FINANCIAL STABILITY BOARD

Peer Review of China

Review Report

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Foreword

Financial Stability Board (FSB) member jurisdictions have committed, under the FSB Charter and in the *FSB Framework for Strengthening Adherence to International Standards*[1], to undergo periodic peer reviews. To fulfil this responsibility, the FSB has established a regular programme of country and thematic peer reviews of its member jurisdictions.

Country reviews focus on the implementation and effectiveness of regulatory, supervisory or other financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving desired outcomes. They examine the steps taken or planned by national authorities to address International Monetary Fund (IMF)–World Bank Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) recommendations on financial regulation and supervision as well as on institutional and market infrastructure that are deemed most important and relevant to the FSB's core mandate of promoting financial stability. Country reviews can also focus on regulatory, supervisory or other financial sector policy issues not covered in the FSAP that are timely and topical for the jurisdiction itself and for the broader FSB membership. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, or its compliance with international financial standards.

FSB jurisdictions have committed to undergo an FSAP assessment every 5 years; peer reviews taking place 2-3 years following an FSAP will complement that cycle. As part of this commitment, China volunteered to undergo a peer review in 2014.

This report describes the findings and conclusions of the China peer review, including the key elements of the discussion in the FSB's Standing Committee on Standards Implementation (SCSI) on 12 May 2015. It is the fourteenth country review conducted by the FSB based on the objectives and guidelines set forth in the *Handbook for FSB Peer Reviews.*[2]

The analysis and conclusions of this peer review are based on the Chinese financial authorities' responses to a questionnaire and reflect information on the progress of relevant reforms as of May 2015. The review has also benefited from dialogue with the Chinese authorities as well as discussion in the FSB SCSI.

The draft report for discussion was prepared by a team chaired by Jon Cunliffe (Deputy Governor, Bank of England) and comprising Gerard Dages (Federal Reserve Bank of New York, United States), Jan Kakes (Netherlands Bank), Alexandre Miremad (Federal Department of Finance, Switzerland) and Carmelo Salleo (European Central Bank). Jason George, Chris Reid and Costas Stephanou (all FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

[1] See http://www.financialstabilityboard.org/wp-content/uploads/r_100109a.pdf.

[2] See http://www.financialstabilityboard.org/wp-content/uploads/FSB-Peer-Review-Handbook-12-March-2015.pdf.

Abbreviations

AML	Anti-Money Laundering
BCBS	Basel Committee on Banking Supervision
BOE	Bank of England
CAR	Capital adequacy ratio
CBRC	China Banking Regulatory Commission
CCDC	China Central Depository Trust & Clearing Co. Ltd
CEO	Chief Executive Officer
CIRC	China Insurance Regulatory Commission
CPMI	Committee on Payments and Market Infrastructures
C-ROSS	China Risk Oriented Solvency System (CIRC)
CSRC	China Securities Regulatory Commission
ESRB	European Systemic Risk Board
FCRG	Financial Crisis Response Group
FHC	Financial holding company
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee (Germany, Netherlands)
FSOC	Financial Stability Oversight Council (US)
FSR	Financial Stability Report
GDP	Gross Domestic Product
GEM	Growth Enterprise Market
HNW	High net worth (individuals)
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IPO	Initial public offering
JMC	Financial Regulatory Coordination Joint Ministerial Conference
LGFV	Local government financing vehicle
MMF	Money market fund
MOF	Ministry of Finance
MoU	Memorandum of Understanding
MSE	Micro and small enterprise
NDRC	National Development and Reform Commission
NFC	Non-financial company
NPC	National People's Congress
NPL	Non-performing loan
OTC	Over-the-counter
PBC	People's Bank of China
PSBC	Postal Savings Bank of China Ltd
RCB	Rural commercial bank
RCC	Rural credit cooperative
RMB	Chinese renminbi
ROSC	Report on the Observance of Standards and Codes
SAFE	State Administration of Foreign Exchange
SCSI	Standing Committee on Standards Implementation
SDDS	Special Data Dissemination Standard (IMF)
SD&C	Securities Depository and Clearing Corporation Limited
SLF	Standing Lending Facility
SME	Small and medium-sized enterprise
TAM	Target Asset Management (securities firms)
TSF	Total Social Financing
WMP	Wealth management product

Executive summary

Background and objectives

The main purpose of this peer review is to examine two topics that are relevant for financial stability and important for China: the macroprudential management framework and non-bank credit intermediation. Both topics, which were selected in consultation with the Chinese authorities before the peer review team was formed, were included in the key Financial Sector Assessment Program (FSAP) recommendations and are topical for the broader FSB membership. The review focuses on the steps taken to date by the authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations.

Main findings

Good progress has been made in addressing the FSAP recommendations on both topics. The authorities have developed formal inter-agency cooperation mechanisms, improved data collection and enhanced the analytical basis and toolkit for a macroprudential framework. They have also improved the monitoring and taken important steps to address financial stability risks in non-bank credit intermediation. However, there is additional work to be done. On the macroprudential side, the authorities need to further clarify the roles of different bodies in the macroprudential framework and strengthen the supporting infrastructure; promote the further development of integrated risk assessments; review the sharing of information for financial stability purposes; and enhance communication on macroprudential policy issues. On the non-bank credit intermediation side, they need to continue to enhance data collection efforts; strengthen risk assessment capabilities within and across sectors; and develop a more activity-based regulatory approach. The authorities should also continue to promote a more diversified and resilient financial system by increasing reliance on market-based pricing mechanisms via financial liberalisation and the removal of implicit guarantees, and by encouraging the development of capital markets and of an institutional investor base as an alternative pillar to bank financing. A unifying theme behind the peer review recommendations is the need for closer coordination and information sharing between the authorities to handle a dynamic financial system. In implementing these recommendations, priority should be given to enhancing coordination and developing an integrated risk assessment framework, since these will promote a common understanding of objectives and risks, which will in turn facilitate joint policy actions and public communication.

Macroprudential management framework

The authorities have made important strides in addressing the FSAP recommendations on the development of a macroprudential management framework. Notable achievements include the elaboration of monitoring frameworks and toolkits (including stress tests) by each agency to assess systemic risk in the sectors under their respective mandates; data improvements and ongoing work to develop a shared statistical platform; and enhanced inter-agency coordination through the establishment of the Financial Regulatory Coordination Joint Ministerial Committee (JMC) by the State Council in August 2013. Importantly, the authorities have a broad range of tools that can be used for macroprudential purposes, and have deployed them frequently in response to economic and financial system developments.

Building on what has been done, and as is being grappled with in many jurisdictions, additional work is needed to flesh out and operationalise a comprehensive and coordinated macroprudential policy framework. Much of that work involves greater inter-agency cooperation and information sharing to promptly and comprehensively identify and address related risks, and to ensure an efficient and effective policy response. The ultimate objective of reforms would be for the authorities to develop an integrated macroprudential framework that takes into account interactions among all parts of the financial system and with the real economy so that decision makers – both collectively and within individual authorities – can coordinate efforts to address financial stability risks. Such a framework would be useful, particularly in the context of a progressively more liberalised financial system, for bringing together different perspectives to identify systemic risks (especially cross-sectoral ones) and formulate policies to address them. It is important to ensure that micro-prudential supervision is not compromised in the process of establishing appropriate macroprudential arrangements.

While some of the recommendations to support this work identify relevant bodies that could potentially carry out these tasks, it is beyond the scope of this review to prescribe the specific institutional configuration that may be appropriate for China. As such, the recommendations primarily focus on desired objectives and tasks rather than on specific institutional design.

- *Institutional and operational arrangements*: There are several bodies – often attended by the same agencies[3] – that are involved in financial stability and macroprudential issues. Two of the most relevant ones are the Financial Crisis Response Group (FCRG) directly under the State Council and the JMC. The FCRG is chaired by the Vice Premier of the State Council in charge of the financial sector, and it meets regularly to discuss new trends in the financial system and major potential risks as well as to coordinate or solve cross-agency issues. The JMC is a useful mechanism to facilitate discussion of cross-sectoral issues and to issue inter-agency regulations. Drawing on good practices in other countries, the authorities may want to further enhance the efficiency and effectiveness of these discussions and of macroprudential policymaking. First, the mandate of the various bodies is rather broad and more diffuse than the FSAP's recommendation of a "permanent committee on financial stability". Specifying the range of issues to be addressed by different committees and groups on the macroprudential framework may help bring greater clarity of their respective roles and responsibilities, and allow these bodies to be supported (in terms of information and analysis) appropriately. Second, at an operational level, building a supporting infrastructure to jointly analyse systemic risk issues could facilitate a common understanding of these issues and help strengthen inter-agency coordination. This could include, for example, the creation of specialised subcommittees and *ad hoc* working groups under the JMC or the State Council.

[3] These comprise the People's Bank of China (PBC), China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). Other agencies that are involved in these bodies include the State Administration of Foreign Exchange (SAFE), the National Development and Reform Commission (NDRC), and the Ministry of Finance (MOF).

- *Analytical framework*: The PBC and regulatory agencies (CBRC, CSRC, CIRC) have made progress in developing a systemic risk monitoring framework since the FSAP. According to the authorities, the framework consists of 3 layers: FCRG meetings to discuss and make decisions *inter alia* on financial stability issues; risk surveillance, analysis and prevention policies by individual agencies; and cooperation among them to arrive at an overall risk assessment.

  Each regulatory agency has interpreted its mandate as including a macroprudential dimension, and each is developing its own analytical framework that includes stress testing, early warning systems and systemic risk analysis. On the cross-agency level, the PBC reports that it coordinates with these agencies to carry out system-wide risk surveillance on both a regular and *ad hoc* basis. However, each regulatory agency's macroprudential orientation reflects its particular sectoral mandate, which can limit the analysis of cross-sectoral effects and thereby constrain an overall view of systemic risks. Many authorities worldwide are currently facing the challenge of developing an integrated risk assessment framework. In the case of China, based on the information available to the review team, it is unclear how the agency-specific analytical approaches fit together into an overall cohesive risk assessment framework. The main role of the JMC is on regulatory coordination and information sharing rather than on developing such a framework, while little information was available to the review team on the briefing that the FCRG receives or on the extent to which it brings together (including by analysing their cross-sectoral effects) and prioritises the risks identified by different agencies. A senior inter-agency body could usefully review the current systemic risk analytical architecture to identify ways in which such efforts could be better coordinated across agencies and to develop a more integrated view on risks. Over time, joint work on systemic risks and policies could be published in an existing or new report, which would also facilitate communication with the financial sector and the public about the evolution of the macroprudential policy stance.

- *Macroprudential tools*: The authorities already have a wide range of macroprudential instruments in their toolkit, and have applied these measures in recent years to enhance system resiliency. The PBC is responsible for maintaining overall financial stability yet its own macroprudential toolkit (dynamic differentiated reserve requirements and window guidance) is rather limited. As financial liberalisation progresses further and in order to be able to carry out its system-wide financial stability mandate, it might be necessary for the PBC to develop its macroprudential role, for example by adapting its own tools and having a greater say in the application of other tools. The sector-specific perspective of different regulatory agencies, stemming from their legal mandates, may also challenge the overall calibration of macroprudential policy, particularly as some measures may (for example) seek to loosen credit for countercyclical purposes while others seek to curb the growth in non-bank credit intermediation. While there seems to be a fair degree of cooperation between agencies (under the leadership of the State Council) when adjusting some of these tools, more work may be needed to assess cross-sectoral systemic risk spillovers and potentially conflicting policy objectives. One way to address this issue would be for relevant bodies with a system-wide remit (such as the JMC or the State Council) to be used more formally as a coordination mechanism for the application of tools for macroprudential purposes and for the assessment of their system-wide effects.

- *Information exchange*: The increased blurring of product lines across the financial industry with the concomitant potential for increased regulatory arbitrage underscores the need for enhanced information sharing across agencies. While the sharing of offsite data seems quite robust and will be further enhanced by ongoing work to develop a joint statistical platform, the sharing of other information (e.g. results of stress tests and on-site inspections) appears more restricted. The relevant authorities indicate that information could be shared if requested or if it raised concerns germane to a particular agency, but this does not appear to occur on a regular basis. To the extent that additional information sharing could enhance financial stability monitoring and assessment without compromising confidentiality concerns, the authorities may want to revise related Memorandums of Understanding (MoUs) so as to include information specifically for financial stability purposes. In principle, the relevant authorities should have access to information (including institution-specific details and stress test results) that could raise financial stability concerns, so that there is awareness of possible systemic implications at the senior level.
- *Communication*: At present, communication on financial stability issues emanates primarily from the PBC and the individual regulatory agencies. In contrast, the FCRG, JMC as well as other inter-agency bodies do not have a separate communication policy and little information is publicly available on their deliberations. There are good reasons for keeping certain discussions confidential and avoid publishing information that may cause adverse market effects. On the other hand, public communication can be a form of 'soft' intervention and is a critical part of the toolkit of macroprudential authorities (in providing signals to financial market participants and the public). It also forms an important part of their accountability. In general, moving towards a more market-oriented financial system requires a higher degree of transparency and of communication about the policy stance and possible measures to be taken. Market participants' expectations about the policy stance need to be anchored around a clearly understandable framework in order to avoid turbulence caused by policy uncertainty and to ensure a smoother transmission of policy measures. The JMC or other bodies (e.g. FCRG) involved in macroprudential matters could therefore explore options to publish their activities in this area.

Non-bank credit intermediation

The peer review examines the progress made by the Chinese authorities in assessing and mitigating financial stability risks in non-bank credit intermediation. This has accounted for an increasing proportion of funding to the economy – around 20% of new financing flows over the period 2012-14 – although the most recent figures indicate that its growth has declined to a more modest pace. As agreed with the Chinese authorities prior to the launch of this peer review, rather than cover all activities and entities involved in non-bank credit intermediation, the review has focused on the risk assessment framework for trust companies, entrusted loans and wealth management products (WMPs). These products and entities collectively represent significant but different aspects of the non-bank intermediation chain:

WMPs are a key funding source for the non-bank sector; trust companies are one of the main intermediation channels; and entrusted loans are a distinct form of intermediation.[4]

A non-bank sector that provides sound and sustainable finance is an essential part of a developed financial system. In that sense, the growth of non-bank credit intermediation in China in part reflects a welcome deepening of the financial system and an alternative source of finance to the real economy. Such intermediation takes many forms, often involving banks in some capacity (e.g. as distributors, intermediaries, clients and owners). Individual products are not overly complex compared to those of advanced economies and the sector does not appear highly leveraged, but its growing size and constantly evolving structure (which can include opaque transaction chains) and linkages with the banking system may give rise to liquidity and maturity transformation risks – hence the need to ensure that it is adequately monitored and the risks are identified and managed. The authorities have improved their monitoring of non-bank credit intermediation in recent years and have taken steps to contain identified risks, both at the State Council/JMC level and by individual regulatory agencies. Specific examples include the augmentation of data collection, enhanced cooperation between the authorities via the JMC, and policy actions to mitigate identified risks related to the interbank market, the trust sector and for banks' WMPs.

Despite notable progress, challenges remain in assessing and mitigating emerging risks in this sector – both in terms of data collection but, more importantly, in terms of undertaking coordinated and comprehensive risk assessments to inform the use of policy tools. This is not unique to China, as many other jurisdictions are in the process of improving their monitoring and developing policy tools to ensure that non-bank activities develop into a transparent, resilient and sustainable source of market-based financing. In that context, it is important for the authorities to find the right balance between promoting financial innovation to support economic expansion and ensuring that financial stability risks are adequately taken into account. This balance is complicated by the fact that China is in a period of transition during which banks continue to play a major role in the development of non-bank intermediation.

Going forward, the authorities should extend their macroprudential framework to better monitor the non-bank financial sector, assess financial stability risks and translate this into regulatory and supervisory action. This involves work under the following broad headings:

- *Enhance monitoring*: Good progress continues to be made in extending data collection for non-bank credit intermediation. The Total Social Financing (TSF) statistic provides up-to-date information into various non-bank funding sources to the economy; regular statistics are available on trust companies and banks' WMPs; and efforts are underway to enhance information on entrusted loans, including stock data and an adjusted figure for intra-group lending. Adhering to the IMF's Special Data Dissemination Standard, as the authorities have recently announced, is a good step in constructing flow-of-funds statistics. Over time, TSF should be further developed into a granular flow-of-funds statistic that makes it possible to analyse how exposures across sectors evolve. In some areas, stronger cooperation between agencies would further improve monitoring, such as in developing a comprehensive database on

[4] Additional information on these products and activities can be found in section 3 and Annex 3 of the report.

