in the company's operations, including divestment, discontinuation of non-core activities, and reductions in staff, to restore financial sustainability and viability.

[14] In 2016, 5,565 cases were accepted, a very low number given the size of the economy.

[15] This could be a duty to file or punishment if trading while insolvent.

81. Recent initiatives to promote SOE debt restructuring may lack clear incentives and parameters, as well as supporting safety nets. Many countries have formulated special programs or "tracks" to deal with SOE debt. But because of the legal, economic, and social implications, the introduction of regional-led programs in China pose special challenges, with similar problems applying to LGFVs. First, policymakers at the regional level may lack sufficiently strong incentives to push for meaningful operational restructuring as a *quid pro quo* for financial restructuring. This is a coordination problem that only central regulators and policy-makers can address, through the introduction of a general framework with meaningful conditions, parameters, and expected outcomes, and the monitoring of such outcomes. Second, the regional and central authorities must commit resources to social programs designed to cushion the impact of real restructuring, and facilitate the relocation of displaced workers.

82. Consideration could be given to a multitrack approach with at least three components or tracks. Cross-country experience shows the value of multitrack approaches spreading the burden of restructuring and liquidation among several players operating under proper incentives. A first step toward such an approach is a detailed mapping of the distressed debt, distinguishing by borrower type, loan volumes, ownership, collaterals, level of financial distress, and expected cash flow generating capacity. Such a mapping serves to precisely define the various tracks. In absence of detailed data for this type of analysis, three tracks could be distinguished.

- A separate track for distressed SOEs (possibly including LGFVs and large private debtors) is warranted, but applied consistently at the provincial level, as discussed above.
- The second track would address the best private NPLs, related to enterprises with the best recovery prospects. The banks should lead the screening and selection of candidates as they have an incentive to retain their best clients. This would be a decentralized, bank-led track, operating commercially along the lines of a London approach or one of its many variants in emerging countries.
- The third track covers distressed private companies that did not manage to find a bank or other investor necessary to undergo operational restructuring under track 2 (and possibly track 1). In practice, the third track is likely to consist primarily of companies with lower recovery prospects (but still with collateral value) or of companies whose operational restructuring failed under track 2. This track involves multiple actions such as sales of loans to AMCs or other third party investors, the realization of any residual collateral, liquidation and sale of any remaining assets, and the distribution of their proceeds among creditors in the order of priorities indicated in the existing insolvency system.

83. Particularly in the first and second tracks of the program, financial restructuring should be accompanied by meaningful operational restructuring. The recent regulatory encouragement for creditors to pursue debt-to-equity swaps appears to focus on financial rather than operational

restructuring. If not designed and implemented properly, it may end up capitalizing losses in overcapacity sectors, rather than being a part of an effective operational restructuring of distressed corporations. Debt equity swaps can be a valuable instrument of restructuring but should be exercised at the discretion of creditors and investors.

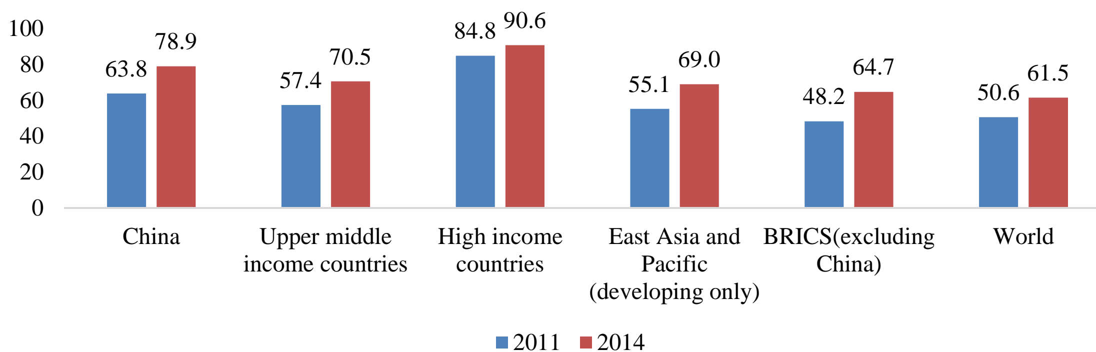
84. An effective debt resolution and corporate restructuring will require the development of a comprehensive strategy and extensive coordination among agencies. The State Council issued guiding opinions on reducing the leverage of enterprises in October 2016, mandating relevant agencies (including the National Development and Reform Commission, PBC, MOF, and CBRC) to set up a committee to coordinate efforts toward this objective. This is an important step, but effective restructuring of viable enterprises and exit of non-viable ones is a multidimensional task that will require policy actions on many cross-cutting issues, including legal frameworks, regulatory policies, tax policies related to restructuring, market access for distressed asset investors, SOE reform and preservation of state assets, and social safety net complementing restructuring efforts. The development of such a strategy should be brought onto the agenda of the government and coordinated at the State Council level.

B. Financial Inclusion

85. China has made significant progress in financial inclusion, but several key challenges remain. High levels of account penetration, savings, and usage of payments services have been achieved, largely due to extensive penetration of branches and access points, innovations by non-bank payment providers, and expansion of government-to-person transfers. Account penetration in China stands at 78.9 percent of adults in 2014, which compares well to the EAP regional average although lower than the high-income country average. Remaining challenges include reaching the "last mile" and providing a wider range of financial services, in particular credit and insurance products, to individuals and MSEs that are technically banked but still underserved. About 36 percent of adults in China reported having borrowed money in 2013, with less than a third of those adults borrowing from a regulated financial institution. Actual usage of financial services such as transaction accounts could also be improved.

Ownership of transaction accounts over time

Percent of adults (age 15+) reporting ownership of a store-of-value transaction account



Source: Global Findex 2014 (Demirguc-Kunt and others 2015)

86. **Expanding financial inclusion further requires a more modern conceptual framework and a shift in the appropriate role of government.** Many stakeholders still believe that financial inclusion means promoting credit to the rural poor via subsidized approaches and preferential policies. While some stakeholders appreciate the importance of market-based approaches, there is a general lack of understanding on how these principles translate into action. A market-based approach does not equate to the government instructing providers to serve underserved segments in a commercially sustainable manner. Rather, a market-based approach entails policymakers taking concrete action to improve the legal and regulatory framework and financial infrastructure (e.g. credit infrastructure, ICT infrastructure, legal frameworks for agent-based models, rural financial institutions (RFIs), and "new-type" providers) so that providers can serve the underserved in a commercially sustainable manner.

87. **This shift also requires moving away from the role of government as promoter to the role of government as enabler.** Mixed messages from government, with quantitative targets on physical outlets and the number of loans disbursed, contradict the principle of commercial sustainability and can—as an unintended consequence—set the stage for an unsustainable buildup of debt among mostly low-income households and SMEs, adversely impacting financial stability. The more appropriate role of government is as enabler, improving the legal and regulatory framework and financial infrastructure (as described above), as well as correcting market failures and distortions. Focusing on the enabling environment will ultimately have greater long-term impact in advancing financial inclusion, as improvements at this macro level have market-wide effects, helping all providers to more sustainably reach the underserved. Regulators should also more clearly distinguish between the role of promoting financial inclusion and the primary responsibility of regulation and supervision.

88. **Strong national leadership, inter-agency and national/local coordination, and collaboration with the private sector should be strengthened.** Strong leadership is needed at the national level, particularly as the role of government shifts to improving the enabling environment, which requires

coordinated action and consensus across different agencies and suffers when too many key actions are decentralized. A high-level body empowered to make strategic decisions should be established in order to take necessary action. A formal entity or mechanism is needed that sits above financial sector regulators and other agencies, is chaired by a high-powered individual, can provide strategic leadership, and has the power to make decisions on issues that are cross-sectoral, related to broader infrastructure, or entail national/local coordination. Better coordination and information sharing among stakeholders is needed, both between national and local governments as well as between the public and private sectors.

89. Credit information should be further expanded to address information asymmetries. Lack of sufficient information on individuals and MSEs remains a major challenge, preventing financial service providers from properly assessing potential borrowers, and hence limiting access to credit. Fintech providers are developing separate credit information platforms, indicating gaps in the system and leading to fragmentation of information. While the PBOC's Credit Reference Center has achieved impressive coverage of individuals and MSEs, efforts should be made to further expand coverage to additional sources such as utilities and P2P platforms, which first requires ensuring that data providers meet minimum operational standards.

90. A comprehensive legal framework for data protection and privacy should be developed that provides clear rules on data ownership, sharing, usage, and informed consent. Public information on potential customers from various government agencies has the potential to provide a wealth of information for MSE finance, but is currently cumbersome to access. A legal framework for data protection and privacy is a necessary foundation to facilitate access to public information. Clearer rules may also help further the development of private scoring companies. Given the rapid innovation in the use of alternative data such as transactional and social data in China, there is a unique opportunity to develop a cutting-edge regulatory approach towards big data that appropriately balances innovation with data privacy and other consumer protection concerns.