WMPs issued by different types of financial institutions. Collecting more information on banks' ownership of non-bank products and banks' exposures to off-balance sheet activities would also be useful to better understand inter-linkages and risks in the financial system. The JMC subcommittee on data issues led by the PBC could coordinate information sharing for risk monitoring purposes, including by ensuring that all regulatory authorities have direct access to underlying data as appropriate. Moreover, the dynamic nature of non-bank credit intermediation requires additional data collection efforts for new products (e.g. asset management products by securities firms and insurance companies) that may not be fully captured by current initiatives.

- *Strengthen risk assessment capabilities*: The authorities have taken some steps in recent years to improve the risk assessment of non-bank credit intermediation. These include the PBC assessing potential shadow banking risks and (partly) incorporating bank exposures to WMPs in its stress testing framework; and the CBRC carrying out stress tests in 2014 with scenarios that include a decline in the issuance of off-balance-sheet WMPs and an increase in the default of non-standardized credit assets associated with off-balance-sheet WMPs. The CBRC also requires banks to take into account non-bank intermediation in their internal stress testing. While other types of non-bank activities and products – such as entrusted loans and asset management services by securities and insurance companies – are monitored, they are not yet explicitly captured in the risk assessment framework.

  From a strictly legal perspective, it is investors rather than banks that bear the risks of WMP and trust investments. However, in practice banks may be keen to avoid the perception of default in these products and guard against any reputational risk. The CBRC should, in its internal stress analysis, assess how far banks (both individually and collectively) may be willing to go to protect investors and to absorb the ensuing financial costs – the objective being to ensure that those banks internalise such risks. This is important, since other jurisdictions' experience in the crisis shows that off-balance activities may return to banks' balance sheets, even though this is not required legally. More broadly, the authorities should develop a more sophisticated and integrated risk assessment framework that considers: liquidity, maturity mismatch/rollover, credit and reputational risks arising from banks' involvement in non-bank credit intermediation activities; second-round effects; and indirect risks to bank lending from entrusted loans to the same counterparties. This is not unique to China: most jurisdictions are at an early stage of incorporating non-bank components into stress tests to capture such risks. In addition, the authorities may want to consider organising crisis simulation exercises, based on extreme but plausible scenarios, to identify possible weak spots in their framework. Given that credit risk in the non-bank sector is primarily related to the performance of the non-financial corporate sector, surveillance of this latter sector should also be enhanced. Finally, given the pressure to expand the non-bank financial sector, its strong linkages with banks and the incentives for regulatory arbitrage, enhancing the surveillance of cross-market activities and risks and developing system-wide tests is an important priority. This would involve developing a comprehensive analytical framework for risk assessments and fostering strong inter-agency coordination, e.g. in the design of stress tests (using commonly agreed scenarios and methodologies) or crisis simulation exercises.

- *Enhance the regulatory framework*: As in many other countries, the prudential regulation of the financial system in China follows a predominantly sectoral, entity-based approach, reflecting the state of the market and nature of different activities. However, the recent blurring of boundaries between sectors and entities as the system develops is creating a need for system-wide approaches to avoid regulatory arbitrage and promote a level playing field. In the absence of such coordination, the tightening of regulation by one agency for certain segments of non-bank credit intermediation, at the same time as it is being relaxed by another agency, can lead to the transfer of activities across these segments rather than the overall system-wide mitigation of risk. In a liberalised system, such arbitrage is likely to become even more relevant. To cope with these challenges, the authorities should seek to develop a common regulatory framework that would be primarily activity-based, applying similar regulation to similar activities where possible. The development of a common standard to regulate WMPs is a good step forward to address some regulatory gaps, but more work is needed. The recently-created inter-agency subcommittee on data under the JMC could play a useful coordinating role in the development of such an approach.
- *Promote diversified and resilient market-based finance*: The authorities have publicly committed to promote a less bank-centric and more market-based financial system, and major steps have been taken in this regard in recent years. Further liberalisation of deposit interest rates and of other prudential controls may, in the first instance, reverse the expansion of the non-bank sector and move activities back to the banking sector. Indeed, recent data suggest that such a process may be underway, driven in part by the slowdown in economic growth and tighter rules for some non-bank intermediation activities (e.g. trust lending). The move of assets back onto bank balance sheets with the commensurate increase in capital may decrease overall financial system risk. However, in order to promote a more diverse financial system, the authorities should continue to develop capital market activities (debt and equity market issuance) and an institutional investor base (insurance companies and pension funds) as an alternative and independent pillar to bank financing. It would also be useful for the authorities to communicate their vision of the evolution of non-bank credit intermediation and how it can be developed in a sound and sustainable manner over the long-term. This necessitates that risks are well identified and accurately priced, and that losses can occur in a transparent and predictable manner. However, the rapid growth of non-bank credit intermediation to date has largely been predicated on investors realising high returns with minimal risk. This may reinforce investor belief that implicit guarantees exist on risky products that are affiliated with the banking system, which may contribute to moral hazard and the mispricing of risks. The fact that banks have on occasion supported such products, despite no legal requirement to do so, has reinforced this perception. The recent introduction of deposit insurance and other planned measures (e.g. further liberalisation of interest rates, bank resolution and corporate bankruptcy reforms) may help address misaligned incentives in non-bank credit intermediation and promote market-based pricing, to the extent that they are accompanied by a firm resolve on the part of authorities to remove implicit guarantees and allow for defaults/losses to occur in a transparent and consistent manner.

Recommendations

In response to the aforementioned findings and issues, the peer review has identified the following recommendations for consideration by the Chinese authorities:

Macroprudential management framework

- In order to enhance the efficiency and effectiveness of the macroprudential framework, the authorities should: (a) clarify the mandate and roles of different inter-agency bodies in surveillance, analytical tools, and coordination and information sharing for the purpose of assessing risks and designing macroprudential policies; and (b) strengthen the supporting infrastructure through standing inter-agency subcommittees and *ad hoc* working groups to jointly analyse systemic risk issues.
- The authorities should further develop an integrated systemic risk assessment framework that incorporates the views of different agencies and takes into account cross-sectoral policy interactions.
- The authorities should analyse the interaction of the various prudential tools by each agency and their implications for the overall stance of macroprudential policy.
- The authorities should consider developing an MoU specifically for financial stability monitoring/assessment and related information sharing, and review whether the current sharing of on-site and stress testing information is consistent with these objectives. The MoU on financial stability should be based on the respective role of each authority in the macroprudential policy framework.
- The authorities should consider publishing the outcome of key inter-agency meetings and deliberations periodically as a means of communicating their macroprudential outlook and policy stance.

Non-bank credit intermediation

- The authorities should continue to enhance efforts to collect and disclose comprehensive and granular data relating to non-bank credit intermediation. Such data (e.g. on various forms of wealth and asset management products) should be routinely shared across agencies for risk monitoring purposes.
- The authorities should enhance their ability to assess systemic risks stemming from non-bank credit intermediation. Extensions to the analytical framework include a focus on the liquidity, maturity transformation, credit and reputational risks for banks stemming from these products, the impact of second-round effects, and the use of crisis simulation exercises. In addition, an inter-agency group should be formed to coordinate the surveillance of cross-market activities and of risk assessments across all relevant authorities and sectors.
- The authorities should develop a more activity-based regulatory approach in order to discourage regulatory arbitrage and ensure a level playing field in non-bank credit intermediation.
- The authorities should continue to promote a more diversified and resilient financial system by: (1) increasing reliance on market-based pricing mechanisms via the removal of implicit guarantees; and (2) further developing capital markets and an institutional investor base as an alternative pillar to bank financing.

1. Introduction

China underwent an assessment under the FSAP in 2011. The FSAP included compliance assessments of the Basel Committee on Banking Supervision's (BCBS) *Core Principles for Effective Banking Supervision*, Committee on Payments and Market Infrastructures (CPMI) *Core Principles for Systemically Important Payment Systems*, International Association of Insurance Supervisors (IAIS) *Insurance Core Principles*, International Organisation of Securities Commissions (IOSCO) *Principles and Objectives of Securities Regulation*, and CPSS-IOSCO *Recommendations for Central Counterparties*.[5,6]

The FSAP concluded that reforms had progressed well in moving to a more commercially-oriented financial system. Despite success and rapid growth, however, China's financial sector was confronting several near-term risks, structural challenges, and policy-induced distortions. The main sources of risks identified by the FSAP were: (i) the effects of a rapid crisis-related credit expansion on credit quality; (ii) growing off-balance sheet exposures and disintermediation; (iii) a reversal in rapidly rising real estate prices; and (iv) an increase in imbalances due to the economic growth pattern.

In order to address these challenges, the FSAP recommended a set of reforms across multiple areas, including: (i) deepening the commercial orientation of banks and other financial firms; (ii) moving to more market-based means of influencing monetary and financial conditions; (iii) continued strengthening of the capacity of the central bank on financial stability issues, and that of the supervisory commissions; (iv) further development of financial markets and instruments to deepen and strengthen China's financial system; and (v) upgrading the framework for financial stability, crisis management, and resolution arrangement. In order to successfully manage such a wide-ranging financial reform agenda, the FSAP noted that priority must be given to establishing the institutional and operational preconditions.

The main purpose of the peer review report is to examine two topics that are relevant for financial stability and important for China: its macroprudential management framework and non-bank credit intermediation. Both topics were included in the key FSAP recommendations and are topical for the broader FSB membership. The peer review focuses on the steps taken to date by the Chinese authorities to implement reforms in these areas, including by following up on relevant FSAP recommendations. In particular, the review evaluates progress with the reforms in order to draw conclusions and policy implications as well as identify remaining impediments and lessons that could be of benefit to China and its FSB peers.

The report has two main sections, corresponding to the two topics being reviewed. Section 2 (and Annex 2) focuses on the development and implementation of a macroprudential

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5 See "People's Republic of China: Financial System Stability Assessment" (IMF Country Report No. 11/321, November 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11321.pdf). All ROSC assessments have been published and are available on the IMF website (http://www.imf.org/external/np/fsap/fsap.aspx).

6 In September 2013, the BCBS assessed the consistency of the Basel III risk-based capital standards in China with the Basel framework. See "Regulatory Capital Assessment Programme: Assessment of Basel III regulations – China" (available at http://www.bis.org/bcbs/implementation/l2_cn.pdf).

management framework. Section 3 (and Annex 3) examines the progress made by the authorities to identify, monitor and address the evolution of non-bank credit intermediation, including associated risks to financial stability, and the development of a framework for its regulation and supervision. In addition to these sections, Annex 1 provides background information on the structure of the Chinese financial system and on recent regulatory developments, while Annex 4 presents the follow-up actions reported by the authorities to other key FSAP recommendations; these actions have not been analysed as part of the peer review and are presented solely for purposes of transparency and completeness.

2. Macroprudential management framework

Background

Over the past several years, China has developed and implemented reforms to facilitate the transition toward a more commercially-oriented financial system. The system has progressively become larger and more complex with high rates of credit growth and increasing linkages, both domestically and internationally, across markets and institutions. In that regard, the FSAP noted that medium-term vulnerabilities – namely, the more complex financial system, the relatively inflexible macroeconomic policy framework and the government's important role in credit allocation and in the financial sector – were building up contingent liabilities that could impair the needed reorientation of the system to support China's future growth.

In view of these vulnerabilities, the FSAP emphasised the importance of continued advances in the financial stability framework in order to effectively respond to these risks and to ensure that further financial reforms are implemented in a sound manner. The FSAP recommended the establishment of a permanent financial stability committee chaired by "a senior official with authority" with the PBC as its secretariat and composed of relevant agencies, as well as enhancements to data collection to facilitate understanding of financial institutions' balance sheets and linkages. It also noted the need to build a comprehensive macroprudential framework for measurement and management of systemic risks. This would include strengthening the resources and capacity of the People's Bank of China (PBC) and regulatory agencies to monitor financial stability and to carry out regular stress tests.[7]

This section reviews the progress made to date and planned next steps vis-à-vis the FSAP recommendations on the development of a macroprudential management framework. Such a framework includes institutional arrangements, systemic risk analysis, data collection and information exchange, macroprudential tools and a communication strategy. In coming up with its findings and recommendations, the section examines China's efforts to develop its

[7] See the table of key recommendations as well as table 13 in Appendix 1 of the FSAP report (IMF Country Report No. 11/321, November 2011, available at http://www.imf.org/external/pubs/ft/scr/2011/cr11321.pdf).

macroprudential framework in the light of available international guidance and cross-country experiences in this area.[8]

Steps taken and actions planned

Institutional arrangements: The institutional arrangements for macroprudential management in China are set out by the laws of the National People's Congress (NPC) and its Standing Committee (see Annex 1). They involve the State Council, which is the highest administrative organ; discussions at the ministerial level among the PBC and regulatory agencies including through a recently formed inter-agency committee (see below); and technical-level coordination. The PBC, under the leadership of the State Council, is responsible for formulating and implementing monetary policies, guarding against and eliminating financial risks, and maintaining financial stability (Article 2 of the PBC law); the China Banking Regulatory Commission (CBRC) is responsible for banking regulation and supervision, with the objective of ensuring a safe and sound banking industry; and the China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC) are responsible for regulating capital markets and insurance activities respectively.

Given the mandates of the PBC and CBRC, as well as the fact that the banking system currently accounts for the large majority of financial system assets, much of overall macroprudential management effectively resides with these two agencies. The PBC and regulatory agencies report directly to the State Council, which plays an active role in monetary and financial sector policymaking.[9] This arrangement facilitates the prioritisation of multiple objectives (e.g. growth and prudential oversight) and the use of prudential tools also for industrial or credit policy purposes (given China's ongoing liberalisation process) – albeit at the cost of lower transparency of decision-making compared to some other countries.

An important inter-agency body involved in macroprudential management is the Financial Crisis Response Group (FCRG), which operates under the aegis of the State Council. The FCRG is chaired by the Vice Premier of the State Council in charge of the financial sector,

[8] See, for example, the section on the macroprudential policy framework in the FSB peer reviews of Germany, Netherlands, Russia, UK and US (http://www.financialstabilityboard.org/publications/peer-review-reports/); "Macroprudential Policy Tools and Frameworks – Progress Report to the G20" by the FSB, IMF and BIS (October 2011, http://www.financialstabilityboard.org/wp-content/uploads/r_111027b.pdf); "Macroprudential Policy: An Organizing Framework" (March 2011, http://www.imf.org/external/np/pp/eng/2011/031411.pdf), "Institutional Models for Macroprudential Policy" (November 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf), "Key aspects of macroprudential policy" (June 2013, http://www.imf.org/external/np/pp/eng/2013/061013b.pdf) and "Staff Guidance on Macroprudential Policy" (December 2014, http://www.imf.org/external/np/pp/eng/2014/110614.pdf) by IMF staff; and "Macroprudential instruments and frameworks: A stocktaking of issues and experiences" (May 2010, http://www.bis.org/publ/cgfs38.pdf) and "Operationalising the selection and application of macroprudential instruments" (December 2012, http://www.bis.org/publ/cgfs48.pdf) by the Committee on the Global Financial System.

[9] For example, Article 5 of the PBC law says that "The PBC shall report its decisions to the State Council for approval concerning the annual money supply, interest rates, foreign exchange rates and other important matters specified by the State Council before they are implemented." The *Law on Banking Regulation and Supervision* states that the agency is under the authority of the State Council, although Article 5 indicates that "The banking authority and its staff shall be…free from interference by local governments, government departments at various levels, public organizations or individuals".

and it includes representatives from the PBC, the State Administration of Foreign Exchange (SAFE), the National Development and Reform Commission (NDRC), the Ministry of Finance (MOF), CBRC, CIRC and CSRC. This group was first formed in 2008 and meets 1-2 times a month (*ad hoc* meetings may also be convened as necessary) to discuss new financial system trends and major potential risks, as well as to coordinate or solve cross-agency issues. The meetings have included a discussion of a number of financial stability topics, including the JMC (which led to its formal establishment by the State Council in August 2013), the regulation and supervision of shadow banking activities (which led to the issuance of State Council guidance in January 2014 – see section 3), and the establishment of a deposit insurance system. The FCRG has held 23 meetings since April 2013.