91. The strategic approach towards rural cash withdrawal points should be reformulated to allow such points to become more functional, sustainable, and fully leveraged. China has successfully built a vast network of rural cash withdrawal points, with nearly one million POS devices located in retail stores in rural areas providing payment services to rural residents. But many points have very low transaction volumes. Policymakers should shift away from mandating universal coverage in all villages and instead encourage greater commercial viability, for example by optimizing placement of such points, increasing functionality for financial and non-financial services to increase both foot traffic and revenue streams, encouraging shared use of agents by both traditional providers and non-bank payment providers, and loosening caps on agent fees and daily transaction limits.

92. **Improvements to the legal and regulatory environment for RFIs and "new-type" providers are needed in order to create a competitive, vibrant sector**. Further reforms should be undertaken to address the weak corporate governance of rural credit cooperatives (RCCs), with the objective of transforming RCCs into commercially-oriented providers without undue interference by local government. Regulatory frameworks for village and township banks and microcredit companies should be revised to address constraints on geographic expansion (such as limitations to operating within single counties), funding, and ownership requirements that currently prevent such providers from achieving economies of scale and reaching their full potential in serving rural clients and MSMEs.

93. **The fintech revolution has played a positive role in financial inclusion and should be leveraged to reach the remaining underserved.** Fintech companies, utilizing network effects, economies of scale, advanced ICT, and big data analytics, have successfully reached hundreds of millions of underserved consumers with new financial products at lower costs and easy accessibility. Policymakers should study how fintech can be more leveraged to reach the remaining underserved, particularly in rural areas. For example, partnerships between fintech providers and RFIs or outsourcing arrangements between traditional providers and fintech service companies could be encouraged and facilitated, particularly where such partnerships enable offline/online models. Potential barriers to undertaking such partnerships should be addressed, such as poor IT systems or governance at VTBs, RCCs, and MCCs. Further improvements in ICT infrastructure to reach the "last mile" could help to expand the positive impact of fintech, in particular increasing internet and mobile coverage to reach the "last mile", improving quality (e.g. expanding broadband and 4G), and decreasing costs. Finally, developing a deeper understanding of the needs and behaviors of "last mile" consumers and improving their financial literacy, particularly with respect to digital finance, would also be beneficial.

94. **At the same time, the legal, regulatory, and supervisory framework for fintech should be strengthened to provide legal clarity and manage risks, allowing for healthy growth.** Policymakers should shift from the previous "wait and see" approach to a proactive approach that allows for innovation while closely monitoring and containing risks, such as via regulatory sandboxes. The legal and regulatory framework for all fintech providers should be enhanced, particularly for peer-to-peer platforms, crowdfunding, and online MCCs, with operational standards adapted to the unique nature of each type of provider, while also aiming to apply consistent rules for similar types of activities. Supervision should be better coordinated and risk-based, with a tiered approach under which the largest providers are directly supervised by the respective national regulator (as opposed to local authorities). Finally, financial consumer protection should be strengthened to ensure coverage of risks related to fintech, such as disclosure requirements in a digital environment. Product suitability rules should also be considered, as aggressive promotion of digital credit can lead to over-indebtedness and systemic risks.

95. Promotional policies and programs should be employed in a strategic manner and regular assessments undertaken to ensure efficiency and impact. A wide range of fiscal, monetary, and supervisory policies and programs have been adopted across agencies to promote financial inclusion, but impact is rarely assessed. Results should be consistently analyzed to design policies that are better targeted and less distortive, and should also be published. Promotional policies should be limited to "last mile" segments for which government support is necessary, and should be well-coordinated and not duplicative. Supervisory or prudential tools used for financial inclusion should be carefully assessed and utilized in a limited manner, in adherence with international best practices and with their potential impact on stability taken into consideration. The M&E system for financial inclusion should be enhanced to allow for performance monitoring and evaluation, in order to allow for evidence-based policymaking.

C. Development of Capital Markets and Institutional Investors

96. The recent growth of bond and equity markets has been impressive, placing China's capital markets among the largest in the world. China's fixed income markets (comprising the large interbank market and the smaller exchange market) grew to RMB 63.8 trillion (85 percent of GDP) in 2016, being today the third largest in the world, after the US and Japan. China's equity market capitalization (including the Shanghai and Shenzhen exchanges), grew to RMB 50.7 trillion (68 percent of GDP) in 2016, ranking second in the world after the US. Capital markets exceed their benchmarks when measured as a ratio of GDP (Annex 3).

97. China's capital markets can develop further and make an important contribution to its economic performance. China's financial system remains primarily bank-based, with a ratio of bank credit to total intermediation (credit and private securities outstanding) of 60 percent, very high by international standards (Annex 3). Research shows that banks and markets are complementary and contribute together to economic growth, with markets becoming more important at higher levels of per capita income[16]. In China's context, capital markets could play a key role in the provision of long term finance to sectors such as infrastructure and housing, unburdening the banking system in these areas. It could also enhance the quality of financial intermediation, enhancing competition and promoting access. Capital markets could also provide key investment and risk management vehicles to long-term savings pools (e.g. life insurance and pensions) in the context of an ageing population.

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[16] Levine and Zervos, 1998. "Stock Markets, Banks, and Economic Growth." *American Economic Review*; Allen and Gale, 2000. "Financial Contagion." *Journal of Political Economy*; Levine, 2002. "Bank-Based or Market-Based Financial Systems: Which Is Better?" *Journal of Financial Intermediation*; Demirguc-Kunt, Feyen, and Levine. 2013. "The Evolving Importance of Banks and Securities Markets." *World Bank Economic Review*; Gambacorta,Yang, and Tsatsaronis. 2014. "Financial Structure and Growth." *BIS Quarterly Review*.

98. **However, China's capital markets need to undergo key reforms to address the risks that have accumulated and enable them to perform effectively their developmental role**. The bond market – the focus of this assessment – has grown impressively in size, but there is still significant scope for further improvements in quality. Its role in resource allocation and rebalancing needs to brought into full play. The system has accumulated credit risk and the banks remain substantially exposed to this risk, both directly as investors and indirectly, through their links with WMPs with significant exposures to fixed income. The system has also generated liquidity risks, through the illiquidity of government and corporate bonds of certain maturities, the duration mismatches of an important part of the investor base including WMPs and the lack of liquidity of certain categories of collateral used in the repo market.

99. **While bond markets can make further gains in depth, the reform agenda should focus at improving its efficiency, access, and resiliency**. Achieving these objectives will require sizable gains in market liquidity, price discovery, and the risk management capacity of issuers and investors. The key issues that policy makers should address would include: (i) the low liquidity of certain categories of central government and corporate bonds; (ii) the weak credit risk culture, and its impact on the pricing of bonds and resource allocation[17]; (iii) the repo market – risks to financial stability and insufficient support for development of the bond market; (iv) strengthened regulation is necessary to drive the sound development of the market, which is currently characterized by a strong presence of shadow products, and a lack of a sound and well-tested institutional investor base (mutual funds, insurance companies, pension funds); and (v) the regulatory fragmentation of the interbank and the exchange markets, constraining access of issuers and investors to the two markets. Actions to address these policy issues would involve cross-cutting measures in different market segments (public debt markets, credit bond market, repo market and derivatives); the investor base; and in the tax and regulatory framework.

100. **The government bond market fails to provide a liquid yield curve, requiring adjustments in tax regulations and improved primary and secondary markets**. The low liquidity of government securities is problematic as it limits the price benchmark role typically provided by these instruments. MoF has issued instruments spanning from 3-month to 50-year maturities and the futures market for 5 and 10-year T-bonds has supported liquidity, but overall secondary market activity remains thin. Tax exemption on coupon payments of T-bonds held to maturity is one of the major reasons behind the lack of trading and liquidity. Banks account for 68% of T-bond holdings (excluding the PBC and policy banks) and unequal tax treatment distort T-Bond yields and crowd out a broader investor base. In fact, the bonds issued by the CDB are more liquid and have become the *de facto* price benchmark. The agenda to enhance liquidity of government bonds involve, among others: (i) harmonization of tax treatment across

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[17] In this context, the selective bond defaults contribute to strengthening the credit risk culture. Their continued expansion, and the occurrence of investor losses, are critical towards countering widespread perceptions of implicit guarantees.

instruments; (ii) greater use of issuance techniques (reopening, buybacks and exchanges and possibly syndications) to reduce debt fragmentation (195 lines of T-bonds) and increase the size of benchmark instruments; and (iii) improving market-making and trading infrastructure arrangements, including a more effective primary dealer system dedicated to T-bonds.

101. **In the credit market, credit culture and trading can be improved and financial stability risks should continue to be addressed**. The emergence of a credit culture requires reliable credit ratings, internal risk management capacity to monitor and price risks and reduced perceptions of implicit guarantees. Accurate price differentiation is an essential step to attract a diversified base of both investors and issuers. The quality of credit ratings could be improved with the entry of foreign rating companies as recently approved by authorities. The apparent gap between domestic and international ratings could be reduced as there is widespread perception that ratings of some issuers may be inflated. Improvements in internal ratings of institutional investors should be encouraged through supervision approaches to avoid overreliance on external ratings. A more refined credit culture would also depend on reducing the strong perceptions of implicit guarantees. While low liquidity in the credit market is not uncommon worldwide, market making for key credit bonds by major underwriters could be further encouraged. The introduction of alternative mechanisms such as call markets could also be examined to concentrate market liquidity and price discovery at certain pre-established periods of the day. Authorities are acting on financial stability risks but key challenges to address include the rising number of defaults; increased debt rollover pressures; and the unwinding of carry trades by banks and shadow banking products.

102. **The repo market should be "securities-driven," and the risk from financing illiquid securities with short-term wholesale funding via the CCP should be better managed**. Repo has grown rapidly, but is not helping to broaden lending channels to the real economy or to reduce bank dependence. The sheer scale and momentum of this market makes its safety and soundness critical to the stability of the Chinese financial system. Changes are required in the structure of the repo market to make it "securities-driven". These would entail the reconfiguration of the inter-bank market around an interdealer core, based on high quality liquid assets, particularly T-bonds. The modifications are essential and linked to reforms in the primary dealer and trading systems for government securities. Actions to improve liquidity in the government and credit markets, as discussed above, could alleviate but not solve the problem of widespread use of illiquid securities as collateral in the exchange. Lack of liquidity coupled with legal uncertainty over collateral rights and netting in an insolvency raise risks to the CCP that need to be closely managed, in spite of recent measures to tighten collateral standards.

103. **Hedging tools could be further developed and constraints to the participation of different investors on derivatives could be reassessed.** A more developed derivatives market would strengthen bond liquidity and the capacity of investors to manage risks. The main types of derivatives that could

support bond markets (FX and interest rate derivatives) are underdeveloped. FX derivatives are still small but growing fast backed by a large FX spot market, the introduction of CCPs by the Shanghai Clearing House and wider access to RMB FX derivatives for non-resident investors in the interbank market. Interest rate derivatives are traded more actively in the interbank market but are concentrated in short-term contracts below 12 months. Expanding maturities and depth may require review of alternative reference rates, as some market participant do not consider the Shibor and the FR007 robust for a deep interest rate swap market. T-Bond futures of 5-year and 10-year maturities are relatively liquid, but there could be a wider range of maturities, especially on the short end of the curve. Moreover, the liquidity of T-Bond futures is subdued by restrictions on banks who are the largest holders of the underlying securities. Interest rate futures could also be created by the China Financial Futures Exchange.

104. The investor base is dominated by banks, with a strong presence of a wide range of asset management schemes that have limited the growth of a broader and more traditional institutional investors (mutual funds, insurance companies and pension funds). Commercial banks hold 57 percent of all bonds, with particularly large allocations to central government, local government and policy bank debt. Asset management products such as WMPs are active participants in the credit market and have grown substantially. The participation of traditional domestic institutional investors and foreign investors is significantly below those observed in other large EMEs and developed economies. Authorities could, inter alia, improve the supporting role banks may play for the development of the bond market (e.g. enhancing banks' trading and hedging practices), take additional actions to increase participation of foreign investors in a prudent way, starting from the government bond market, and articulate an agenda for the development of the domestic institutional investor base.

105. The development of a solid domestic institutional investor base takes time and will require efforts in different areas. Further strengthening the regulation of WMPs and leveling the regulatory playing field with other CIS, would boost the growth of mutual funds and contractual savings schemes. This would entail *inter alia* prohibiting the use of expected returns in marketing, improving the content of prospectus, and strengthening disclosure of valuation, purchase and redemption procedures. The bancassurance model offers considerable potential to expand insurance coverage, including collective and individual retirement products. Regulatory frameworks need to strike an appropriate balance between the customer's concerns to have sufficient product and provider choice and contestability, and the bank's legitimate interest in channeling business through a preferred insurance company. The private pension sector is the class of institutional investor with the greatest potential for further growth, as shown by modest coverage, assets of only 1.5 percent of GDP, and very conservative portfolios. The authorities may consider adopting a new approach to expand the coverage of pension plans including automatic enrollment, default lifecycle portfolios, default contribution rates, and immediate vesting, with all default

rules accompanied by opt out clauses. In addition, the authorities may consider adopting simplified, standardized, low cost arrangements to facilitate further the offer of such plans by SMEs.[18]

106. Regulatory and tax frameworks need greater harmonization to integrate market segments and participation of different issuers and investors. The existence of the two main bond market segments (interbank and exchange) does not pose a problem *per se*, but regulations need to be integrated to avoid pricing distortions and ensure equitable access of issuers and investors. Authorities have made significant progress in improving market integration and internationalization and further regulatory harmonization is expected. Issuance approval requirements have been streamlined and many sectors (e.g. private placed corporate bonds) are close to registration based issuance. Moreover, the interbank bond market has largely opened up to overseas institutions, while access to Hong Kong retail investors is being enhanced through the "bond connect" program. However, there is further room to improve integration of bond markets and expand access to a broader investor base. Regulations-induced market segmentation still exists in certain products, investor access and market infrastructure, as illustrated for the case of derivatives. Regarding the tax framework, neutrality across instruments (e.g. government bonds and corporate bonds) and investors should be improved to avoid price and allocation distortions.

D. Enhancing the Role of Policy Banks

107. China Development Bank (CDB), a development finance institution, and the two policy banks, Export-Import Bank of China (EXIM), and the Agricultural Development Bank of China (ADBC), have broad mandates in supporting the nation's strategic priorities. The three banks are among the top 15 largest banks in China, accounting together for 28 percent of GDP and 10 percent of total banking assets. The stock of CDB and policy bank bonds exceeds that of Treasury. The three banks, which were established in 1994 to strip policy lending functions from the commercial banks, have expanded over the years and got into new business areas, raising concerns over operational overlap and competition with commercial banks. The global financial crisis motivated a renewed attention to the developmental and countercyclical roles of policy banks. The reform plans approved in 2014 and 2015 affirmed the broad role of CDB and policy banks to serve the nation's strategies. The banks have since experienced another round of fast asset growth with a broad range of mandates domestically and overseas, reflecting a mix of short-term GDP growth-stabilizing strategies and long-term development priorities.

108. The authorities have been working on the implementation of the CDB and policy bank reform. In 2015, the capital adequacy of the three banks was strengthened with capital injections of $48 billion in CDB and $45 billion in EXIM using foreign reserves, and RMB 37 billion in ADBC using retained earnings and cash from the MOF. Various agencies are developing plans aimed at improving

[18] Rudolph, H 2016. "Building Voluntary Pension Schemes" World Bank Policy Research Paper No. 7779.

corporate governance, defining business scope, and putting in place a differentiated regulatory framework to encourage the policy banks to focus on their policy mandates.

109. The broad mandates of CDB and the policy banks raise questions about their additionality. These questions are especially pertinent in a country with vast savings and a fast growing financial system. While the special characteristics of policy banks are generally recognized, the authorities acknowledge that there are areas where CDB and the policy banks overlap and compete with commercial banks. In addition, they rely almost exclusively on direct lending and active investments. There is limited use of other financial instruments, such as credit enhancement and co-financing, which could better leverage commercial sources of financing. Advisory services (e.g. to help structure financing for infrastructure projects and develop financial instruments) are another area that could be further improved to tackle the underlying impediments to constrained financing and help catalyze market development.

110. The CDB and policy banks play an important role in financing projects sponsored by local governments and their affiliated entities, the scale and impact of which warrant careful evaluation. CDB, and more recently ADBC, seem to have built up significant exposures to local governments and entities through infrastructure finance and shantytown redevelopment projects. It is advisable for the authorities to closely monitor these exposures to local governments (including contingent liabilities) to ensure fiscal discipline and financial sustainability.[19] In addition, the short-term policy objective of providing countercyclical support to the economy through public investments should be de-emphasized to minimize long-term efficiency losses.

111. The government should further clarify the mandates of CDB and the policy banks to ensure that they supplement and catalyze commercial financing. The broad positioning of the policy banks in supporting key industries and underdeveloped sectors and during critical periods should be translated into better defined mandates to prevent excessive expansion of their scope. In this regard, the ongoing efforts to define the business scope of these banks is commendable. However, further efforts should be put into identifying specific market failures,[20] with an explicit requirement for the policy banks to target gaps that the private sector is unable to fill. Periodical review and update of policy mandates would allow for withdrawal from certain segments once market for commercial financing has developed.

112. The governance framework of CDB and the policy banks could be improved. The latest reform plans of the policy banks include the appointment of government officials from several cabinet

[19] The CBRC has issued regulations on the exposure of banks (including the policy banks) to local governments and put in place statistical requirements. The CBRC also issued communications providing warnings on the risks associated with local government debt. However, these exposures could not be assessed due to data limitations.