Another inter-agency group involved in macroprudential management is the Financial Regulatory Coordination Joint Ministerial Committee (JMC), which was established in August 2013 by the State Council on an administrative basis (rather than in law). The JMC comprises the Governor of the PBC (as JMC chair), and the chairs of the CBRC, CSRC, CIRC, SAFE and, as necessary, the ministers of the NDRC and MOF. The JMC's Rules of Procedure state that it is a coordinating body and that it does not alter the configuration of regulatory decision-making responsibilities among its member agencies, nor does it substitute for the decision making of the State Council. The JMC, according to its remit, aims to enhance regular inter-agency regulatory coordination and information sharing in respect of:

- monetary policies and financial regulatory policies;
- financial regulatory policies, laws and regulations;
- financial stability and preventing regional or systemic financial risks;
- cross-sector financial products and cross-market financial innovations;
- financial information sharing and the establishment of an integrated financial statistical system; and
- other tasks as assigned by the State Council.

The JMC is expected to meet at least quarterly and had met seven times as of February 2015. Preparation of the agenda is led by the PBC, but all members can submit topics for discussion. Issues discussed tend to vary across meetings; there are no standing agenda items. Notwithstanding its broad remit, the JMC has focused most of its discussions to date on cross-sectoral issues. Current financial stability conditions and potential vulnerabilities are not a standing agenda item of JMC discussions, but have been considered by the JMC on occasion when explicitly included as a discussion item.

In addition to overall responsibility for setting the agenda of JMC meetings, the PBC, in its role as secretariat to the JMC, is responsible for drafting the annual work plan of financial regulatory coordination; organising background materials to facilitate discussion of the agenda items; coordinating the implementation of JMC decisions; conducting research on financial regulatory coordination; and submitting briefings on the work of the JMC to the State Council and member agencies. Coordination is facilitated by liaison officers at each of the member agencies. In addition, the JMC has formed two subcommittees to support its mandated tasks: one on developing an integrated financial statistics system and data sharing, and another one on improving communications with the public.

JMC decisions are made by consensus, with any proposals or views on major cross-sectoral financial regulatory issues being sent to the State Council for approval. Significant differences of view among members are also reported to the State Council. The JMC considers issues of importance to multiple agencies, but issues may also be sent directly to the State Council from individual agencies based on their respective mandates and with bilateral input from other agencies as needed. Authorities were broadly of the view that the JMC had improved coordination and had facilitated work on interagency regulations, such as on interbank activity[10] (issued in May 2014) and internet finance.

In addition to the JMC and FCRG, there are several other groups and committees – often attended by the same agencies – that are involved *inter alia* in discussions on financial stability and macroprudential issues. These include:

- A committee that brings together the heads of the PBC, MOF and NDRC on a monthly basis to discuss macroeconomic conditions and potential financial risks (e.g. stemming from real estate market conditions). As an informal mechanism, this committee does not have an official mandate or rules for the selection of topics to be discussed, and it is not a formal coordinating or decision-making mechanism.
- The Monetary Policy Committee, chaired by the PBC, meets on a quarterly basis to discuss monetary and supervisory policies; its representation includes MOF and NDRC as well the banking, securities and insurance regulators.
- Ad hoc senior-level meetings chaired by the Premier are also used to discuss and take decisions on significant financial sector policy issues.
- Financial stability conditions, risks and related tools are discussed as necessary at State Council meetings with representation by the relevant agencies, and supported by agency briefing materials.

Analytical framework: The FSAP recommended that China build a macroprudential framework for measurement and management of systemic risks, which should include increasing the resources and capacity of the PBC and regulatory agencies to monitor financial stability and to carry out regular stress tests.

The Chinese authorities continue to enhance their systemic risk monitoring framework. According to the authorities, the framework consists of 3 layers:

1) The FCRG of the State Council convenes regular meetings to discuss systemic risks and decide on prevention policies. The topics are chosen based on recent financial system developments and concerns, while the materials for discussion are prepared by the relevant agencies in advance of the meeting. For financial stability topics, the PBC, together with CBRC, CSRC and CIRC (and with feedback from MOF and NDRC), prepares and submits a report that analyses the current financial risks.
2) The relevant agencies undertake risk surveillance and analysis for their respective sectors. This work, which is undertaken both on a regular and ad hoc basis at the request of the State Council, is carried out under the organisation of the PBC, together

[10] See http://www.pbc.gov.cn/image_public/UserFiles/english/upload/File/规范同业业务.pdf.

with related agencies. In addition, the JMC may be involved in the analysis and deployment of policies to address identified systemic financial risks.

3) The relevant agencies cooperate in order to arrive at an overall view of risks. For example, in the case of preparing the Financial Stability Report (FSR), the agencies establish an FSR steering group and drafting team to facilitate the full exchange of individual agencies' risk judgments and views.

In practice, each agency has interpreted its mandate as including a macroprudential dimension, and each of them is separately developing its own analytical framework that includes stress testing, early warning systems and systemic risk analysis (see Box 1).

The PBC has a Financial Stability Bureau at head office dedicated to systemic risk analysis that comprises 45 staff in 10 divisions, organised mainly along industry lines. Supporting the Financial Stability Bureau, PBC staff in branch offices undertake financial stability monitoring and inspections. The CBRC carries out financial stability oversight by drawing on output and analysis from the supervision, policy research and statistics areas. Currently, the PBC and regulatory agencies are collectively building a systemic risk index, based on 5 categories (macroeconomy and markets, banking, securities, insurance, and quasi-financial institutions), with responsibilities organised according to each agency's mandate.

While it is encouraging that each agency has incorporated a macroprudential perspective in its oversight, there is still some room to improve the coordination in approaches and the sharing of information so as to arrive at an effective and well-integrated system-wide monitoring framework. For example, while there are some commonly agreed macroeconomic inputs to stress testing exercises, it appears that early warning and stress test exercises are generally carried out separately by the different agencies, with the results only shared on an *ad hoc* basis. To illustrate, stress tests of securities firms, primarily performed by the Securities Association of China under the leadership of the CSRC, do not involve the PBC or other agencies and the results are not shared with those agencies. Moreover, the stress tests are restricted to firms under CSRC supervision and do not capture cross-sectoral linkages or spillovers with banks and securities firms. In the insurance sector, the CIRC shares stress test results with other agencies and/or reports them to the JMC when necessary. Finally, it is not clear how the PBC's on-site financial stability reviews of banks complement the CBRC's examination of the same institutions (see below).

Macroprudential tools: The Chinese authorities have a wide range of tools that can be used for macroprudential purposes. Most of these are located at the CBRC and, to a lesser extent, the PBC (see Table 1).[11] The CBRC is of the view that it already has a comprehensive set of tools at its disposal, although a formal methodology for assessing their effectiveness has not yet been developed (as is the case for supervisory authorities in many other countries).

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[11] Monetary tools (e.g. changes in official benchmark lending rate) and fiscal tools (e.g. changes in taxes on property transactions) are also available to address financial stability risks.

Box 1: Systemic Risk Analysis at a Glance

The PBC has issued an annual Financial Stability Report (FSR) since 2005 and performs a variety of risk analyses of banks, nonbanks and key industries and markets. The FSR covers developments, trends and risks in the international and domestic economy; the banking, securities and futures, and insurance sectors; as well as financial markets and the financial infrastructure. The report also highlights developments in macroprudential regulation internationally and domestically and provides recommendations on regulatory challenges and/or areas for improvement.

Since 2012, the FSR has also included the results of annual PBC stress tests of 17 major commercial banks (which the PBC is seeking to expand, including to securities firms), which comprise top-down tests performed by the PBC and bottom-up tests carried out by the banks themselves. The credit risk stress test estimates the impact on capital ratios of an increase in overall and sector-specific non-performing loan (NPL) ratios; the market risk test estimates the impact of changes in interest and exchange rates; and the liquidity stress test, carried out by the banks themselves, evaluates the impact of increases in NPL ratios and a run-off of deposits and interbank funding. The FSR also includes the results of the PBC's interbank network analysis of the impact and transmission of liquidity shocks. The PBC is also exploring the development of an early warning system.

In 2011, the PBC also began conducting financial stability oriented on-site reviews of banks; thus far, it has carried out over 600 such reviews. According to the PBC, these on-site reviews are helpful for it to get a full picture of financial institutions, especially systemically important banks (SIBs), and thereby enable it to identify potential systemic risks to maintain financial stability. The results of the reviews are shared with the CBRC and, while the PBC does not have the power to fine institutions, it can in principle request that the CBRC follows up on identified issues.

The CBRC carries out a range of banking system risk analyses, including horizontal reviews to assess common risks and trends within types of banks and across the banking sector as a whole. The CBRC is also developing a systemic risk early warning system and, building on the guidelines it first issued in 2007 and revised in 2014, carries out stress testing exercises both at a macro level and for target sectors. In 2014, the CBRC carried out top-down and bottom-up stress testing of 19 major banks. The results of systemic risk analyses are published in the CBRC Annual Report and its Quarterly Reports on Banking Sector Operations.

The CSRC is developing a capital markets risk index monitoring system and stress testing framework and is exploring the publication of a capital markets financial stability report. The Securities Association of China published in 2011guidelines for stress tests by securities firms.

The CIRC carries out a cash flow stress test and dynamic solvency test under its current solvency system and is in the process of implementing the China Risk Oriented Solvency System (C-ROSS) – a new solvency framework that will also run a range of stress tests.

The authorities have made extensive use of many of these tools in recent years. The PBC, for example, introduced the dynamic adjustment of differentiated reserve requirements[12] as a key macroprudential tool in 2011. The PBC also provides window guidance that is used to guide bank lending and is adjusted on a countercyclical basis. The CBRC has applied higher capital requirements for the largest five banks, higher and more forward-looking loan loss provisioning requirements, a leverage ratio, and loan-to-value, loan-to-income, and loan-to-

[12] Under this system, a bank's reserve requirement ratio varies on a quarterly or monthly basis based on its loan growth relative to the aggregate trend, implementation of government credit policy, and prudential indicators such as provisioning, leverage and capital adequacy. See "China's Evolving Reserve Requirements" by Ma, Xiandong and Xi (November 2011, BIS Working Paper 360, http://www.bis.org/publ/work360.pdf).

deposit requirements. A number of these measures were tightened in response to robust credit growth (particularly frothiness in the property market) in the past few years, and while required reserve ratios have been reduced recently in response to slower growth, the aim has bene to do this in a more targeted manner by providing incentives for banks to support activity in specific sectors of the economy.[13]

Significant changes in the use of these tools are reported to the State Council. While individual tools are typically the domain of a particular authority, bilateral consultation among agencies takes place regularly on the development of prudential tools and major policy changes related thereto. Most often this involves soliciting PBC views on proposed changes to CBRC tools (e.g. loan-to-deposit ratio) before they are reported to the State Council for notification.

The PBC and CBRC are in the process of jointly developing prudential guidelines for domestic systemically important banks, setting out relevant capital and resolution requirements, as well as the framework for a countercyclical capital buffer. While the framework remains under development, it appears that activation of this buffer will be a joint decision and will include the views of other agencies.

Data collection: The FSAP recommended that the authorities upgrade data collection on financial institutions including their leverage, contingent liabilities, off-balance sheet positions, unregulated products, and cross-border and sectoral exposures. This is an important but challenging task given the dynamic nature and evolution of the Chinese financial system.

Since the FSAP, the agencies have continued to make progress in improving financial sector data infrastructure, particularly in terms of data definitions and standards. They have also made efforts to keep pace with changes in the financial system landscape, particularly with respect to non-bank intermediation activities. For example, the PBC has augmented the granularity of its non-bank credit intermediation data, while the CBRC has improved data collection on wealth management and trust products (see section 3). Monitoring systems however, have yet to be integrated across the two agencies and there remain gaps in data availability. The authorities are working to narrow such gaps and, beginning in December 2013, formed an inter-agency subcommittee under the JMC to build a statistical information sharing platform and promote integrated financial statistics.

Improvements to ongoing data collection have also been evident for banks as part of the implementation of Basel III. The monitoring of banks' off-balance sheet positions (including acceptance bills, letters of credits, guarantees and commitments), interbank claims and derivatives has reportedly been upgraded to levels necessary to meet Basel III capital and liquidity requirements. With respect to sectoral concentrations, the authorities have focused their efforts on monitoring banks' exposure to local government financing vehicles (LGFVs), an area that has grown rapidly since 2008, as well as on real estate and industrial sectors with excess capacity. The CBRC currently requires commercial banks to monitor these exposures and submit comprehensive reviews of their loan books on a periodic basis.

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[13] For a related discussion, see "How Effective are Macroprudential Policies in China?" by Wang and Sun (March 2013, IMF working paper 13/75, https://www.imf.org/external/pubs/ft/wp/2013/wp1375.pdf).

Table 1: Overview of Selected Tools for Macroprudential Purposes

Tools	Administering agency	Description	Recent use
Prudential tools			
Loan-to-value (LTV) ratio and floors on mortgage rates	PBC and CBRC	Typically involves terms for first and second mortgages (i.e. LTV limits and floor on interest rates). Currently, the LTV limits are 70% for first mortgages and 60% for second mortgages. Rates on first mortgages offered at 30% discount to benchmark lending rate; rates on second mortgages offered at 10% premium.	Apr 2015: LTV limit increased to 60% for second mortgages Sep 2014: Eased mortgage terms (first residential mortgage definitions broadened) Jan 2011: LTV limit lowered to 40% for second mortgages Oct 2010: mortgages for third home suspended Apr 2010: LTVs lowered to 50% on second mortgages; LTVs lowered to 70% for first mortgages; interest rates for second mortgages raised to 1.1 times benchmark lending rate Sep 2008: LTV limits raised to 80% for first mortgages
Loan-to-income ratio	CBRC	Since 2004, LTI requirements have been less than 50%	Ongoing
Loan-to-deposit ratio	CBRC	Ceiling set at 75%	July 2014: Adjusted basis for calculation (excluded micro/small enterprise and rural loans that are funded by bond issuance, included more types of liabilities)
Liquidity Coverage Ratio (LCR)	CBRC	High quality liquid assets/net cash outflow in the next 30 days	Introduced in March 2014. Banks required to meet the 60% LCR requirement by end-2014, which will be raised in increments of 10% in each following year until it reaches the required 100% by end-2018, in line with the Basel III requirements.
Leverage ratio	CBRC	Formally established regulatory standard and policy framework; the minimum leverage ratio is 4% for all banks but with different transition period	SIBs were required to meet standard by end-2013; other banks by end-2016
Loan loss provisioning requirements	CBRC	Minimum loan loss reserves coverage ratio increased to 150% in 2009	Ongoing
Capital buffers	PBC and CBRC	In 2012, a capital conservation buffer of 2.5%, a countercyclical capital buffer of 0-2.5% and a capital surcharge of 1% for SIBs was introduced	Ongoing
Administrative guidance			
Sectoral guidance	PBC and CBRC	Broad guidance on encouraging lending to certain sectors (such as SMEs and agriculture) and restricting lending to others (e.g. industrial sectors with excess capacity, LGFVs)	Ongoing (most recently, in the PBOC's 2015Q1 Monetary Policy Report)
Communications	PBC and CBRC	Public statements on website, micro-blog postings, annual and quarterly reports	Ongoing
Other quantity-based tools			
Reserve Ratio Requirements (RRR)	PBC	Share of bank reserves at the central bank	2015: 2 cuts (February, April) 2014: 2 targeted cuts (April, June) Dec 2011- May 2012: 3 cuts Jan 2010-Jun 2011: 12 incremental increases Sep 2008-Dec 2008: 3 cuts and two-tier system established (large/small banks)
Dynamic adjustment on differentiated reserve ratio	PBC	Introduced in 2011for individual banks on a quarterly/monthly basis, it considers each bank's contribution to the deviation of aggregate credit growth from historical trend, stance of government credit policy and other prudential indicators (e.g. provisioning, leverage ratio and capital adequacy)	Ongoing. The PBC publicly announces broad changes to the credit guidance and the differentiated reserve ratios in its quarterly Monetary Policy Report.

Source: PBC, CBRC, IMF.

Information exchange: Coordination among the regulatory agencies is supported by a Memorandum of Understanding (MoU) on Supervisory Responsibilities and Cooperation.[14] Bilateral MoUs between authorities also exist, but they do not explicitly address financial stability matters. The sharing of on-site examination information appears to be restricted, and the PBC and regulatory agencies indicated that such information can be shared if requested, or if the source agency felt that its findings were germane to the other agency's mandate. The MoU between the PBC and the CBRC seems to be narrowly defined, although both authorities maintain that this has not unduly restricted information sharing.

Communication: The adoption of new macroprudential policy measures – once agreed upon – are generally announced by the relevant agency. The PBC, which is responsible for convening the JMC, has not issued regular press releases about the Committee meetings, deliberations and decisions.[15] However, as noted above, the PBC and CBRC publish periodic reports on the financial system that include the results of stress tests and their views on market developments and risks. In addition, the CBRC periodically provides risk alerts on lending to particular sectors, and has held quarterly meetings since 2006 with Chairmen and Chief Executive Officers (CEOs) of all major banks to communicate its views on potential risks and supervisory expectations.

Lessons learned and issues to be addressed

The Chinese authorities have made important strides in addressing the FSAP recommendations on the development of a macroprudential management framework. Notable achievements include the elaboration of monitoring frameworks and toolkits (including stress tests) by each agency to assess systemic risk in the sectors under their respective mandate; data improvements and ongoing work to develop a shared statistical platform; and enhanced inter-agency coordination through the establishment of the JMC. Importantly, the authorities have a broad range of tools that can be used for macroprudential purposes, and have deployed them frequently in response to economic and financial system developments.

Building on what has been done, and as is being grappled with in many jurisdictions, additional work is needed to flesh out and operationalise a comprehensive and coordinated macroprudential policy framework. Much of that work involves greater inter-agency cooperation and information sharing to promptly and comprehensively identify and address related risks, and to ensure an efficient and effective policy response. This is particularly important for China given its evolving monetary framework (involving the gradual shift from quantity-based to price-based tools), ongoing efforts to further liberalize the financial system and the effects of rapid credit growth in recent years (particularly from nonbank intermediaries, as discussed in the following section). As noted above, many other countries are dealing with similar issues and a variety of institutional arrangements are evident globally – the table in Annex 2 (based on recent FSB peer reviews covering this topic) illustrates a

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14 See http://www.cbrc.gov.cn/EngdocView.do?docID=718.

15 The only such press release was issued in April 2014 following the conclusion of the third JMC meeting. See http://www.pbc.gov.cn/publish/english/955/2014/20140424101826151312427/20140424101826151312427_.html.

variety of institutional arrangements that take into account country circumstances and policymaker preferences.[16] China's progress in developing its macroprudential framework should therefore be viewed in this context and in the light of the significant "learning by doing" by various countries around the world.

The ultimate objective of reforms in this area would be for the authorities to develop an integrated macroprudential framework that takes into account interactions among all parts of the financial system and with the real economy so that decision makers – both collectively and within individual authorities – can coordinate efforts to address financial stability risks. Such a framework would be useful, particularly in the context of a progressively more liberalised financial system, for bringing together different perspectives in order to identify systemic risks (especially those that are cross-sectoral in nature) and formulate regulatory policies to address them. It is important to ensure that micro-prudential supervision is not compromised in the process of establishing appropriate macroprudential arrangements.

The recommendations described below to support this work involve strengthening institutional and operational arrangements; developing a coordinated system-wide analytical framework, including with respect to the use of relevant tools; expanding coordination and information sharing; and enhancing communication. While some of the recommendations identify relevant bodies that could potentially carry out these tasks, it is beyond the scope of this review to prescribe the specific institutional configuration that may be appropriate for China. As such, the recommendations primarily focus on desired objectives and tasks rather than on specific institutional design.

Institutional and operational arrangements: There are several bodies – often attended by the same agencies – that are involved in financial stability and macroprudential issues. Two of the more relevant ones are the FCRG under the aegis of the State Council and the JMC. The FCRG is chaired by the Vice Premier in charge of the financial sector, and it meets regularly to discuss new trends in the financial system trends and major potential risks as well as to solve cross-agency issues. The JMC is a relatively new body and, while it does not alter the configuration of regulatory decision-making responsibilities, it has already proved to be a useful mechanism to facilitate discussion of cross-sectoral issues and to issue inter-agency regulations. Drawing on good practices in other countries, the authorities may want to strengthen institutional and operating arrangements in order to further enhance the efficiency and effectiveness of these discussions and of macroprudential policymaking.

In particular, the mandate of the various bodies is rather broad and more diffuse than the FSAP's recommendation of a "permanent committee on financial stability". Specifying the range of issues to be addressed by different committees and groups on the macroprudential framework may help bring greater clarity to their respective roles and responsibilities, and allow these bodies to be supported (in terms of information and analysis) appropriately.

[16] See also the section on the macroprudential policy framework in the FSB peer reviews of Germany, Netherlands, Russia, UK and US, as well as "Towards Effective Macroprudential Policy Frameworks: An Assessment of Stylized Institutional Models" by Nier et al (November 2011, IMF working paper 11/250, http://www.imf.org/external/pubs/ft/wp/2011/wp11250.pdf).

At an operational level, building a supporting infrastructure to jointly analyse systemic risk issues could facilitate a common understanding of these issues and help strengthen inter-agency coordination. This could include, for example, the creation of specialised subcommittees and *ad hoc* working groups – for example, under the JMC or the State Council – on the identification of systemic risk issues, leveraging the work of individual agencies; the design of coordinated system-wide stress tests (see below); and the analysis of the implications of tools being used and those under development, which would increase awareness of the system-wide linkages and repercussions of these tools.[17]

- ***Recommendation 1*: *In order to enhance the efficiency and effectiveness of the macroprudential framework, the authorities should: (a) clarify the mandate and roles of different inter-agency bodies in surveillance, analytical tools, and coordination and information sharing for the purpose of assessing risks and designing macroprudential policies; and (b) strengthen the supporting infrastructure through standing inter-agency subcommittees and ad hoc working groups to jointly analyse systemic risk issues.***

Analytical framework: The PBC and regulatory agencies have made progress in developing a systemic risk monitoring framework since the FSAP. According to the authorities, the framework consists of 3 layers: FCRG meetings to discuss and make decisions *inter alia* on financial stability issues; risk surveillance, analysis and prevention policies by individual agencies; and cooperation among them to arrive at an overall risk assessment. Each agency has interpreted its mandate as including a macroprudential dimension, and each is developing its own analytical framework that includes stress testing, early warning systems and systemic risk analysis. On the cross-agency level, the PBC reports that it coordinates with related agencies to carry out system-wide risk surveillance on both a regular and *ad hoc* basis.

However, each regulatory agency's macroprudential orientation reflects its particular sectoral mandate, which can limit the analysis of cross-sectoral effects and thereby constrain an overall view of systemic risks – as in the case of risks stemming from non-bank credit intermediation (see section 3 for a discussion). Many authorities worldwide are currently facing the challenge of developing an integrated risk assessment framework. In the case of China and based on the information provided to the review team, it is unclear how the agency-specific analytical approaches fit together into an overall cohesive risk assessment framework. The main role of the JMC is on regulatory coordination and information sharing rather than on developing such a framework, while little information was available to the review team on the briefing that the FCRG receives or on the extent to which it brings together (including by analysing their cross-sectoral effects) and prioritises the risks identified by different agencies.

Stress testing, for example, is currently undertaken by all regulatory agencies but these efforts do not appear to be sufficiently coordinated (e.g. using common scenarios and taking into

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[17] In the US. for example, the Financial Stability Oversight Council (FSOC) has a range of committees and sub-committees, including the Deputies Committee, Systemic Risk Committee, Institutions and Markets Subcommittees, as well as standing functional committees with respect to designated systemically important non-banks and financial market utilities, heightened prudential standards, orderly liquidation authority and resolution, and data. See http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx.

account cross-sectoral interactions as well as second-round effects affecting the economy). The results are also not consistently shared across agencies or leveraged to arrive at a comprehensive view for macroprudential policy purposes, i.e. to assess the system-wide and economic impact of identified risks and of policy measures to address them.

A senior inter-agency body could usefully review the current systemic risk analytical architecture to identify ways in which such efforts could be better coordinated across agencies and to develop a more integrated view on risks. Over time, as joint work on systemic risks is undertaken, the macroprudential analysis and stress tests of different agencies could: feed into a 'heat map' prioritising systemic risks in terms of their significance (i.e. likelihood and impact on the financial system/economy) or immediacy; involve the analysis of transmission channels via which identified risks may be propagated to the financial system and economy at-large; lead to recommendations for possible action (whether in terms of further analysis/data collection or policy measures) to address these risks; and include a framework for monitoring and assessing the effectiveness of policy responses. The publication of such analyses in an existing or new report covering macroprudential policies and their effects would also facilitate communication with the financial sector and the public about the evolution of the macroprudential policy stance.[18]

- ***Recommendation 2*: The authorities should further develop an integrated systemic risk assessment framework that incorporates the views of different agencies and takes into account cross-sectoral policy interactions.**

Macroprudential tools: The authorities already have a wide range of macroprudential instruments in their toolkit, and have applied these measures in recent years to enhance system resiliency. There is a question, however, about how responsibilities and tools are aligned: the PBC is responsible for maintaining overall financial stability yet its own macroprudential toolkit (dynamic differentiated reserve requirements and window guidance) is rather limited. As financial liberalisation progresses further and in order to be able to carry out its system-wide financial stability mandate, it might be necessary for the PBC to develop its macroprudential role, for example by adapting its own tools and having a greater say in the application of other tools.

The sector-specific perspective of different regulatory agencies, stemming from their legal mandates, may challenge the overall calibration of macroprudential policy, particularly as some measures may (for example) seek to loosen credit for countercyclical purposes while others seek to curb the growth in non-bank credit intermediation. While there seems to be a fair degree of cooperation between agencies (under the leadership of the State Council) when adjusting some of these prudential tools, more work may be needed to assess cross-sectoral systemic risk spillovers and potentially conflicting policy objectives. One way to address this issue would be for bodies with a system-wide remit (such as the JMC or the State Council) to be used more formally as a coordination mechanism for the application of tools for macroprudential purposes and for the assessment of their system-wide effects. A more

[18] The UK Financial Policy Committee's meeting records and statements (http://www.bankofengland.co.uk/financialstability/pages/fpc/default.aspx) and the FSOC's annual report (http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2014-Annual-Report.aspx) are examples of such a communication strategy.

integrated approach would help define the appropriate macroprudential policy stance and ensure that the various agencies better understand the interaction between financial stability concerns and their other mandates.

- ***Recommendation 3*: The authorities should analyse the interaction of the various prudential tools by each agency and their implications for the overall stance of macroprudential policy.**

Information exchange: Effective inter-agency information sharing is critical to the oversight and overall stability assessment of China's large and increasingly diversified financial system. At present, given that the banking sector accounts for the large majority of financial system assets, good coordination and information sharing between the PBC and CBRC is particularly important. However, the increased blurring of product lines across the financial industry with the concomitant potential for increased regulatory arbitrage underscores the need for enhanced information sharing across agencies.

While the sharing of offsite data seems quite robust[19] and will be further enhanced by ongoing work to develop a joint statistical platform, the sharing of other information (e.g. results of stress tests and on-site inspections) appears more restricted. The relevant authorities indicate that information could be shared if requested or if it raised concerns germane to a particular agency (e.g. financial stability concerns for the PBC, bank safety and soundness issues for the CBRC), but this does not appear to occur on a regular basis. Confidentiality of institutional information understandably needs to be safeguarded and to comply with relevant laws and regulations. But a discretionary approach to information sharing may lead to insufficient sharing and important gaps in understanding. To the extent that additional information sharing could enhance financial stability monitoring and assessment without compromising confidentiality concerns, the authorities may want to revisit current practices by revising related MoUs accordingly.[20]

In particular, while there are currently a number of gateways for information sharing, these do not specifically include information for financial stability purposes. In principle, the relevant authorities should have access to information (including institution-specific details and stress test results) that could raise financial stability concerns, so that there is awareness of possible systemic implications at the senior level.[21] Such information is shared among members of some macroprudential bodies in other countries (at least between central banks and regulatory agencies) given its relevance for financial stability analysis.

- ***Recommendation 4*: The authorities should consider developing an MoU specifically for financial stability monitoring/assessment and related information**

[19] The PBC shares with the CBRC all data on bank deposits and loans, while the CBRC shares with the PBC all data on individual institutions in its off-site surveillance system on a real-time basis.

[20] For example, the European Systemic Risk Board (ESRB) has the power to request all national and European Union financial supervisors for information as long as there is a business case and approval, by vote, of its General Board. This power was used to produce, for example, a report about interconnectedness, risks and possible mitigating actions in the credit default swap market.

[21] In this context, the FSAP had noted that, as part of the permanent financial stability committee, "the PBC… along with each of the commissions would be empowered to provide and to receive necessary information, including confidential institution-specific supervisory information".

sharing, and review whether the current sharing of on-site and stress testing information is consistent with these objectives. The MoU on financial stability should be based on the respective role of each authority in the macroprudential policy framework.

Communication: At present, communication on issues relating to financial stability emanates primarily from the PBC (e.g. via the FSR) and the individual regulatory agencies. In contrast, the FCRG, JMC as well as other relevant bodies do not have a separate communication policy and little information is publicly available on their deliberations. There are good reasons for keeping certain discussions confidential and avoid publishing information that may cause adverse market effects. On the other hand, public communication can be a form of 'soft' intervention and is a critical part of the toolkit of macroprudential authorities (in terms of providing signals to financial market participants and the public). It also forms an important part of their accountability. In general, moving towards a more market-oriented financial system requires a higher degree of transparency and of communication about the policy stance and possible measures to be taken. Market participants' expectations about the policy stance need to be anchored around a clearly understandable framework to avoid turbulence caused by policy uncertainty and to ensure a smoother transmission of policy measures. The JMC or other bodies (e.g. FCRG) involved in macroprudential matters could therefore explore options to publish their activities in this area, such as issuing a press release with a summary of the topics discussed and decisions reached[22] or publishing an annual report summarising work, recommendations and follow-up by member institutions.

- ***Recommendation 5: The authorities should consider publishing the outcome of key inter-agency meetings and deliberations periodically as a means of communicating their macroprudential outlook and policy stance.***

3. Non-bank credit intermediation

Background

The previous section reviewed the progress made in developing a macroprudential management framework. The rapid increase in non-bank credit intermediation over the past few years represents an important macroprudential challenge for China. While a well-developed non-bank sector is a useful – and indeed essential – part of a modern financial system, it is important that the authorities are able to effectively monitor and address risks such that it grows in a sound and sustainable manner.

This section examines the progress made by the Chinese authorities in assessing and mitigating financial stability risks in non-bank credit intermediation. It provides a high-level overview of non-bank credit intermediation in China and, applying a macroprudential framework perspective, reviews the authorities' efforts to: monitor the evolution of such

[22] An example in this area is how the ESRB a body with only soft powers of issuing warnings and recommendations, communicates after the meetings of its General Board (https://www.esrb.europa.eu/news/pr/2014/html/index.en.html).

intermediation by collecting and sharing relevant information; identify and assess associated risks to financial stability; and translate findings into regulatory and supervisory actions.

As agreed with the Chinese authorities prior to the launch of this peer review, rather than cover all activities and entities involved in non-bank credit intermediation, the review has focused on trust companies, entrusted loans and wealth management products (WMPs). These products and entities collectively represent significant but different aspects of the non-bank intermediation chain: WMPs are a key funding source for the non-bank sector; trust companies are one of the main intermediation channels; and entrusted loans are a distinct form of intermediation.

The FSAP had highlighted the "growing disintermediation by shadow banks and off-balance sheet exposure" as one of the financial system's near-term risks. With non-bank lending representing a considerable and growing share of credit intermediation, there was a need to develop tools and metrics to accurately monitor the size and composition of the market and to better identify emerging risks. In that context, the FSAP recommended the upgrading of data collection on financial institutions concerning contingent liabilities, off-balance sheet positions and unregulated products.

Subsequent to the FSAP, non-bank lending continued to increase its share of new credit intermediation, with the sector growing rapidly in recent years. The 2013 Article IV report recommended further upgrading the regulation and supervision of non-bank and off-balance sheet intermediation, including by clarifying the regulatory policies that apply to non-bank credit providers and identifying which agencies are responsible for oversight of this sector.[23] The 2014 Article IV report encouraged the authorities to eliminate financial system distortions by further strengthening regulation and supervision and by eliminating implicit guarantees,[24] which may contribute to moral hazard and price distortions.