[20] The authorities consider the role of CDB as a development finance institution is to address both market failures and government failures. However, economic literature has focused on market failures as the rationale for government interventions in financial intermediation, including through development finance institutions.

ministries as ministerial directors to the boards of policy banks (in addition to the traditional equity directors representing government ownership). The representation of relevant government ministries on the board of development finance institutions is common in many countries and is intended to ensure that these institutions fulfill their policy mandates. This arrangement, however, has some drawbacks, including the scope for undue political interference in their operations and conflicts of objectives with other public policy priorities of the various agencies. International best practice (in particular as summarized in the OECD Guidelines on Corporate Governance of SOEs) suggests that limiting board membership by representatives of the ownership entity or by other state officials can increase professionalism and help minimize conflict of interests and prevent excessive government intervention in management. The government should instead focus on setting the broad mandates and objectives, based on which the board independently carries out its function of setting strategy and supervising management.

113. Emphasis should also be given to ensuring relevant competencies within the boards to set strategic direction and policies. In line with the OECD Guidelines on Corporate Governance of SOEs, board members should be nominated in a transparent process, based on qualifications, and consideration could be given to including independent directors,[21] who would be able to monitor compliance with the banks' mandates and evaluate the performance of the banks without conflicts of interest or undue influence of interested parties. Some development banks in other countries (e.g. Business Development Bank of Canada, Development Bank of Southern Africa) have adopted transparent mechanisms to bring in independent directors, which is considered an important element to ensure competence in the board and management and, in turn, success in achieving policy objectives.[22]

114. Performance evaluation and transparency of policy bank operations could be improved to gauge the effectiveness of policy intervention, and increase accountability. The authorities have put in place a new performance framework with a focus on the developmental impact and financial sustainability of the policy banks. In addition to regular monitoring of standardized indicators, impact evaluation on targeted programs/interventions could also be conducted. The level of disclosure of policy bank operations should be more aligned with its public accountability given the fact that they enjoy sovereign credit guarantee and serve public policy objectives. Improvement could start with the compiling and disclosing of different type of exposures, terms of lending, portfolio composition by borrower type and industry, and improving the disclosure of financial soundness indicators.

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[21] "*To enhance the objectivity of SOE boards a certain minimum number of independent board members on SOE boards should be required. Some countries require that SOEs apply the same rules for independent board members that apply to listed companies*." OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015.
[22] Rudolph, H. 2009. "State Financial Institutions: Mandates and Governance" World Bank Research Paper No. 5141.

115. To facilitate informed decision-making, the government could consider conducting a comprehensive assessment of the policy banks. The diagnostic should entail a detailed review of existing mandates, governance and policies of the policy banks, as well as a functional analysis of instruments and impact evaluation of main lending and investment programs to gauge the effectiveness of interventions. The findings could be used to inform the implementation plans on the various aspects of the ongoing policy bank reform.

Annex 1. Select Economic and Financial Indicators

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections					
	(Annual percentage change, unless otherwise indicated)										
NATIONAL ACCOUNTS											
Real GDP (base=2015)	7.9	7.8	7.3	6.9	6.7	6.8	6.5	6.3	6.2	6.0	5.8
Total domestic demand	7.9	8.1	7.2	7.2	7.4	6.9	6.9	6.7	6.6	6.3	5.9
Consumption	8.7	7.2	7.2	8.3	8.4	8.0	7.9	7.4	7.0	6.6	6.2
Investment	7.1	9.1	7.1	6.1	6.3	5.7	5.6	5.8	6.0	5.8	5.6
Fixed	9.0	9.3	6.8	6.7	6.7	5.8	5.7	5.9	6.2	6.0	5.8
Inventories (contribution)	-0.6	0.1	0.2	-0.2	-0.1	0.1	0.0	0.0	0.0	0.0	0
Net exports (contribution)	0.3	0.1	0.4	-0.1	-0.5	0.0	-0.2	-0.3	-0.2	-0.2	-0.1
Total capital formation (percent of GDP)	47.2	47.3	46.8	44.7	44.2	44.0	43.3	42.8	42.4	42.1	41.8
Gross national saving (percent of GDP)[1]	49.7	48.8	49.0	47.5	45.9	45.4	44.5	43.7	43.0	42.5	42
LABOR MARKET											
Unemployment rate (annual average)[2]	...	5.0	5.1	5.1	5.0	5.0	5.0	5.0	5.0	5.0	5
Wages (migrant workers)	33.1	12.9	10.0	9.5	7.1	7.0	6.8	6.7	6.6	6.5	6.5
PRICES											
Consumer prices (average)	2.6	2.6	2.0	1.4	2.0	1.8	2.4	2.5	2.6	2.6	2.6
GDP Deflator	3.2	2.4	1.0	1.1	0.0	1.8	1.9	2.0	2.1	2.1	2
FINANCIAL											
7-day repo rate (percent)	3.5	4.3	3.6	2.9	2.6	…	...	...	...	...	...
10-year Treasury bond yield (percent)	3.6	4.6	3.6	2.8	3.0	3.9	...	...	...	...	...
Real effective exchange rate (average)	6.0	6.4	2.4	9.7	-4.1	…	…	…	…	…	…
Nominal effective exchange rate (average)	5.7	5.6	2.5	9.5	-4.6	…	…	…	…	…	…
MACROFINANCIAL											
Total social financing[3]	19.1	17.5	14.3	12.4	12.8	10.9	11.4	12.2	11.2	10.5	9.9
In percent of GDP	169.0	180.0	189.8	197.6	207.4	213.2	218.9	226.6	232.4	237.3	241.7
Total domestic nonfinancial sector debt	18.4	17.5	14.3	15.3	16.8	15.7	13.7	12.6	12.0	11.1	10.4
In percent of GDP	178.7	190.3	200.7	214.3	234.5	249.6	261.5	271.5	280.4	287.8	294.5
Domestic credit to the private sector	19.8	16.6	13.1	14.7	16.7	14.5	12.5	11.4	10.5	9.8	9.4
In percent of GDP	134.6	142.3	148.5	157.6	172.3	181.4	188.0	193.1	196.8	199.7	202.5
House price[4]	8.7	7.7	1.4	9.1	11.3	10.4	8.6	8.3	7.9	7.2	6.8
Household disposable income (percent of GDP)	59.4	60.0	60.7	61.0	61.4	61.7	62.0	62.0	62.1	62.2	62.5
Household savings (percent of disposable income)	38.1	38.5	38.0	37.6	36.1	35.3	34.1	33.0	32.0	31.3	31
Household debt (percent of GDP)	29.6	33.0	35.4	38.2	44.2	46.4	48.9	51.6	54.4	57.4	60.8
Nonfinancial corporate domestic debt (percent of GDP)	105.0	109.3	113.0	119.4	128.1	134.9	139.1	141.5	142.4	142.3	141.6
GENERAL GOVERNMENT (Percent of GDP)											
Net lending/borrowing[5]	-0.3	-0.8	-0.9	-2.8	-3.7	-3.7	-3.7	-3.9	-4.0	-4.1	-4.2
Revenue	27.8	27.7	28.1	28.5	28.2	27.5	27.5	27.4	27.1	27.0	26.8
Expenditure	28.1	28.5	29.0	31.3	31.9	31.2	31.2	31.2	31.1	31.1	31
Debt[6]	15.5	16.0	38.6	36.4	36.6	37.5	38.5	39.4	40.4	41.3	42.4
Structural balance	-0.1	-0.5	-0.5	-2.5	-3.6	-3.8	-3.8	-3.9	-4.0	-4.1	-4.1
BALANCE OF PAYMENTS (Percent of GDP)											
Current account balance	2.5	1.5	2.3	2.7	1.8	1.4	1.2	0.9	0.6	0.4	0.2
Trade balance	3.6	3.7	4.1	5.1	4.4	4.0	3.7	3.4	3.1	2.9	2.6
Services balance	-0.9	-1.3	-2.0	-1.9	-2.2	-2.2	-2.2	-2.3	-2.3	-2.3	-2.4
Net international investment position	21.8	20.7	15.2	14.9	16.0	16.5	16.2	15.9	15.2	14.4	13.4
Gross official reserves (in billions of U.S. dollars)	3,388	3,880	3,899	3,406	3,098	2,930	2,876	2,823	2,751	2,655	2,533
MEMORANDUM ITEMS											
Nominal GDP (in billions of renminbi)[7]	54,099	59,696	64,718	69,911	74,631	81,133	88,029	95,444	103,468	111,984	120,795
Augmented debt (percent of GDP)[8]	44.1	48.1	52.3	56.6	62.2	68.2	73.5	78.3	83.5	88.0	91.8
Augmented net lending/borrowing (percent of GDP)[8]	-5.1	-7.6	-7.2	-8.4	-10.4	-10.6	-10.8	-11.1	-11.2	-11.0	-10.8
Augmented fiscal balance (percent of GDP)[9]	-7.8	-10.3	-9.8	-10.2	-12.4	-12.6	-12.6	-12.6	-12.6	-12.3	-11.9

Sources: CEIC Data (2017); Information Notice System, International Monetary Fund (2017); and IMF staff estimates and projections.

[1] IMF staff estimates for 2015 and 2016.

[2] Surveyed unemployment rate.