Structure, characteristics and drivers

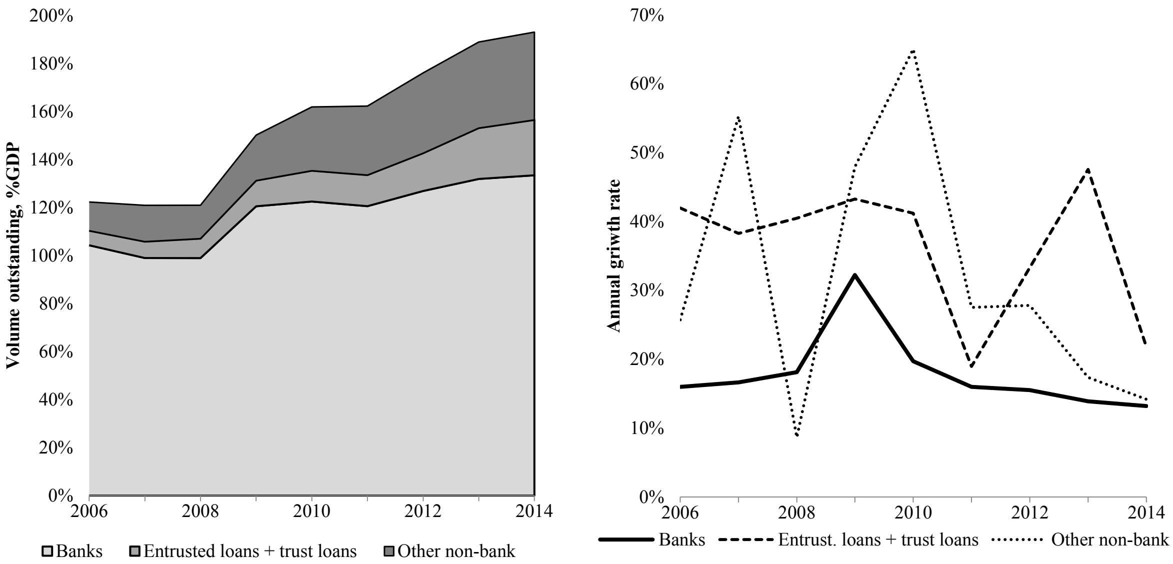
Overview of the sector: The nature of non-bank credit intermediation in China, as in other countries, is multi-faceted and gives rise to different definitions. A broad measure of financial intermediation can be derived from the Total Social Financing (TSF) statistics published by the PBC since 2011, which capture the flow of new funding to the economy. While TSF can distinguish between bank and non-bank financing, it only reflects the end provider of finance and does not therefore clarify the structure of the credit chain or the extent to which different financial institutions might be involved in it. TSF data show that non-bank credit (which includes entrusted and trust loans, but not corporate bond and equity issuance) has accounted for an important proportion of funding to the economy – around 20% of new financing flows over the period 2012-14 – although the most recent figures indicate that its growth has declined to a more modest pace (see Figure 1).[25]

[23] See http://www.imf.org/external/pubs/ft/scr/2013/cr13211.pdf.

[24] See http://www.imf.org/external/pubs/ft/scr/2014/cr14235.pdf.

[25] Non-bank credit intermediation – a subset of non-bank finance – as defined in this report is different from the measure of shadow banking for China presented in the FSB's Global Shadow Banking Monitoring Report (http://www.financialstabilityboard.org/wp-content/uploads/r_141030.pdf).

Figure 1: Evolution of Total Social Financing (2006-14)



Source: PBC, peer review estimates.
Note: The graph on the left hand side shows the evolution in the TSF stock. The graph on the right hand side shows the annual growth rate of TSF since 2006. Bank loans consist of domestic and foreign currency loans; entrusted loans and trust loans are defined in the text, while other non-bank financing includes undiscounted bankers' acceptances, corporate bond and equity issuance.

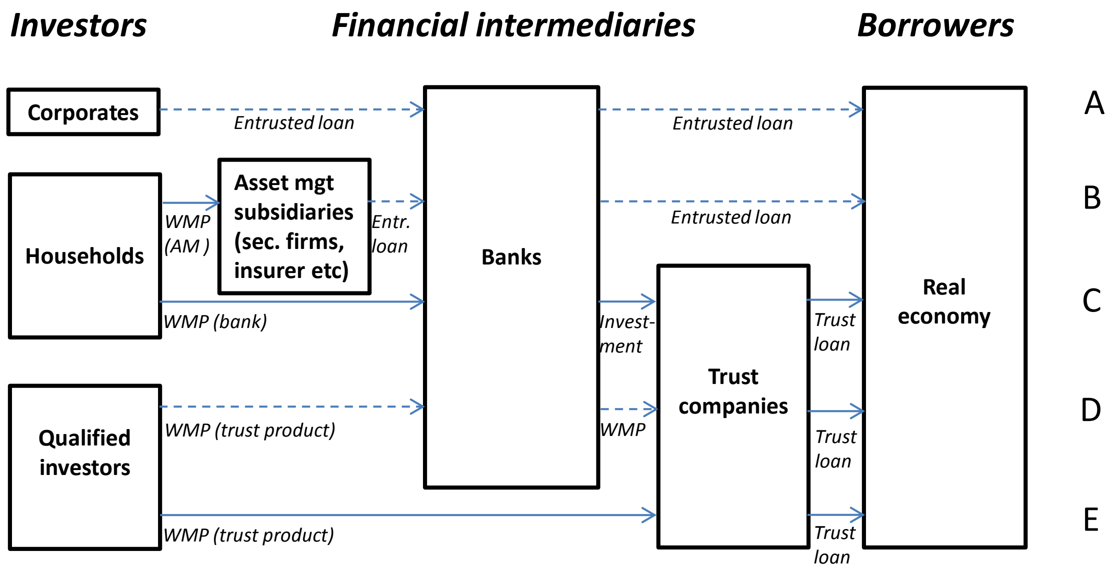
The growth of non-bank credit intermediation in China can be attributed to a number of factors.[26] Continued rapid economic development has increased the demand for lending as financial broadening and deepening take place, giving rise to new forms of intermediation. This has been particularly the case following the global financial crisis, when the Chinese authorities embarked on a substantial economic stimulus package that gave added impetus to this type of intermediation. At the same time, the existence and (in some cases) tightening of various regulatory restrictions – such as a ceiling on deposit rates, sectoral lending guidance and a 75% loan-to-deposit limit for banks – while presumably effective in meeting prudential and other goals, have created incentives for investors, intermediaries (including banks) and borrowers to bypass the formal bank lending channel. This is particularly the case for companies that may be perceived by banks to be riskier compared to large state-owned firms, and for firms operating in sectors subject to lending restrictions (e.g. sectors facing overcapacity such as construction, steel and shipbuilding). The relatively small size of the corporate bond market compared to the banking sector (see Annex 1) means that such firms have limited alternative financing options. As a result, investors (both institutions and individuals) are incentivised to use non-bank products to earn higher yields on their investments, while borrowers are incentivised to seek funding from non-bank entities.

[26] See, for example, "Chinese Shadow Banking: Bank-Centric Misperceptions" by Dang, Yang and Yao (September 2014, Hong Kong Institute for Monetary Research Working Paper No. 22/2014, http://www.hkimr.org/uploads/publication/394/wp-no-22_2014-final-.pdf).

One of the distinguishing characteristics of non-bank credit intermediation in China is that the banking sector is closely involved in several aspects of the intermediation chain. An example is the so-called "tunnelling business", in which banks are involved at every step of the process, from raising funds for a trust through their distribution networks to selling financial assets (including loans) to that trust. The close interaction between banks and non-banks has partly been a by-product of the rapid transition towards a more market-based financial system, which necessitated the reliance by other intermediaries on banks' networks. However, it is also prompted by the aforementioned regulatory restrictions that incentivise banks (particularly small and medium-sized ones that are more likely to be subject to funding or lending constraints) to get involved in the non-bank intermediation chain.

As previously mentioned, the review focuses on three elements of that chain in order to examine the progress made by Chinese authorities in assessing and mitigating related financial stability concerns. These elements are entrusted loans, trust companies and WMPs, and their main features are summarised below (see Figure 2 for a stylised overview of the intermediation chain and Annex 3 for a detailed description of these elements).

Figure 2: Stylised overview of the intermediation chain for entrusted loans, trusts and WMPs



Note: Arrows indicate financial transactions involving a direct exposure for banks (solid line) or only featuring banks as an intermediary or distributor of financial products (dotted line). The funds flow from investors through intermediaries to borrowers as follows: (A) entrusted loan between corporates, with a bank acting as an intermediary; (B) WMP issued by asset management subsidiaries of securities and other firms that is used to fund an entrusted loan, with a bank acting as an intermediary; (C) bank-issued WMP used to fund investment in a trust loan; (D) trust product, distributed via a bank, which is invested in a trust loan; and (E) trust product, sold directly by the trust to a qualified investor, which is invested in a trust loan.

Entrusted loans: In China, banks and trust companies are the only entities permitted to directly issue loans to non-financial corporations. Other entities, such as other non-financial corporations as well as securities and insurance companies, can only lend to non-financial corporations in the form of an entrusted loan transaction using a bank.[27] Since the bank acts as an intermediary on behalf of the lender, this type of transaction is not captured on the bank's balance sheet. This form of lending is widespread (its size was estimated to be around RMB 9.3 trillion at end-2014, or 15% of GDP) and typically involves lending by bigger companies – with easy access to funding – to their subsidiaries or to smaller companies for commercial (e.g. supplier/trade credit) or financial (i.e. profit-making) reasons.

Trust companies: These companies conduct asset management activities on behalf of their customers, and they managed assets of RMB 14 trillion (22% of GDP) as of end-2014.[28] They invest these assets in various financial instruments, such as bond and equity securities, but can also provide credit directly to non-financial firms in the form of loans (RMB 5.3 trillion, corresponding to 8% of GDP, as of end-2014). To raise funding, trust companies issue different types of trust products to investors; these are similar to closed-end investment funds with fixed maturity dates and without the right to exercise early redemption. The trust beneficiary rights are transferable, i.e. trust products can be sold to other investors prior to their maturity. Non-financial companies, other financial institutions (including banks) and high net worth (HNW) individuals are allowed to purchase shares in trust products.

WMPs: WMPs are investment vehicles, the majority of which are closed-end funds that are not redeemable prior to maturity. A number of financial institutions – banks, trust companies and securities and insurance firms – can issue WMPs (in the case of trust companies, these products are also known as trust beneficiary rights). Banks create WMPs (which are higher-yielding compared to normal deposit products) and sell them to a variety of clients including HNW individuals, institutional investors and private banking clients. As of end-June 2014, the size of bank WMPs was RMB 12.7 trillion (around 22% of GDP and 10% of total bank deposits). Banks can also sell WMPs of other financial institutions, such as trust companies and securities and insurance firms. Bank WMPs are mainly short-term products with a maturity of less than one year and invest in a variety of assets, including bonds, equities, interbank placements, trust products and so-called 'non-standard credit assets'.[29] Around one-third of bank WMPs are guaranteed by the distributing bank, so they are included in the bank's balance sheet as a deposit liability; the other two-thirds are non-guaranteed products, which are off-balance sheet for the distributing bank and are therefore not included in the definition of deposits for accounting and regulatory purposes. This may explain in part why, up until recent regulatory changes, these products tended to have a very short term maturity, often around four months, so that they expired before the regulatory reference date of loan-to-deposit ratios (maturing funds were often placed in the customers' bank account and hence counted as deposits).[30]

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27 These entities can also take credit exposures to non-financial corporations by investing in bonds or securitized credit.

28 Trust companies also hold proprietary positions, which are relatively small compared to their total assets under management; these positions are managed separately.

29 Non-standard credit assets are defined by the CBRC as assets that are not traded in the interbank market and securities markets; trust loans are included in this category.

30 In September 2014, the CBRC issued a regulation on deposit deviation, requiring month-end deposits not to deviate more than 3% from intra-month daily average deposit balances. This requirement applies to the last

Recent developments: Given China's dynamic and constantly evolving financial system, regulatory efforts to address emerging developments and risks related to the supply of credit have catalyzed innovation and rapid market adaptations designed to circumvent new restrictions. While the aforementioned elements in the non-bank credit intermediation chain have played a key role in the last few years, new forms of intermediation with similar economic functions have emerged more recently. These include, for example:

- as an alternative to bank WMPs, the growth of money market funds (MMFs) via internet providers offering daily liquidity and access to the (liberalized) rates available in the interbank market;[31]
- as an alternative to trust company products, asset management services provided by securities and insurance companies.[32] The growth of this industry, whose assets are estimated to have reached more than RMB 6 trillion as of end-2013 (11% of GDP) can be largely attributed to the tightening of regulations on trust products and the relaxation of regulations on securities firms in 2009 and insurance companies in 2012 (see below).[33]

Risks: Relative to advanced economies, most non-bank credit products in China are not highly structured – in the sense of creating leverage through the way they are constructed – and do not therefore give rise to the same types of risks as in the case of, for example, Collateralized Debt Obligations or re-securitisations. Moreover, the non-bank sector is still relatively small (less than 20% of total financial system assets) and notable for its lack of leverage: trust companies can only obtain funding through interbank borrowing for up to 20% of their equity, while trust products and bank-related WMPs operate without leverage.[34]

Nonetheless, non-bank credit intermediation activities pose a number of risks that require close monitoring and assessment. As previously mentioned, the close interaction of banks with the non-bank sector suggests that at least part of the credit risk that resides in the non-bank sector could come back onto bank balance sheets in a stress scenario – for instance, due to reputational reasons (see below) or as a result of a broad-based economic downturn. In the few cases where trusts have defaulted to date, investors have often recouped their principal and at least a portion of the accrued interest. The manner in which these pay-outs have

month of every quarter, and is expected to significantly reduce the temporary increase in reported bank deposits – for instance, as a result of expiring WMPs – around the loan-to-deposit reference dates.

[31] The interbank market in China comprises transactions between banks as well as with non-bank financial institutions, and can therefore be used for funding or investing in various forms of non-bank credit.

[32] The most important examples are asset management subsidiaries – also called Target Asset Management (TAM) business – and fund management companies of securities firms and asset management subsidiaries of futures companies and insurance firms.

[33] According to the PBC's 2014 FSR, the TAM business represented the largest proportion of securities and insurance companies' asset management services, with about RMB 5 trillion in assets under management as of end-2013. The fund management sector (RMB 0.9 trillion as of end-2013) and asset management subsidiaries of insurance companies (estimated at about RMB 0.6 trillion) are much smaller in size.

[34] However, trusts and WMPs can be invested in products with embedded (structural) leverage. Moreover, in "umbrella trusts", high net worth investors can use funds borrowed from WMPs to leverage investments in the equity market. The CSRC banned brokers from selling these types of trusts in February 2015.

occurred and the role of various entities in this process is not fully transparent, reinforcing the perception among investors of an implicit guarantee that gives rise to moral hazard.

Furthermore, the monitoring of risks in the sector is complicated by opaque credit chains and the emergence of innovative new instruments and entities (not all of which are regulated) that can obscure the ability to determine end-exposures and properly account for counterparty risk. This becomes even more important given the dynamic nature of the financial system, the fact that regulatory restrictions may have channelled non-bank lending to riskier companies and investors' incentives given the perception of implicit government guarantees.

From a more macroeconomic perspective, the short maturities of trust products combined with regulatory restrictions on maturity mismatches between the underlying trust assets and their funding implies that a large part of the credit provided through the non-bank sector is of a short-term nature.[35] While restrictions on maturity mismatch are a means to protect investors, they may inadvertedly create a dynamic in which the riskiest companies face constant rollover risk of their financing in the absence of mechanisms to cope with defaults. This process can propagate as long as credit continues to grow rapidly and risky companies have continued access to funding, but can reverse quickly in the face of a credit event and result in a sudden spike in funding rates and corporate defaults.

Steps taken and actions planned

In January 2014, the State Council issued general guidelines on shadow banking that clarify and attribute regulatory responsibilities to financial sector regulators in accordance with their designated legal mandates as follows:

- the PBC assesses the risks from the non-bank financial sector as part of its overall financial stability mandate, collects data (including for entrusted loans and trust loans) and publishes the TSF;
- the CBRC regulates and supervises banks and trust companies, including banks' and trusts' WMPs;
- the CSRC regulates and supervises securities and futures markets, including the TAM and asset management business of fund companies; and
- the CIRC regulates and supervises insurance companies, including the activities of their asset management subsidiaries.

Data collection*:* The authorities have made significant efforts in recent years to build up their monitoring capabilities. Data collection has been extended, in particular by the TSF statistic that provides an indication of the importance of non-bank financing sources. The PBC is refining TSF by addressing two of its weaknesses: it has recently come up with a stock figure to complement flow data, and it plans to exclude intragroup lending (i.e. parent company lending to its subsidiaries, which does not represent true intermediation) from entrusted loans.

[35] The CBRC requires that maturities of invested assets in trusts match those of their liabilities, so there can be no maturity mismatch.

However, further breakdowns of the entrusted loans statistics (e.g. in terms of the volume of credit provision by sector or type of provider) are currently not planned.

The CBRC is collecting WMP data (e.g. duration, maturity, types on investments, remaining products, types of clients etc.) through monthly wealth management statements of commercial banks and a registration system that started in June 2013. In addition, the CBRC collects data on the trust sector, including information on trust products and assets under management (i.e. by sector, types of investment, types of products etc.). Statistics on the trust sector are published on a quarterly basis and bank-related WMPs on a semi-annual basis.[36] The CSRC collects data for WMPs issued by asset management subsidiaries of securities, futures and fund companies, while CIRC collects data on WMPs issued by asset management subsidiaries of insurance companies; however, CSRC and CIRC data are not published.

The PBC and the regulatory agencies have arrangements to facilitate data sharing between them, with the PBC acting as a central collection centre of data in this area. Moreover, as mentioned in section 2, a subcommittee under the JMC that is led by the PBC is working on the construction of an overall statistical framework for non-bank financial institutions. To date, however, it is unclear to what extent the regulatory agencies can access and are making full use of the data assembled by PBC for risk monitoring purposes. While such data is available on request, their effective use may require prior knowledge of definitional/methodological issues and an understanding of the related activities of firms and their regulations by each agency (e.g. various types of WMPs). In that regard, some agencies noted that they sometimes rely on publicly available data (i.e. through the press) to gauge the extent of activities being conducted outside of their direct regulatory perimeter.

Risk assessment: Developments in non-bank credit intermediation are discussed in various documents, such as the PBC's FSR and other authorities' annual reports. Some concerns have been expressed in these publications about the pace of expansion of non-bank credit.[37] At the same time, however, the authorities have expressed the view that non-bank credit contributes positively to the economy and does not represent a significant financial stability risk.[38]

Risk assessment is carried out primarily on a sectoral basis by the respective regulatory agencies, with the results being shared only at a final stage. While a lot of granular data is collected that is relevant for the assessment of risks stemming from the non-financial corporate and non-bank sectors, this is mainly used for monitoring and factual reporting rather than for analytical system-wide exercises examining the impact of hypothetical

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[36] See http://www.chinawealth.com.cn/zzlc/sjfx/lcbg/list.shtml (China wealth website, only in Chinese) for information on WMPS and http://www.xtxh.net/xtxh/english/index.jhtml (China Trustee Association)for information on trusts.

[37] The 2013 FSR included a chapter on shadow banking, signalling potential risks as non-bank finance may reduce the effectiveness of macroeconomic policies, facilitate lending to weak sectors and lead to spillovers of risk to the banking sector. The 2014 FSR included a box on the surge of the interbank business, indicating that it may undermine macroeconomic controls, create maturity mismatches and liquidity risks, reduce transparency and increase complexity. The 2014 FSR also included a box on the emergence of the TAM business. The CBRC expressed concerns about the rapid increase in banks' off-balance business and WMPs in its 2013 annual report, which was followed by the tightening of regulation on bank WMPs' investments.

[38] For instance, the 2013 FSR stressed that shadow banking in China is smaller than in many other countries, that is not highly leveraged and that it provides finance to the real economy and increases market liquidity.

scenarios. Some stress tests taking into account non-bank financial intermediation have been performed by the PBC, but only for banks and using static and partial scenarios.[39] The CBRC carried out stress tests in 2014 incorporating scenarios that included a decline in the issuance of off-balance sheet WMPs and an increase in the defaults of non-standardized credit assets associated with off-balance sheet WMPs. Banks are also required by the CBRC to take into account non-bank intermediation in their internal stress testing, for instance by assessing the impact on funding conditions of a downward scenario affecting off-balance sheet WMPs. According to the CBRC, most banks' internal stress tests already take account of the possibility that some losses from WMP investments may come back on their balance sheets even though, from a strictly legal perspective, it is investors rather than the banks that bear these risks. However, comprehensive macroprudential stress tests and crisis simulation exercises, involving the collaboration of various agencies and the use of commonly agreed scenarios and methodologies, are not carried out.[40]

Regulatory action: The Chinese authorities have taken a number of policy measures related to non-bank finance over the last few years, and have intensified their efforts more recently (see Table 2). Consistent with the risk assessment framework, regulatory action has been primarily implemented on a sectoral basis. This approach, while effective in terms of sectoral outcomes, can result in the shifting rather than the mitigation of risks in the overall financial system. For example, an important regulatory tightening was the CBRC's imposition of a ceiling on the amount of bank WMP investments in non-standard credit assets, including trust loans, in 2013. This coincided with the relaxation of regulations for asset management subsidiaries of securities and insurance firms by the CSRC and the CIRC – also driven by these agencies' mandate to promote the development of their respective sectors – which likely contributed to the subsequent surge of asset management activities of those firms.

The authorities are aware of the possibility of sectoral arbitrage and are working on a more harmonized regulatory framework. One of the main objectives of the recently-created JMC (see section 2) is to promote inter-agency coordination on cross-sector products and innovations, including on non-bank credit intermediation. The JMC has taken the initiative to improve the consistency of regulations for different types of asset management activities funded by WMPs and requested the CSRC, in collaboration with the other regulatory agencies, to prepare proposals for the State Council. The objective is to develop a common regulatory standard in this area in order to promote a level playing field, which each agency will have to implement via its own regulations.

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[39] More specifically, the PBC conducted a stress test for 17 major banks at the end of 2013 involving stress scenarios for credit, market and liquidity risks (see the 2014 FSR for a discussion). The scenarios for credit risk included losses on banks' on and off-balance exposures to WMPs that are used to invest in credit products, assuming 10-30% losses on these products. However, these scenarios did not include any potential losses from other similar products sold through banks (e.g. trust WMPs), while banks' WMP exposures were not included in the liquidity stress test.

[40] According to a recent typology by the IMF, such "macroprudential stress tests" are typically carried out as a joint exercise of different authorities, covering all (systemically relevant) financial institutions, assuming extreme shocks that are unlikely but plausible. The goal of such stress tests is primarily to support surveillance, and the outcomes are typically published. See *Macrofinancial Stress Testing – Principles and Practices* by IMF staff (August 2012, http://www.imf.org/external/np/pp/eng/2012/082212.pdf).

Table 2: Selected regulatory actions relating to non-bank credit intermediation

1996	Prohibition of direct lending among non-financial companies and individuals, who can only lend through an entrusted loan transaction with a bank acting as an intermediary.
Oct 2001	National People's Congress issued *Trust Law,* which provides the legal requirements for trust activities.
2005	CBRC authorises bank WMPs.
Mar 2007	CBRC issued *Regulation for Trust Company,* which provides detailed supervisory requirements for trust companies.
Mar 2007	CBRC issued *Regulation for Collective Trust Product,* which provides detailed guidance and requirements for trust companies when issuing collective trust products.
2011	PBC started publishing the TSF, with series calculated back to 2002.
2012	CIRC authorises insurer-related asset management activities.
Oct 2012	CSRC relaxes regulation of the fund management industry. This involves streamlining administrative approval requirements, allowing asset management companies to set up subsidiaries, and expanding the investment scope (Securities law, *Detailed rules on TAM Business of Securities Companies* No. 30).
Mar 2013	CBRC issues *Notice No. 8 on Relevant Issues on Regulating the Investment Operation of Wealth Management Business of Commercial Banks*. It imposes a 35% maximum on the proportion of bank WMPs' investments in non-standard credit assets, and prohibits explicit or implicit guarantee for those assets.
Jul 2013	PBC issues *Notice on furthering market-based interest rate reform*, which removes all controls on bank lending rates.
Oct 2013	State Council promulgates the *Guidance on Defusing Conflicts of the Serious Excess Capacity*, in which the tasks of financial sector in resolving serious excess capacity are deployed.
Jan 2014	State Council issues Document no. 107 providing general guidelines on shadow banking and attributing regulatory responsibilities among financial sector regulators
Jan 2014	PBC issues *Guideline on Implementing the Credit Policies*, requiring the banking institutions to strictly implement the related rules and guidance to better fulfil the responsibilities of financial sector in defusing conflicts of serious excess capacity.
Apr 2014	CBRC issues Document 99 (*Guidelines on Regulating Risks of Trust Companies*)
Apr 2014	Securities fund laws are amended and the CSRC issues a *Notice on Further Strengthening Risk Controls of Specific-Client Asset Management Business by Fund Management Companies and Subsidiaries*, requiring these firms to improve their compliance management and risk controls.
May 2014	PBC, CBRC, CSRC, CIRC and SAFE issue *Notice on Regulating Interbank Business of Financial Institutions*, to better regulate interbank transactions. This notice includes several guidelines to improve internal management, requiring financial institutions to manage their interbank business separately for six categories: interbank lending, borrowing, deposits, agent payments, repo and reverse repo.
Jul 2014	CBRC releases *Notice on Issues Related to Improving the Organization and Management System of Wealth Management Business of Banks*, requiring banks to better separate wealth management assets from their own assets, set up dedicated departments responsible for wealth managements and improve the differentiation of wealth management products to link them to costumers' risk profiles.
Sep 2014	CBRC issues *deposit deviation* regulation, requiring that end-of-month deposits do not deviate more than 3% from daily averages.
Nov 2014	State Council publishes for consultation draft regulation on deposit insurance.
May 2015	The *Regulations on Deposit Insurance* took effect. PBC will manage and operate the system, whose major characteristics include an RMB 500,000 maximum compensation limit; compulsory membership; a combination of basic and risk-based differentiated premium rate; and the creation of an ex-ante deposit insurance fund.

Lessons learned and issues to be addressed

A non-bank sector that provides sound and sustainable finance is an essential part of a developed financial system. In that sense, the growth of non-bank credit intermediation in China in part reflects a welcome deepening of the financial system and an alternative source of finance to the real economy. Such intermediation takes many forms, often involving banks in some capacity (e.g. as distributors, intermediaries, clients and owners). Individual products are not overly complex compared to those of advanced economies and the sector does not appear highly leveraged, but its growing size[41] and constantly evolving structure (which can include opaque transaction chains) and linkages with the banking system may give rise to liquidity and maturity transformation risks – hence the need to ensure that it is adequately monitored and the risks are identified and managed. The authorities have improved their monitoring of non-bank credit intermediation in recent years and have taken steps to contain identified risks, both at the State Council/JMC level and by individual regulatory agencies. Specific examples include the augmentation of data collection, enhanced cooperation between the authorities via the JMC, and policy actions to mitigate identified risks related to the interbank market, the trust sector and for banks' WMPs.

Despite notable progress, challenges remain in assessing and mitigating emerging risks in this sector – both in terms of data collection but, more importantly, in terms of undertaking coordinated and comprehensive risk assessments (see below) to inform the use of policy tools. This is not unique to China, as many other jurisdictions are in the process of improving their monitoring and developing appropriate policy tools to ensure that non-bank activities develop into a transparent, resilient and sustainable source of market-based financing.[42] In that context, it is important for the authorities to find the right balance between promoting financial innovation to support further economic expansion and ensuring that financial stability risks are adequately taken into account. This balance is complicated by the fact that China is in a period of transition during which banks continue to play a major role in the development of non-bank credit intermediation.

Going forward, the authorities should extend their macroprudential framework – as discussed in section 2 – to better monitor the non-bank financial sector, assess financial stability risks and translate this into regulatory and supervisory action. In addition, the authorities should carefully consider and communicate a longer-term path for the eventual role and structure of non-bank credit intermediation in the Chinese financial system. The remainder of this section outlines recommendations for further improvement under the broad headings of: enhancing identification and monitoring; strengthening risk assessment capabilities; enhancing the regulatory framework; and promoting a more diversified and resilient market-based system.

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[41] Based on the TSF measure, the outstanding stock of entrusted loans, trust loans and bankers' acceptances as of end-2014 was 15%, 8% and 11% of GDP, respectively.

[42] See the FSB's *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* (August 2013, http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf). The framework includes a number of overarching principles that emphasize – among other things – the importance of defining and updating the regulatory perimeter, and of collecting and exchanging information needed to make risk assessments.

Enhance monitoring: Good progress continues to be made in extending data collection for non-bank credit intermediation. The TSF statistic provides up-to-date information into various non-bank funding sources to the economy. Data on relevant activities has also improved, with quarterly statistics on trust companies and monthly statistics on banks' WMPs (which are published on a semi-annual basis). Efforts are underway to enhance information on entrusted loans, including stock data and an adjusted figure for intra-group lending. Arriving at this latter figure is an important means of scoping the size of potential risks in the entrusted loan market and should remain a key short-term priority. Adhering to the IMF's Special Data Dissemination Standard (SDDS), as the authorities have recently announced, is a good step in constructing flow-of-funds statistics.[43] Over time, the TSF statistic should be further developed into a granular flow-of-funds statistic that makes it possible to analyse how exposures across sectors evolve.

In some areas, stronger cooperation between agencies would further improve monitoring, such as in developing a comprehensive database on WMPs issued by different types of financial institutions. It would also be useful to publish WMP statistics more frequently (e.g. on a quarterly rather than semi-annual basis) and to encourage banks and other financial institutions to disclose these products in their financial statements. Data on WMPs not issued by banks or trusts is still incomplete and not routinely shared between agencies for risk monitoring purposes. Collecting more information on banks' ownership of various non-bank products and banks' exposures to off-balance sheet activities would also be useful in order to better understand inter-linkages and risks in the financial system. The JMC subcommittee on data issues led by the PBC could play a coordinating role in strengthening information sharing among supervisors for risk monitoring purposes, including by ensuring that all regulatory authorities have direct access to underlying data as appropriate.

Moreover, the dynamic nature of non-bank credit intermediation requires additional data collection efforts for new products that may not be fully captured by current initiatives. Recent examples are the emergence of MMFs and asset management products provided by securities firms and insurance companies. Regular information on these products' sectoral exposures, funding sources and performance would be particularly helpful.

- ***Recommendation 6**: The authorities should continue to enhance efforts to collect and disclose comprehensive and granular data relating to non-bank credit intermediation. Such data (e.g. on various forms of wealth and asset management products) should be routinely shared across agencies for risk monitoring purposes.*

Strengthen risk assessment capabilities: The authorities have taken some steps in recent years to improve the risk assessment of non-bank credit intermediation. These include the PBC assessing potential shadow banking risks in its FSR and (partly) incorporating bank exposures to WMPs in its stress testing framework; and the CBRC carrying out stress tests in 2104 with scenarios that include a decline in the issuance of off-balance sheet WMPs and an

[43] China announced that it would implement SDDS standards (http://dsbb.imf.org/Pages/SDDS/Home.aspx) at the G20 Brisbane Summit in November 2014. Improving flow-of-funds statistics, with special priority for non-bank finance, is also one of the recommendations of the data gaps action plan – see the FSB-IMF report to the G20 on *The financial crisis and information gaps* (October 2009, http://www.financialstabilityboard.org/wp-content/uploads/r_091029.pdf).

increase in the default of non-standardized credit assets associated with off-balance sheet WMPs. The CBRC also requires banks to take into account non-bank intermediation in their internal stress testing. While other types of non-bank credit activities and products – such as entrusted loans and asset management services by securities and insurance companies – are monitored, they are not yet explicitly captured in the risk assessment framework.[44]

The authorities should develop a more sophisticated and integrated risk assessment framework that considers liquidity, maturity mismatch/rollover, credit and reputational risks arising from banks' involvement in non-bank credit intermediation activities (e.g. distribution or management of trust products); and indirect risks to bank lending from entrusted loans to the same counterparties. Second-round effects could also be incorporated, for instance by making assumptions about possible behavioural responses of banks to negative shocks – such as tightening lending standards – which may further exacerbate an economic downturn. In that respect, the authorities may want to consider organising crisis simulation exercises based on extreme but plausible scenarios, to identify possible weak spots in their crisis management framework. Given that credit risk in the non-bank sector is primarily related to the performance of the non-financial corporate sector, surveillance of this latter sector (through model building and scenario analysis) should also be enhanced.