[3] Not adjusted for local government debt swap.

[4] Average selling prices estimated by IMF staff based on housing price data (Commodity Building Residential Price) of 70 large and mid-sized cities published by National Bureau of Statistics

[5] Adjustments are made to the authorities' fiscal budgetary balances to reflect consolidated general government balance, including government-managed funds, state-administered SOE funds,

[6] Official government debt (narrow definition). Estimates of debt levels before 2015 include central government debt and explicit local government debt (identified by MoF and NPC in Sep

[7] Expenditure side nominal GDP.

[8] Augmented fiscal data expand the perimeter of government to include local government financing vehicles and other off-budget activity.

[9] "Augmented fiscal balance" = "augmented net lending/borrowing" - "net land sales proceeds" (in percent of GDP), i.e., with land sales treated as financing.

Annex 1. Select Economic and Financial Indicators (continued)

Core Financial Stability Indicators for Deposit Takers

(In percentages, unless otherwise stated)

	2013	2014	2015: Q2	2015: Q4	2016: Q2
Regulatory capital to risk-weighted assets	12.2	13.2	13	13.5	13.1
Regulatory Tier 1 capital to risk-weighted assets	9.9	10.8	10.8	11.3	11.1
Non-performing loans net of provisions to capital	-11.6	-9.8	-8.9	-7.9	-7.9
Non-performing loans to total gross loans	1	1.2	1.5	1.7	1.7
Sectoral distribution of total loans:					
Residents	99.4	99	98.9	98.9	98.9
Deposit-takers	11.2	8.8	8.6	7.1	3.4
Central bank	0.4	0	0	0	0
Other financial corporations	3.7	3.7	3.7	4.3	4.6
General government	-	-	-	-	-
Nonfinancial corporations	59.6	60	59.4	58.6	59.5
Other domestic sectors	24.5	26.6	27.1	28.9	31.4
Nonresidents	0.6	1	1.1	1.1	1.1
Return on assets	1.3	1.2	1.2	1.1	1.1
Return on equity	19.2	17.6	17.3	15	15.2
Interest margin to gross income	78.9	78.5	75.4	76.3	74.3
Non-interest expenses to gross income	32.9	31.6	27.2	30.6	26.7
Liquid assets to total assets (liquid asset ratio)	21.2	19.9	19.7	21.1	21.6
Liquid assets to short-term liabilities	44	46.4	46.2	48	48.1
Net open position in foreign exchange to capital	3.7	3.5	3	3.7	3.1

Source : Financial Soundness Indicators, International Monetary Fund (2016).
(-) indicates that a figure is zero.
(...) indicates a lack of statistical data that can be reported or calculated from underlying observations.

Annex 2. Financial System Structure – Statistics

	Assets, CNY billions						
	2010	2011	2012	2013	2014	2015	2016
Banking institutions[1]	**95,305**	**113,288**	**133,605**	**151,333**	**172,310**	**199,238**	**232,253**
Commercial banks	74,160	88,404	104,570	118,799	134,798	155,746	181,506
Large commercial banks	46,894	53,634	60,040	65,601	71,014	78,163	86,598
Joint-stock commercial banks	14,904	18,379	23,527	26,936	31,380	36,988	43,473
City commercial banks	7,853	9,985	12,347	15,178	18,084	22,680	28,238
Rural commercial banks	2,767	4,253	6,275	8,522	11,527	15,234	20,268
Foreign banks	1,742	2,154	2,380	2,563	2,792	2,681	2,929
Policy banks & China Development Bank	7,652	9,313	11,217	12,528	15,614	19,285	22,994
Cooperative financial institutions	7,894	8,610	9,237	9,827	9,788	9,417	8,386
New-type rural financial institutions & China Postal Savings Bank	3,510	4,354	5,351	6,211	7,098	8,302	9,507
Other non-bank financial institutions regulated by CBRC	2,090	2,607	3,230	3,968	5,012	6,488	7,931
Banking asset management companies[2]					1,464	1,991	3,392
Non-bank financial institutions	**10,670**	**11,010**	**13,454**	**15,093**	**21,033**	**30,041**	**33,216**
Insurance companies	5,054	5,983	7,355	8,289	10,159	12,360	15,117
Life	4,267	4,980	6,099	6,825	8,249	9,932	12,437
Non-life	584	792	948	1,094	1,406	1,848	2,374
Reinsurance	115	158	185	210	351	519	276
Captive and others	2	2	3	3	13	16	29
Securities companies	1,969	1,572	1,721	2,080	4,034	6,417	5,790
Pension funds	1,138	1,226	1,588	1,845	2,305	2,866	3,150
National Social Security Fund	857	869	1,106	1,242	1,536	1,914	2,042
Enterprise annuities	281	357	482	604	769	953	1,108
Public funds by fund management companies[3]	2,510	2,229	2,790	2,879	4,535	8,397	9,159
Asset management businesses	**3,040**	**4,811**	**7,471**	**24,088**	**36,979**	**62,229**	**84,482**
Client-specific funds by fund management companies/subsidiaries				1,445	4,963	11,422	15,607
Bank off-balance sheet WMPs, AUM[4]				6,530	10,090	17,430	23,110
Trust companies, AUM	3,040	4,811	7,471	10,907	13,980	16,304	20,219
Securities companies, AUM				5,206	7,946	11,895	17,376
Futures companies, AUM						106	279
Private equity[5]						5,072	7,891
Financial system, total	**109,016**	**129,109**	**154,530**	**190,514**	**230,323**	**291,508**	**349,952**

	Share of GDP, %						
	2010	2011	2012	2013	2014	2015	2016
Banking institutions[1]	**230.7**	**231.5**	**247.2**	**254.2**	**267.6**	**289.1**	**309.4**
Commercial banks	179.6	180.7	193.5	199.6	209.3	226.0	241.8
Large commercial banks	113.5	109.6	111.1	110.2	110.3	113.4	115.4
Joint-stock commercial banks	36.1	37.6	43.5	45.3	48.7	53.7	57.9
City commercial banks	19.0	20.4	22.8	25.5	28.1	32.9	37.6
Rural commercial banks	6.7	8.7	11.6	14.3	17.9	22.1	27.0
Foreign banks	4.2	4.4	4.4	4.3	4.3	3.9	3.9
Policy banks & China Development Bank	18.5	19.0	20.8	21.0	24.2	28.0	30.6
Cooperative financial institutions	19.1	17.6	17.1	16.5	15.2	13.7	11.2
New-type rural financial institutions & China Postal Savings Bank	8.5	8.9	9.9	10.4	11.0	12.0	12.7
Other non-bank financial institutions regulated by CBRC	5.1	5.3	6.0	6.7	7.8	9.4	10.6
Banking asset management companies[2]					2.3	2.9	4.5
Non-bank financial institutions	**25.8**	**22.5**	**24.9**	**25.4**	**32.7**	**43.6**	**44.2**
Insurance companies	12.2	12.2	13.6	13.9	15.8	17.9	20.1
Life	10.3	10.2	11.3	11.5	12.8	14.4	16.6
Non-life	1.4	1.6	1.8	1.8	2.2	2.7	3.2
Reinsurance	0.3	0.3	0.3	0.4	0.5	0.8	0.4
Captive and others	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities companies	4.8	3.2	3.2	3.5	6.3	9.3	7.7
Pension funds	2.8	2.5	2.9	3.1	3.6	4.2	4.2
National Social Security Fund	2.1	1.8	2.0	2.1	2.4	2.8	2.7
Enterprise annuities	0.7	0.7	0.9	1.0	1.2	1.4	1.5
Public funds by fund management companies[3]	6.1	4.6	5.2	4.8	7.0	12.2	12.2
Asset management businesses	**7.4**	**9.8**	**13.8**	**40.5**	**57.4**	**90.3**	**112.5**
Client-specific funds by fund management companies/subsidiaries				2.4	7.7	16.6	20.8
Bank off-balance sheet WMPs, AUM[4]				11.0	15.7	25.3	30.8
Trust companies, AUM	7.4	9.8	13.8	18.3	21.7	23.7	26.9
Securities companies, AUM					12.3	17.3	23.1
Futures companies, AUM						0.2	0.4
Private equity[5]						7.4	10.5
Financial system, total	**263.9**	**263.9**	**286.0**	**320.1**	**357.7**	**423.1**	**466.2**