From a strictly legal perspective, it is investors rather than banks that bear the risks of WMP and trust investments. However, in practice banks may be keen to avoid the perception of default in these products and guard against any reputational risk. The CBRC should, in its internal stress analysis, assess how far banks (both individually and collectively) may be willing to go to protect investors and to absorb the ensuing financial costs – the objective being to ensure that those banks internalise such risks. This is important, since other jurisdictions' experience in the crisis shows that off-balance activities (e.g. structured investment vehicles) may return to banks' balance sheets, even though this is not required legally. The outcome of these types of stress tests need not be published, but it is important that the authorities are confident that banks can withstand such an event, however unlikely.

Given that most stress testing conducted by individual agencies is sectoral in nature and primarily focused on banks' on-balance sheet exposures, cross-sectoral risks may not be sufficiently captured. This is not unique to China: most jurisdictions are at an early stage of developing system-wide stress tests and incorporating non-bank components into such tests to capture the risks that banks may face in their interactions with this sector. Given the pressure to expand the non-bank financial sector, its strong linkages with banks and the incentives for regulatory arbitrage, enhancing the surveillance of cross-market activities and risks and developing system-wide tests is an important priority for China. In that context, it would be important to develop a comprehensive analytical framework for risk assessments and foster strong inter-agency coordination, for example, in the design of stress tests (using commonly agreed scenarios and methodologies) or crisis simulation exercises.[45] Joint stress

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[44] As noted in the text, the SAC published in 2011 guidelines for stress tests by securities firms. It is also developing a capital markets risk index monitoring system and stress testing framework and is exploring the publication of a capital markets financial stability report.

[45] As an example, the ESRB has established a permanent working group on shadow banking that brings together staff members from different sectoral authorities to analyse developments and make proposals to improve the regulatory framework in the EU.

tests are conducted between non-supervisory central banks and regulatory agencies in other jurisdictions and can provide useful insights into financial system risk while improving coordination and communication between domestic authorities. As noted in section 2, the JMC and other inter-agency bodies could potentially play a useful role in this area.

- ***Recommendation 7:* The authorities should enhance their ability to assess systemic risks stemming from non-bank credit intermediation. Extensions to the analytical framework include a focus on the liquidity, maturity transformation, credit and reputational risks for banks stemming from these products, the impact of second-round effects, and the use of crisis simulation exercises. In addition, an inter-agency group should be formed to coordinate the surveillance of cross-market activities and of risk assessments across all relevant authorities and sectors.**

Enhance the regulatory framework: As in many other countries, the prudential regulation of the financial system in China follows a predominantly sectoral, entity-based approach, reflecting the state of the market and nature of activities. However, the recent blurring of boundaries between sectors and entities as the financial system develops is creating a need for system-wide approaches to avoid regulatory arbitrage and promote a level playing field. In the absence of such coordination, the tightening of regulation by one agency for certain segments of non-bank credit intermediation, at the same time as it is being relaxed by another agency, can lead to the transfer of activities across these segments rather than the overall system-wide mitigation of risk. In recent years, regulatory actions applied to a particular sector were followed by a transfer of activities to other areas. For example, asset management activities conducted via securities firms are not subject to similar regulation as for trust companies, which may have contributed to the rapid expansion of the former at the expense of the latter. In a liberalised system, such arbitrage is likely to become even more relevant.

To cope with these challenges, which are common to many countries worldwide, the authorities should seek to develop a common regulatory framework that would be primarily activity-based, applying similar regulation to similar activities where possible. The development of a common standard to regulate WMPs is a good step forward to address some regulatory gaps, but more work is needed. The recently-created inter-agency subcommittee on data under the JMC could play a useful coordinating role in the development of such an approach. While most countries are facing similar challenges in developing a common regulatory framework, this is particularly relevant for China given the importance and rapid evolution of its non-bank credit intermediation sector.

- ***Recommendation 8:* The authorities should develop a more activity-based regulatory approach in order to discourage regulatory arbitrage and ensure a level playing field in non-bank credit intermediation.**

Promote diversified and resilient market-based finance: The Chinese authorities have publicly committed to promote a less bank-centric and more market-based financial system,[46] and major steps have been taken in this regard in recent years. The expansion of the non-bank sector has made the financial system more diverse, although this can be partly attributed to regulatory restrictions that provide incentives for banks to shift some activities off-balance

[46] State Council (2010), 12th Five-year Plan for the Development and Reform of the Financial Industry.

sheet. Further liberalisation of deposit interest rates and of other prudential controls (e.g. lending restrictions and the loan-to-deposit limit) may, in the first instance, reverse this trend and move activities back to the banking sector. Indeed, recent data suggest that such a process may be underway, driven in part by the slowdown in economic growth and tighter rules for some non-bank intermediation activities (e.g. trust lending).

The move of assets back onto bank balance sheets with the commensurate increase in capital may decrease overall financial system risk. However, in order to promote a more diverse financial system, the authorities should continue to develop capital market activities (debt and equity market issuance) and an institutional investor base (insurance companies and pension funds) as an alternative and independent pillar to bank financing. It would also be useful for the authorities to communicate their vision of the evolution of non-bank credit intermediation and how it can be developed in a sound and sustainable manner over the long-term.

A well-developed market-based financial system does not imply that all risks are removed, but rather that the risks are well identified and accurately priced, and that losses can occur in a transparent and predictable manner. However, the rapid growth of non-bank credit intermediation to date has largely been predicated on investors realising high returns with minimal risk. In some cases, investors have not realized the full impact of defaults on the trust and wealth management products in which they have invested. This may reinforce investor belief that implicit guarantees exist on risky products that are affiliated with the banking system, which may contribute to moral hazard and the mispricing of risks. The fact that banks have on occasion supported such products, despite no legal requirement to do so, has reinforced this perception. In that respect, the recent introduction of a deposit insurance system and other planned related measures (e.g. further liberalisation of interest rates, bank resolution and corporate bankruptcy reforms) may help address misaligned incentives in non-bank credit intermediation and promote market-based pricing, to the extent that they are accompanied by a firm resolve on the part of authorities to remove the implicit guarantee on financial assets and allow for defaults/losses to occur in a transparent and consistent manner.

- ***<u>Recommendation 9:</u> The authorities should continue to promote a more diversified and resilient financial system by: (1) increasing reliance on market-based pricing mechanisms via the removal of implicit guarantees; and (2) further developing capital markets and an institutional investor base as an alternative pillar to bank financing.***

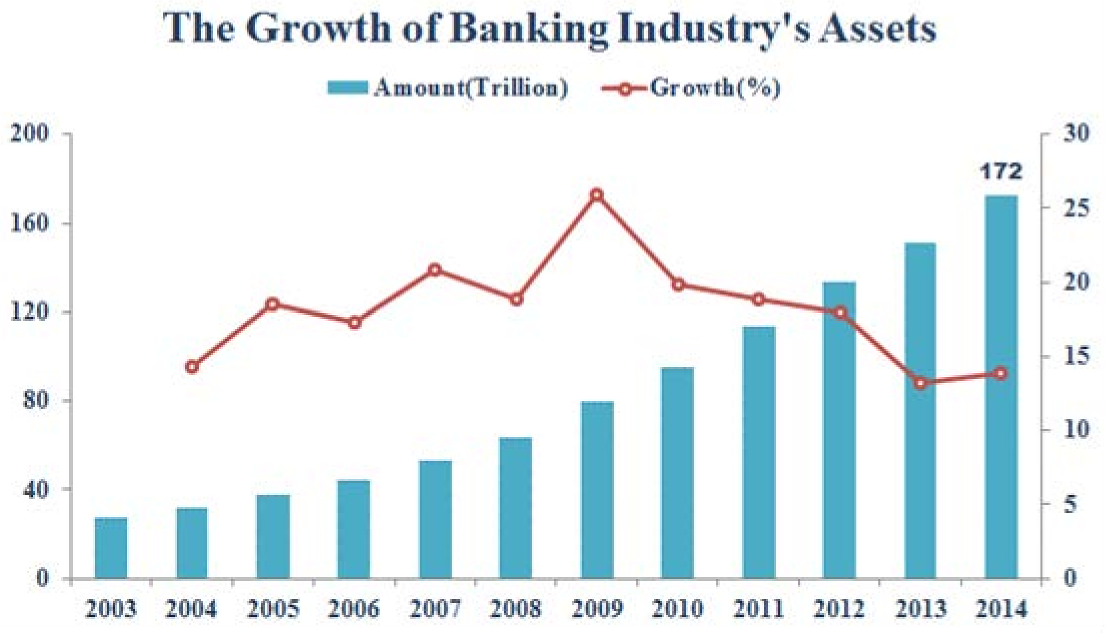
Annex 1: Structure of the financial system and recent developments[47]

Structure of the Chinese financial system

General profile of financial institutions

Banking sector

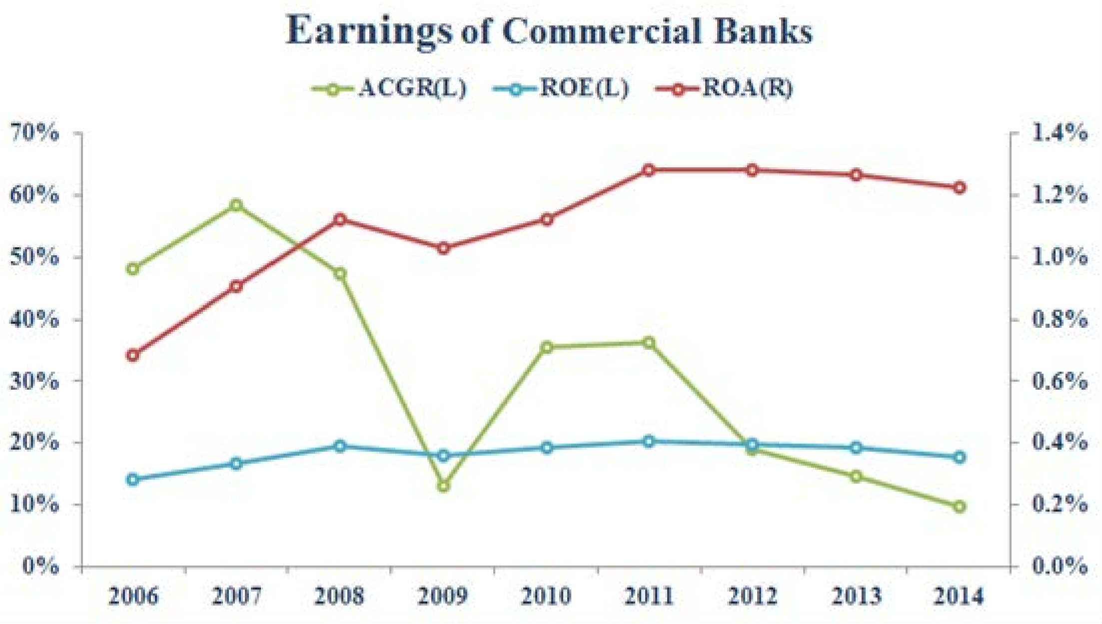
The total assets of China's banking sector continue to increase, albeit at a progressively slower pace since 2010. As of end-2014, total assets increased by RMB 77 trillion from end-2010, reaching RMB172 trillion; total liabilities increased by RMB 71 trillion from end-2010, reaching RMB160 trillion; and total equity increased by RMB 6.5 trillion from end-2010, reaching RMB12 trillion.



As of end-2014, large commercial banks and joint-stock commercial banks accounted for 41% and 18% respectively of the total assets of China's banking sector, while rural financial institutions, city commercial banks and policy banks accounted for 13%, 11% and 9% respectively. Non-bank financial institutions (including trust companies, finance companies, financial leasing companies and consumer finance companies which are supervised by CBRC) and foreign banks accounted for 3% and 2% respectively.

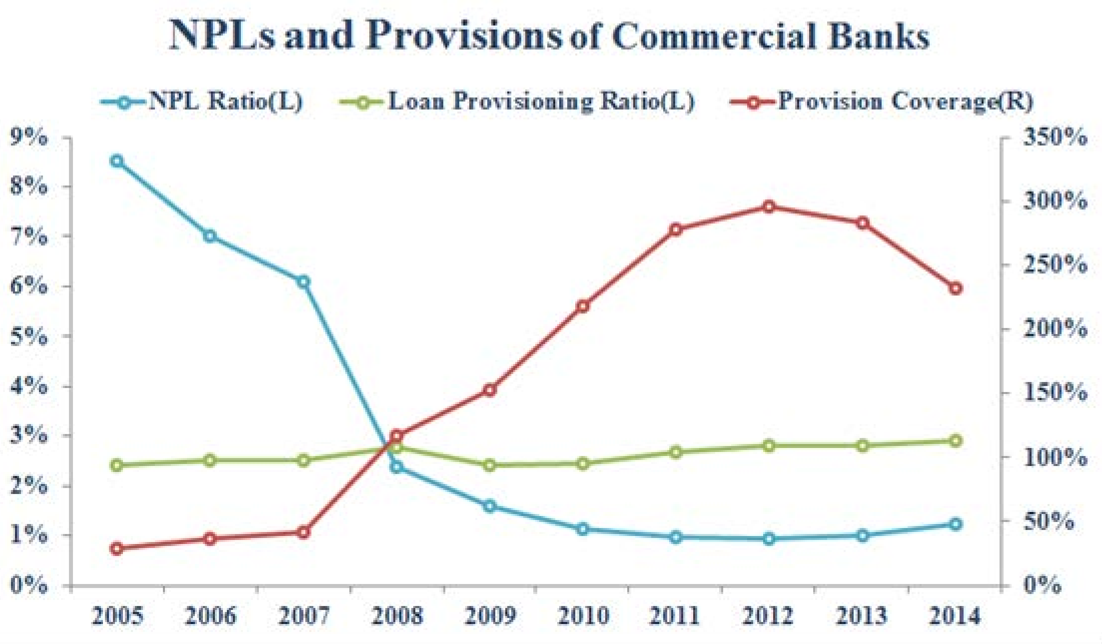
Commercial banks have maintained strong profitability. In 2014, the return on equity of commercial banks stood at 17.6%, while the return on assets was 1.2%. The after-tax profits of commercial banks amounted to RMB 1.6 trillion, up by 9.7% year-on-year.

[47] Based on information provided by the Chinese authorities.

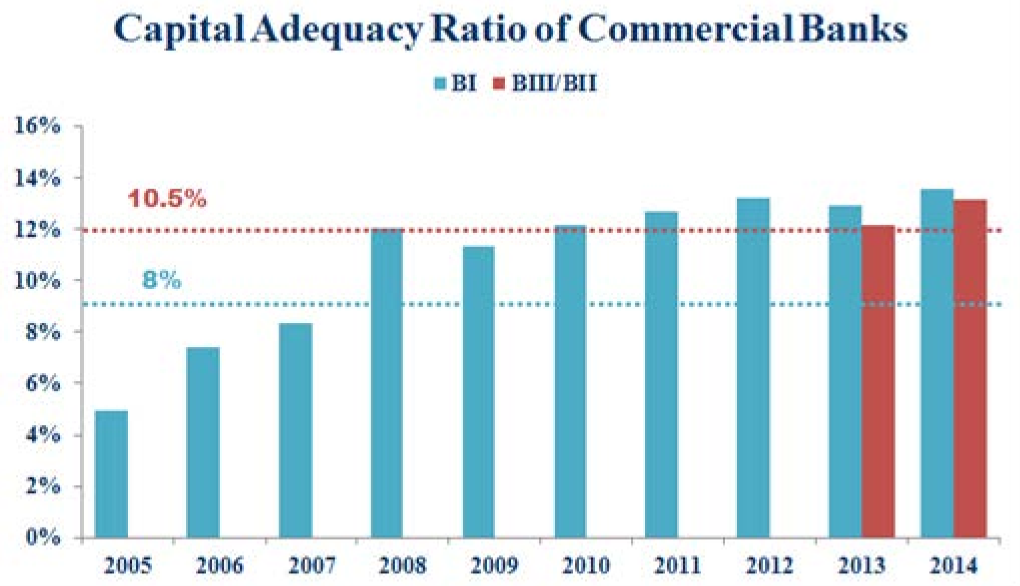


Note: ACGR = Annual cumulative growth rate. ROE = Return on equity. ROA = Return on assets.