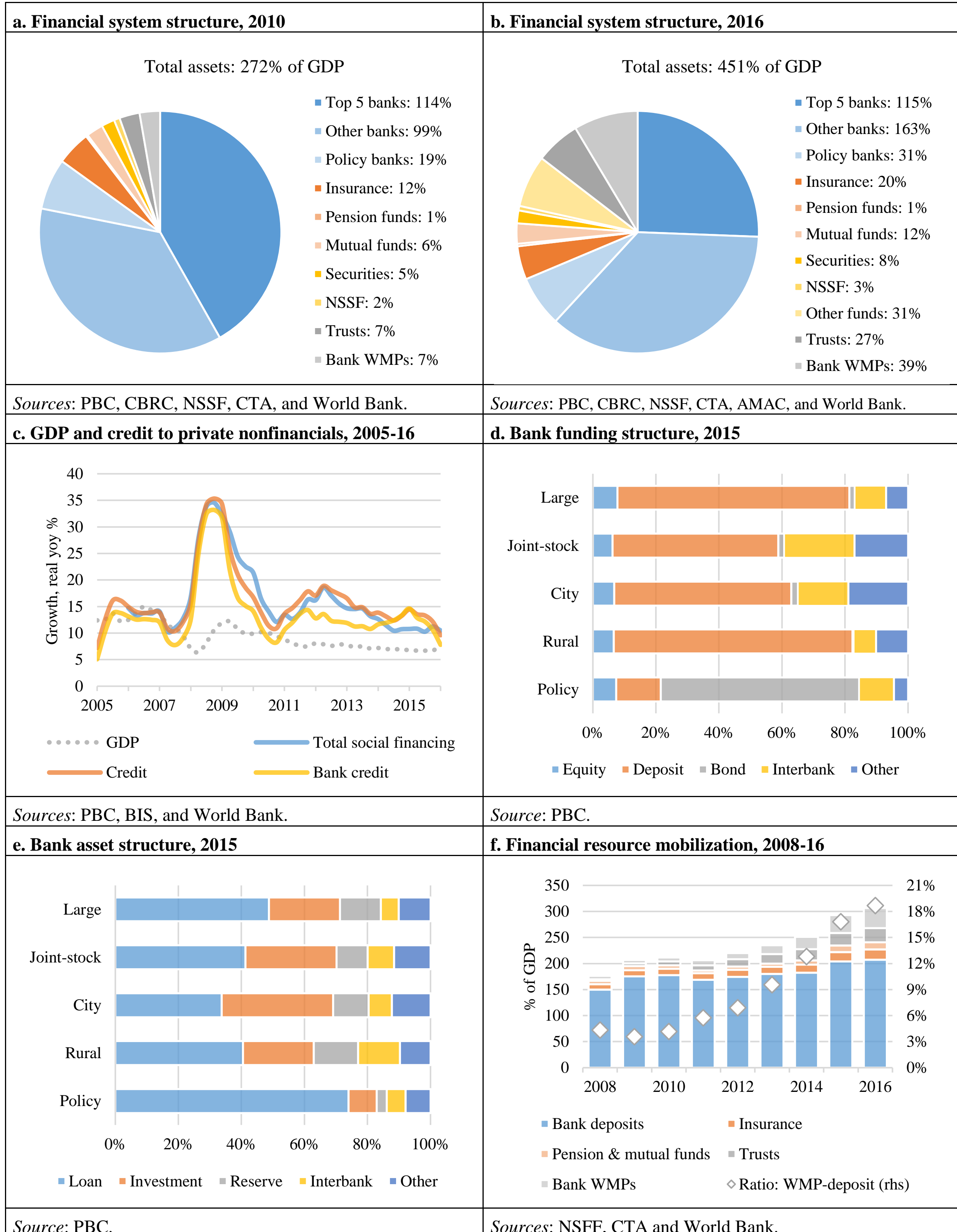
	Share of system assets, %						
	2010	2011	2012	2013	2014	2015	2016
Banking institutions[1]	**84.6**	**84.1**	**82.2**	**80.6**	**75.5**	**69.5**	**68.4**
Commercial banks	65.8	65.7	64.3	63.3	59.1	54.3	53.5
Large commercial banks	41.6	39.8	36.9	35.0	31.1	27.3	25.5
Joint-stock commercial banks	13.2	13.7	14.5	14.4	13.7	12.9	12.8
City commercial banks	7.0	7.4	7.6	8.1	7.9	7.9	8.3
Rural commercial banks	2.5	3.2	3.9	4.5	5.1	5.3	6.0
Foreign banks	1.5	1.6	1.5	1.4	1.2	0.9	0.9
Policy banks & China Development Bank	6.8	6.9	6.9	6.7	6.8	6.7	6.8
Cooperative financial institutions	7.0	6.4	5.7	5.2	4.3	3.3	2.5
New-type rural financial institutions & China Postal Savings Bank	3.1	3.2	3.3	3.3	3.1	2.9	2.8
Other non-bank financial institutions regulated by CBRC	1.9	1.9	2.0	2.1	2.2	2.3	2.3
Banking asset management companies[2]					0.6	0.7	1.0
Non-bank financial institutions	**9.5**	**8.2**	**8.3**	**8.0**	**9.2**	**10.5**	**9.8**
Insurance companies	4.5	4.4	4.5	4.4	4.5	4.3	4.5
Life	3.8	3.7	3.8	3.6	3.6	3.5	3.7
Non-life	0.5	0.6	0.6	0.6	0.6	0.6	0.7
Reinsurance	0.1	0.1	0.1	0.1	0.2	0.2	0.1
Captive and others	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities companies	1.7	1.2	1.1	1.1	1.8	2.2	1.7
Pension funds	1.0	0.9	1.0	1.0	1.0	1.0	0.9
National Social Security Fund	0.8	0.6	0.7	0.7	0.7	0.7	0.6
Enterprise annuities	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Public funds by fund management companies[3]	2.2	1.7	1.7	1.5	2.0	2.9	2.7
Asset management businesses	**2.7**	**3.6**	**4.6**	**12.8**	**16.2**	**21.7**	**24.9**
Client-specific funds by fund management companies/subsidiaries				0.8	2.2	4.0	4.6
Bank off-balance sheet WMPs, AUM[4]				3.5	4.4	6.1	6.8
Trust companies, AUM	2.7	3.6	4.6	5.8	6.1	5.7	6.0
Securities companies, AUM					3.5	4.1	5.1
Futures companies, AUM						0.0	0.1
Private equity[5]						1.8	2.3
Financial system, total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Sources: CBRC, CIRC, CSRC, AMAC, SAC, MOHRSS, NSSF, CTA, annual reports.

Notes: [1] Calculated as the sum of individual components. [2] Including the national AMCs of Cinda, Huarong, and Orient. [3] 2010-13 values including mutual funds only. [4] Bank WMPs, AUM amounted to 7.4% of GDP in 2010, according to estimate by PwC (2015). [5] Reported as "privately offered funds" by AMAC.

Annex 3. Financial System Structure – Figures

Figure 1. Financial System Structure



a. Financial system structure, 2010

Sources: PBC, CBRC, NSSF, CTA, and World Bank.

b. Financial system structure, 2016

Sources: PBC, CBRC, NSSF, CTA, AMAC, and World Bank.

c. GDP and credit to private nonfinancials, 2005-16

Sources: PBC, BIS, and World Bank.

d. Bank funding structure, 2015

Source: PBC.

e. Bank asset structure, 2015

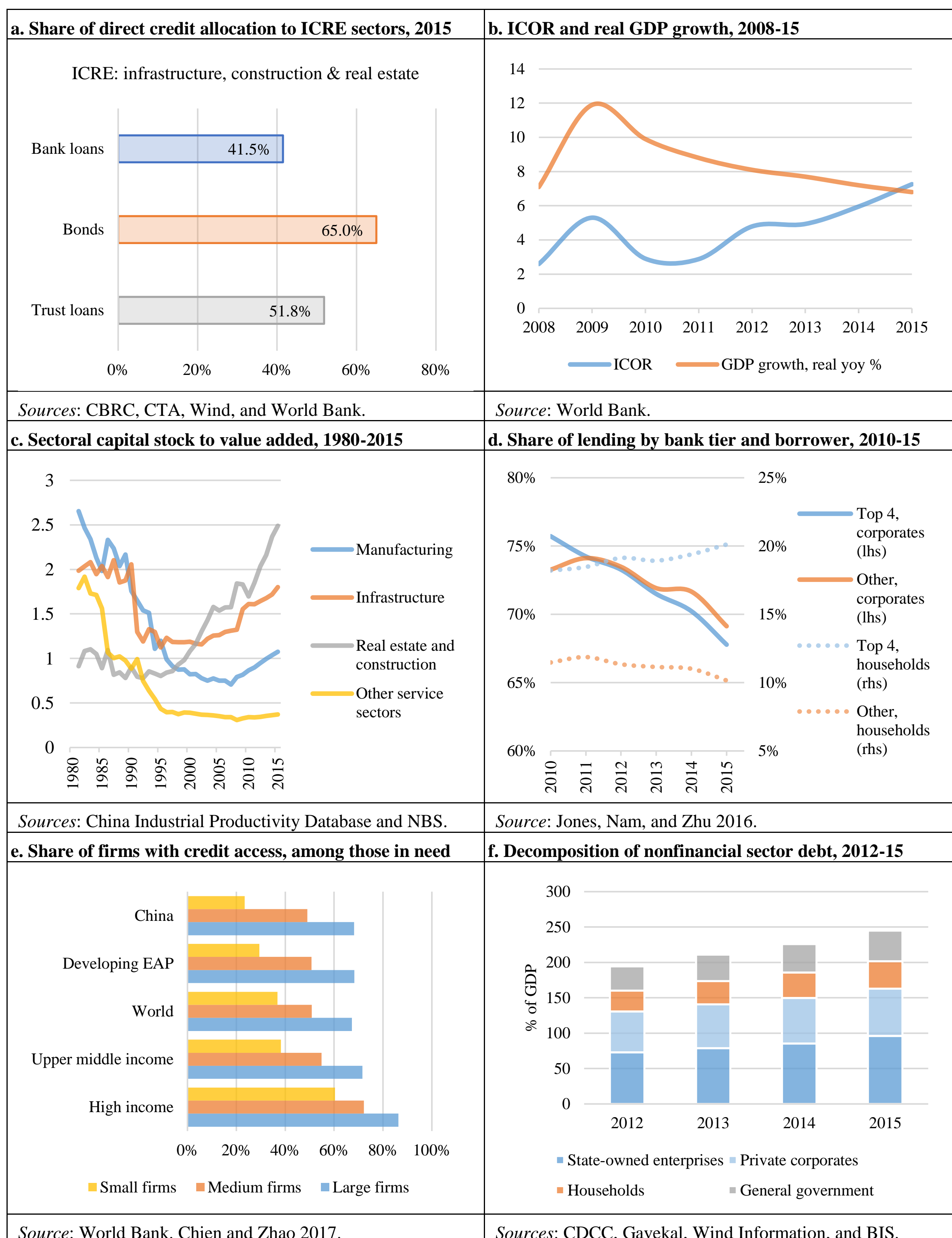
Source: PBC.

f. Financial resource mobilization, 2008-16

Sources: NSFF, CTA and World Bank.

Annex 3. Financial System Structure – Figures (continued)

Figure 2. Credit Allocation and Efficiency



Sources: CBRC, CTA, Wind, and World Bank.

Source: World Bank.

Sources: China Industrial Productivity Database and NBS.

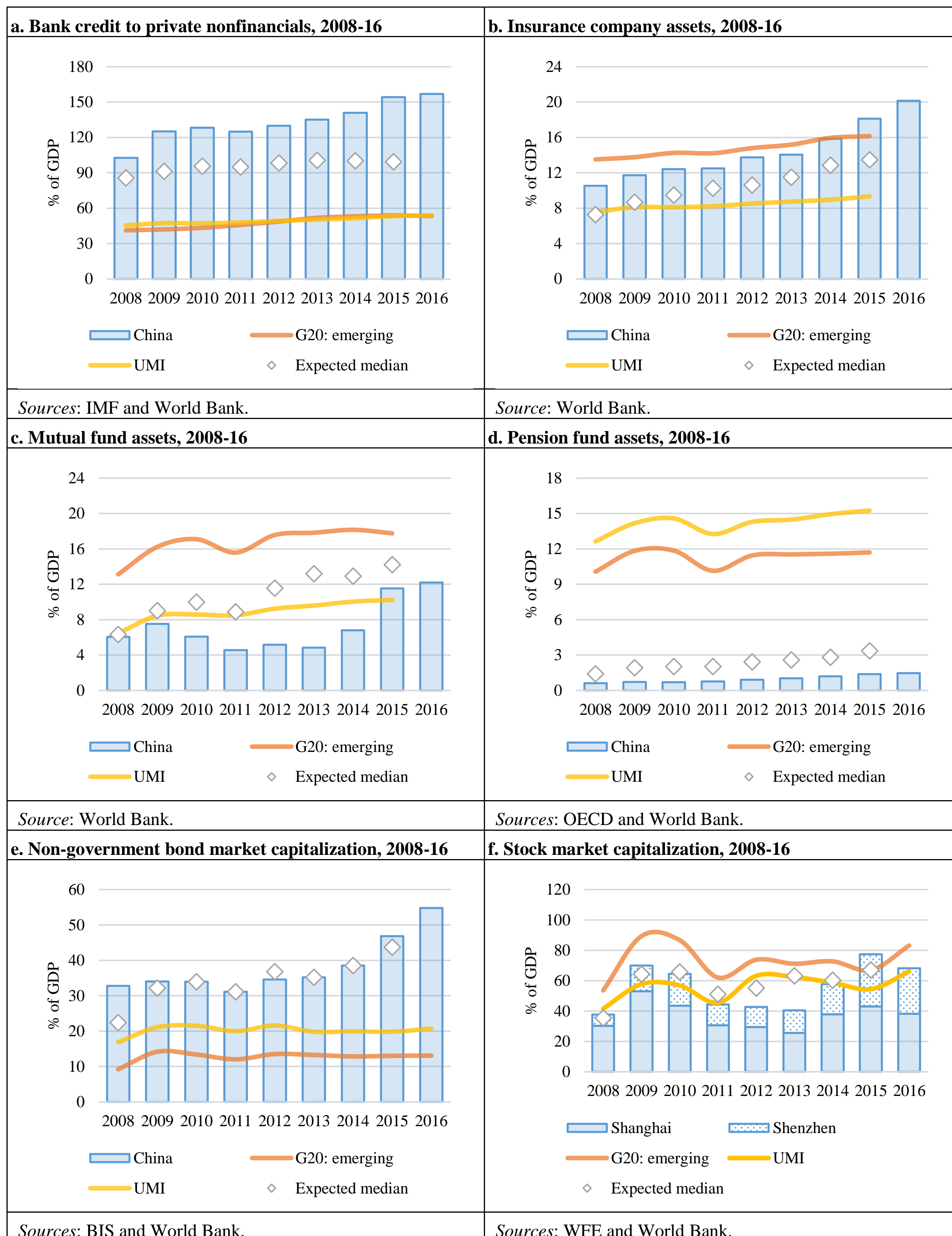
Source: Jones, Nam, and Zhu 2016.

Source: World Bank. Chien and Zhao 2017.

Sources: CDCC, Gavekal, Wind Information, and BIS.

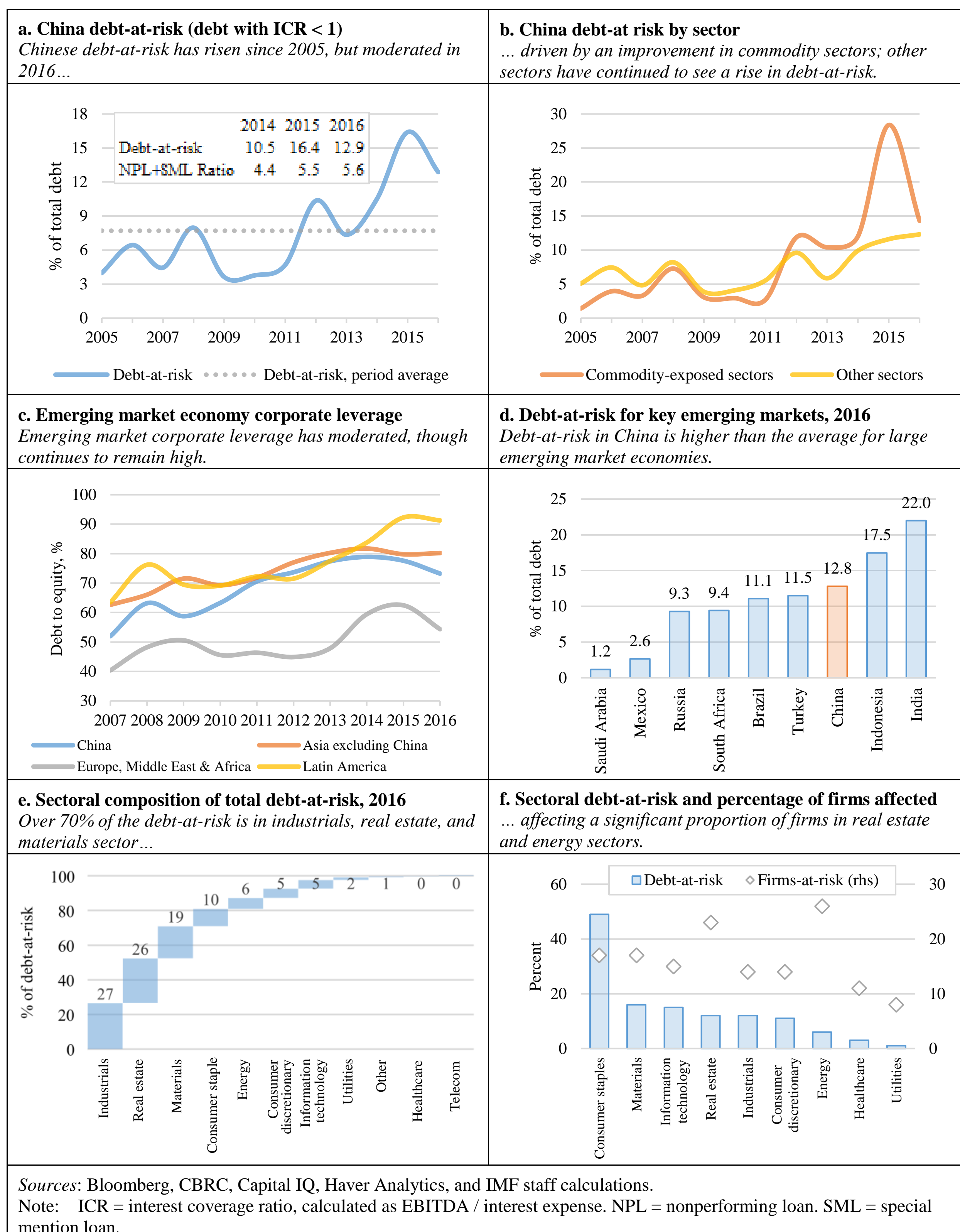
Annex 3. Financial System Structure – Figures (continued)

Figure 3. NBFI Assets and Securities Markets



Annex 3. Financial System Structure – Figures (continued)

Figure 4. Chinese Corporate Sector: Debt-at-Risk, 2005-16



Sources: Bloomberg, CBRC, Capital IQ, Haver Analytics, and IMF staff calculations.
Note: ICR = interest coverage ratio, calculated as EBITDA / interest expense. NPL = nonperforming loan. SML = special mention loan.

Annex 4. Implementation 2011 FSAP Recommendations

Key Recommendations	Status
1. China should continue to carry out reforms on interest and exchange rates, while ensuring that financial institutions are able to provide appropriate credit risk management.	**LD**
2. Clear distinction should be made between the role and function of policy financial institutions and commercial financial institutions.	**LD** Revised articles of association for the three policy banks clarify their scope of business
3. The four asset management companies should be transformed into commercial entities. As a first step, they will be required to regularly publish financial statements and management reports.	**PD** The four national AMCs have broadened their activities into more commercial areas, and regional AMCs have led to more competition. Two are now publicly listed and disclose information accordingly.
4. The PBC and the three regulatory commissions should be given specialized mandates, operational autonomy and flexibility. They must also have adequate capital and skilled personnel, with increased inter-departmental collaboration, in order to address the challenges to the financial sector brought on by rapid development.	**PD** While regulatory mandates are clear, operational autonomy and flexibility have not been addressed. The PBC and other regulatory authorities are constrained in terms of headcount and budgets. The JMC facilitates some awareness and cross sectoral policy discussion.
5. A regulatory framework should be set up for financial holding companies, financial group companies and informal financial enterprises. During the transition period, any M & A activity by the regulated institutions must be approved by their respective regulatory commission.	**PD** The regulatory regime for oversight of such FHCs and industrial conglomerates with financial subsidiaries in China is limited, and the overall regulatory framework for FHCs is still lacking.
6. A more forward-looking assessment of credit risk should be practiced within the CBRC's risk rating system, in order to eliminate any gaps with regular credit risk ratings and the market risk capital framework.	**D**
7. A formal mechanism should be put in place for the Chinese Securities Regulatory Commission (CSRC) to conduct regular onsite inspections of securities exchanges for enhanced oversight.	**D** All exchanges are now subject to onsite inspections.
8. A risk capital solvency regime should be instituted for insurers, with an appropriate transitional period, that will prohibit insurance companies from developing new business if their solvency level is lower than 100 percent.	**D** CIRC's China Risk-Oriented Solvency Standards (C-ROSS) were implemented on January 1. 2016. Some insurers were not yet meeting the 100 percent requirement at the time of the assessment.
9. Clear and transparent regulations should be developed to facilitate the exit from market by insurance companies through termination at expiration or through transfer of assets.	**PD** The updated Insurance Law and regulations (e.g., on portfolio transfers) have helped address this issue. A clear point at which it is no longer permissible for an insurer to continue its business is still needed.
10. A law governing payment systems should be developed to provide comprehensive protection of the finality of payments and the settlement of derivatives and securities contracts.	**LD**
11. It is imperative that information on beneficial ownership	**PD** The Enterprise Information Disclosure Regime (2014) is

Key Recommendations	Status
and control is sufficient and accurate and that such information is available to the competent authorities.	a database for registration of business, but beneficial ownership information is not consistently captured or assessed for financial groups. Regulators can obtain information ex post.
12. Information sharing and collaborative arrangements must be improved between The PBC and other relevant agencies on anti-money laundering (AML) and other regulatory issues.	**LD** The PBC and the CBRC have announced plans for joint onsite AML/CFT inspections. The CIRC's AML/CFT onsite inspection plan does not include entities that were subject to a PBC onsite inspection.
13. The establishment of the Financial Stability Board, with the PBC as its secretariat.	**LD** The JMC was created in 2013 to facilitate interagency coordination with the PBC acting as a secretariat. The JMC's mandate and powers are not legally defined. The Central Committee of the Party and the State Council announced at the National Financial Work Conference in July 2017 that a Financial Stability and Development Committee (FSDC) under the State Council will be set up. The PBC will act as secretariat.
14. Improved data collection on financial institutions, including their leverage, liabilities, off-balance sheet positions, unregulated products and cross-border and sectoral exposures.	**LD** CBRC overhauled prudential data and analytical systems for banks and banking groups. A uniform platform for interagency data sharing is under construction. Securities markets data is shared between CSRC and CBRC on trust plans, and CSRC, PBOC, and NDRC on bond markets.
15. The establishment of a macro-prudential framework to measure and manage systemic risk, which should include increased resources at the PBC and the regulatory agencies and their improved ability to monitor financial stability and regularly carry out stress tests.	**LD** The PBC and three regulatory agencies are all engaged in financial stability analysis and participate in macroprudential work.
16. Enhanced hedging of structural liquidity through market-based tools and managing spillovers from systemic liquidity through indirect monetary policy tools.	**LD** PBC reserve money management now stabilizes short-term rates, and provides a liquidity backstop to the banks.
17. The implementation of an average reserve system to facilitate liquidity management and to improve stability and efficiency.	**D**
18. Launching a trial run of the targeted short-term repo rate, as an experiment of indirect liquidity management, and starting daily open market operations.	**D**
19. Ensuring the deposit and lending operations at the PBC is on a real time and automatic basis, with uniform collateral requirements for all domestically registered entities.	**LD** PBC has introduced the Standing Lending Facility: lending operations are on a real time and automatic basis, with uniform collateral requirements for all domestically-registered entities.
20. The implementation of a deposit insurance system to provide support for the orderly shutdown of financial institutions; and assistance for sorting out contingent liabilities.	**PD** The State Council issued the Deposit Insurance Regulation in 2015, and the new deposit insurance scheme is being operationalized, including by establishing single customer view. Since "deposits" are not clearly defined, coverage may extend to investment products.
21. Ensuring consistency of regulatory rules and assigning regulatory responsibilities in support of developing the	**PD/LD** Agreements have been reached to develop a

Key Recommendations	Status
fixed-income market.	harmonized regime for bond markets.
22. Continued improvement of bond issuing strategies by the Ministry of Finance and the PBC, to help improve the existing market-making activities in products of various maturities on the yield curve.	**LD** Instruments of several maturities are being regularly issued by the MoF, however large instrument fragmentation requires further improvements in bond issuance strategies.
23. Enhancing the management and operational framework of the repo market, in order to improve market liquidity and risk management, in addition to strengthening the linkage between money market rates and bond market rates.	**PD** Measures have been taken to contain risks in the repo market, but critical risks still need to be managed (e.g., illiquidity of collateral) and other changes are required to improve the supporting role of repos for bond market development.
24. Relaxing the restriction that accumulated balance of market-issued bond of a company may not exceed 40 percent of net assets, in order to expand its capacity for direct financing.	**PD**
25. Improving the interoperability among the inter-bank bond market and the Shanghai and Shenzhen Stock Exchanges, by upgrading the linkage between the China Central Depository and Clearing Co., Ltd. (CCDC) and the China Securities Depository and Clearing Corporation Limited (SD&C), thus providing support for the further development of these three markets, and help improve their efficiency.	**LD** The PBC and CSRC are actively coordinate with relevant institutions in joint work such as cross account opening, to support the market development.
26. Building a multi-pillared pension system, focusing on a basic pension system that is fully funded.	**PD**
27. Reviewing existing governmental programs to determine their effectiveness in terms of promoting financing for rural and small and micro-enterprises, and developing a comprehensive and coherent strategy on such financing.	**PD** There have been some improvements in design and targeting of government programs, but a comprehensive strategy and coordinated use of such programs should be strengthened, and data on impact and effectiveness is insufficient.
28. Further reforms of rural credit cooperatives, to enhance their efficiency and sustainability as commercial providers of financial products and services.	**LD** Reforms have been undertaken, but further reforms in the RCC system are necessary to improve corporate governance and commercial orientation.
29. Completing the reform of the Postal Savings Bank by optimization of the ownership structure, marketization and the establishment of effective corporate governance.	**LD** Reforms have been undertaken, including listing on the Hong Kong stock exchange in 2016, but further reforms are necessary to improve corporate governance and institutional capacity.
D = Done; LD = Largely Done; PD = Partly Done; NA = No Action.	