In terms of other performance indicators, the NPL ratio of commercial banks was 1.3% at year-end 2014; the ratio increased for 13 consecutive quarters and was up by 42.3% from the previous year. At year end-2014, the provisions for loan losses represented 232% of NPLs, corresponding to 2.9% of the loan portfolio. In addition, the liquidity ratio was 46.4% (up 4.2% from end-2010) while the loan-to-deposit ratio stood at 68.6% (up 4.2% from end-2010).



The capital adequacy ratio (CAR) of commercial banks currently exceeds regulatory requirements. Since 2013, commercial banks have calculated and submitted capital adequacy ratio data according to the *Capital Rules for Commercial Banks (Provisional)* (hereinafter *the New Capital Rules*), in which the minimum requirements are consistent with those of Basel III. According to the *New Capital Rules*, as of end-2014, the weighted average CAR of commercial banks reached 13%, while the weighted average Core Tier I CAR reached10.6%.



Note: BI = Basel I. BIII/II = Basel II and III.

Securities and futures sector

As of end-2014, there were 120 securities companies across China, of which 21 were listed. The total assets and liabilities of securities companies amounted to RMB 4.1 and 3.2 trillion respectively, an increase of 97% and 146% year-on-year. Their total net assets and net capital accounted for RMB 921 billion and RMB 679 billion respectively, an increase of 22% and 30% respectively. Throughout 2014, the industry generated an operating income of RMB 260 billion (an increase of 64% year-on-year), while the annual cumulative net profit was RMB 96.6 billion (an increase of 120% year-on-year).

As of end-2014, there were 152 futures companies across China, with the total assets (excluding client assets), net assets and net capital accounting for RMB 73 billion, RMB 62 billion and RMB 48 billion respectively, reflecting an increase of 14%, 19% and 10% year-on-year. Total clients' margin amounted to RMB 271 billion (increase of 28% year-on-year); annual operating income reached RMB 19 billion (increase of 4% year-on-year); and the net profit was RMB 4.2 billion (increase of 17% year-on-year).

Fund management companies experienced steady growth, with accelerated innovation in money market funds. As of the end of 2014, there were 95 fund management companies in China managing a total of 1,899 public funds, with total net value at about RMB 4.5 trillion, which represents an increase of 51% year-on-year. Money market funds increased by 179% during 2014 and accounted for around one-quarter of the total by the year-end.

Table 4: Statistics of Financial Institutions in the Securities and Futures Industry

	2010	2011	2012	2013	2014
Securities companies					
Number	106	109	114	115	120
Total assets (billion)	1,969	1,573	1,721	2,079	4,092
Total net assets (billion)	566	630	694	754	921
Total net capital (billion)	432	463	497	521	679
Net profit (billion)	78	39	33	44	97
Fund management companies					
Number	63	69	77	89	95
Net value of the funds (billion)	2,518	2,190	2,870	3,000	4540
Futures companies					
Number	163	161	160	156	152
Total assets (excluding client assets) (billion)	34	43	55	64	73
Net profit (billion)	2.6	2.3	3.6	3.6	4.2

Insurance sector

The number of insurance institutions as of end-2014 was 180, increasing by 6 compared to the previous year. The sector comprised 10 insurance groups and shareholding companies, 65 property insurance companies, 74 personal insurance companies, 9 reinsurance companies, 18 asset management companies, 1 export credit insurance company and 3 others. By the end of 2014, total sector assets were RMB10.2 trillion, increasing by 23% year-on-year.

In 2014, premium income nationwide amounted to RMB 2 trillion, increasing by 18% year-on-year. Insurance claims payment amounted to RMB 722 billion, increasing by 16% year-on-year. The annual profits of the insurance sector reached RMB 205 billion, increasing by 107% year-on-year.

Table 5: General Information of Insurance Sector

Year	2010	2011	2012	2013	2014
Premium Income (billion)	1,453	1,434	1,549	1,722	2,023
Claim Payment (billion)	320	393	472	621	722
Profit (billion)	84	67	47	99	205
Total Assets (billion)	5,048	6,014	7,355	8,289	10,159
Net Assets (billion)	516	557	792	847	1,016
Number of Institutions	142	152	164	174	180

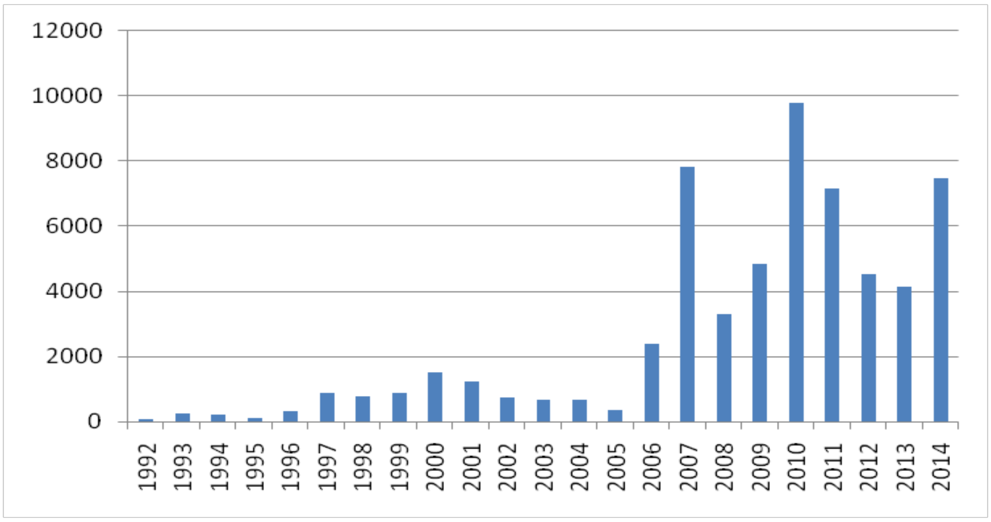
General profile of financial markets

Equity market

Throughout 2014, 758 A-share[48] stocks were issued in Shanghai and Shenzhen Stock Exchanges in all, raising a total of RMB 747 billion, of which: RMB 67 billion came from initial public offerings (IPOs); RMB 0.4 billion came from public follow-on offering; RMB 402 billion from private placement in cash; RMB 263 billion from private placement by assets subscription; and RMB 14 billion came from rights issue. In the same year, private placement by companies listed in the National Equities Exchange and Quotation amounted to RMB 13 billion.

In 2014, the Shanghai Stock Exchanges Composite Index rose by 53%, while the Shenzhen Stock Exchanges Composite Index rose by 34%. The total stock turnover and average daily turnover of the two stock exchanges reached RMB 74 trillion and RMB 304 billion respectively, corresponding to an increase of 59% and 54% over 2013. Annual stamp duty on stock transactions accounted to RMB 74 billion, an increase of 59% compared to 2013; the total turnover and average daily turnover of the stocks listed in the National Equities Exchange and Quotation respectively accounted for RMB 13 billion and RMB 53 million.

A-share market financing volumes (unit: 100 million)



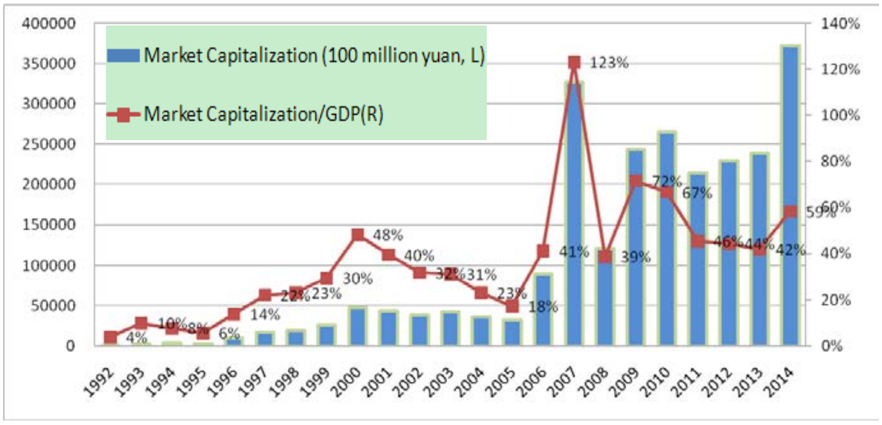
Note: A-share financing volume refers to the fund raised by issuing A-shares through IPO, additional offerings (public offering, private placement in cash and assets), rights issue, and warrant exercise.
Source: CSRC.

As of end-2014, there were a total of 2,613 listed companies on the Shanghai and Shenzhen Stock Exchanges, representing an increase of 124 companies compared to end-2013. Among them, 732 were traded on the Small and Medium-sized Enterprise (SME) Board and 406 on the Growth Enterprise Market (GEM). The total market value of the two Exchanges amounted to RMB 37 trillion with a tradable market value of RMB 31.6 trillion, up by 56%

[48] A-share stocks, also known as RMB-denominated ordinary shares, refer to common stocks issued by Chinese domestic companies, which can be subscribed and traded in RMB by domestic institutions, organizations and individuals (starting from 1 April 2013, residents of Hong Kong, Macao and Taiwan living within the Chinese territory were allowed to open A-share stock accounts).

and 58% respectively since the end of 2013. The total market value of the SME Board and the GEM amounted to RMB 5.1 and 2.2 trillion respectively, corresponding to a tradable market value of RMB 5.1 trillion and 2.5 trillion. There were 1,572 companies listed in the National Equities Exchange and Quotations, with a total market value of RMB 459 billion.

Total Market Capitalization and Market Capitalization/GDP Ratios



Source: CSRC.

Debt market

Bond trading in China consists of interbank trading, trading on exchanges and over-the-counter (OTC) trading through commercial banks. The categories include government bonds, financial bonds, non-financial corporate credit bonds and asset-backed securities. Bonds are traded mainly through spot transactions and repurchase transactions.

RMB-denominated bond issuance (including central bank bills) in 2014 totalled RMB 11 trillion on the bond market, an increase of 22% year-on-year. This included RMB 10.7 trillion issued on the interbank market, while 515 bonds were issued on the exchange traded market raising RMB 415 billion. As of end-2014, the total bonds under custody on the bond market (including central bank bills) amounted to RMB 35 trillion, of which RMB 32.4 trillion came from the interbank market.

Repo and interbank borrowing market

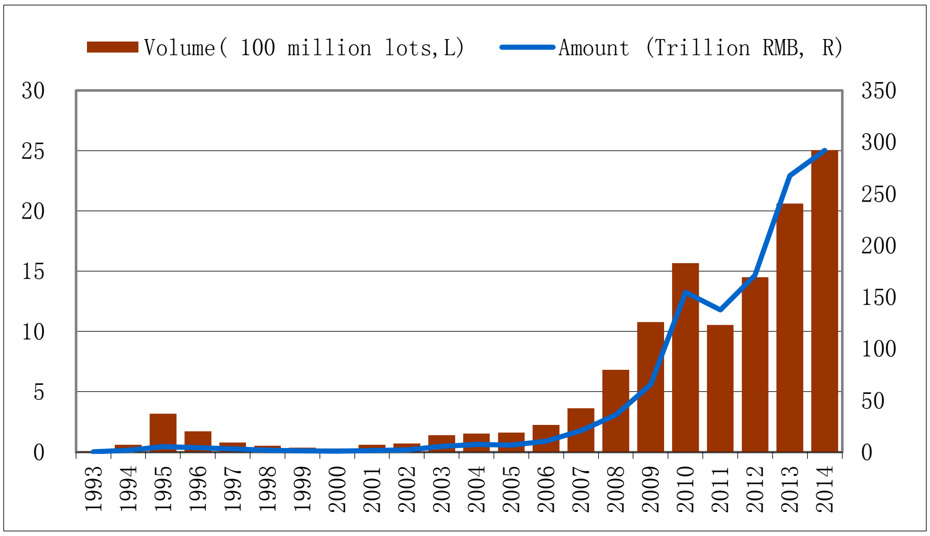
The total trading volume of interbank borrowings in 2014 reached RMB 38 trillion, while the trading volume of bond repos reached RMB 224 trillion. The maturity of trading bonds was short-term. Interbank borrowings maturing no longer than 7 days totalled RMB 36 trillion and accounted for 94% of the total trading volume (equal to 2013), while the trading volume of pledged repos within 7 days totalled RMB 197 trillion and accounted for 93% of total pledged repos (1% higher than 2013).

Futures market

There are three commodity futures exchanges and one financial futures exchange in China. These are the Shanghai Futures Exchange, Dalian Commodity Exchange, Zhengzhou Commodity Exchange and the China Financial Futures Exchange. As of end-2014, there were 46 futures contracts in all of these exchanges, including 44 commodity futures contracts and

2 financial futures contracts. The turnover volume and amount of the futures market in 2014 amounted to 2.5 billion lots and RMB 292 trillion, up by 22% and 9% respectively over 2013. Of these, the total turnover volume of financial futures was 218 million lots and the turnover amount was RMB 164 trillion, respectively accounting for 9% and 56% of the total futures traded.

Futures MarketTurnover Volumes and Amounts



Legal framework and regulatory process governing the financial sector

Currently, China's legal system for financial regulation consists of three levels. At the supreme level, there are laws enacted by the National People's Congress (NPC) or the NPC Standing Committee. Next, there are administrative regulations established pursuant to the Constitution and the relevant laws by the State Council as the country's highest administrative organ, the legal effect of which are subordinate only to the supreme laws. Besides, departmental rules and normative documents formulated by the regulatory authorities in accordance with the laws and administrative regulations are also applicable, though with a lesser legal effect compared to the above mentioned laws and administrative regulations.

People's Bank of China

According to Article 62 of *Constitution of the People's Republic of China,* the NPC and NPC Standing Committee approved the *Law of the People's Republic of China on the People's Bank of China*, the *Law of the People's Republic of China on Commercial Banks,* and the *Law of the People's Republic of China on Anti-Money Laundering.* The State Council issued *Regulations on RMB, Regulations on Foreign Exchange System,* and *Regulations on Credit Investigation Industry.* Based on these laws and regulations, the PBC issued rules and supervisory guidelines, including but not limited to the *Financial Institutions Anti-money Laundering Provisions, Administrative Rules for the Reporting of Large-Value and Suspicious Transactions, Administrative Rules for Financial Statistics,* and *Administrative Rules for RMB Bank Settlement Accounts.*

As stated in Article 2 of the *Law of the People's Republic of China on the People's Bank of China*, the PBC is the central bank of the People's Republic of China. The PBC shall, under the leadership of the State Council, formulate and implement monetary policies, prevent and resolve financial risk and maintain financial stability.

China Banking Regulatory Commission

The banking regulatory authority under the State Council is designated by the *Law on Banking Supervision and Regulation* and the *Law on Commercial Banks* to supervise and regulate all banking institutions incorporated in China as well as their business operations, in order to promote a safe and sound banking industry through preventing and reducing banking risks while protecting the legitimate interests of depositors and other clients. The *Law on Banking Supervision and Regulation* also applies to asset management companies, trust companies, finance companies, financial leasing companies incorporated in China and other non-bank financial institutions approved by the CBRC.

The banking regulatory authority under the State Council has the following powers**:** 1) formulate and promulgate supervisory rules and regulations on banking institutions and their operations; 2) approve the establishment, changes, termination and business scope of banking institutions, verify the qualification of potential shareholders with over 5% of the overall shares, conduct fit and proper test of board members and senior management etc.; 3) conduct off-site surveillance and on-site supervision of business operations and risk profile of banking institutions, establish a regulatory rating system and a risk warning mechanism and take regulatory measures in time; 4) establish a resolution system for banking emergencies in collaboration with the PBC and the financial sector under the State Council; and 5) take corrective measures, for instance, requiring prompt correction or restrictions of business. Those in violation of laws and regulations are subject to administrative sanctions.

China Securities Regulatory Commission

Authorized by the State Council, the CSRC is responsible for unified supervision and management of the securities and futures markets nationwide in accordance with the relevant laws and regulations, including *the Securities Law, the Company Law, the Law on Securities Investment Funds, the Rules on the Regulation of Securities Companies, and the Rules on the Regulation of Futures Trading*, with a mandate to safeguard the orderly and legitimate operation of securities and futures markets.

In addition, *the Property Law, the Criminal Law, the Bankruptcy Law, the Anti-Money Laundering Law, the Corporate State-owned Asset Law* and other relevant laws as well as the judicial interpretations of the Supreme People's Court are closely connected to capital markets, acting as a whole to provide a good external legal environment for the healthy and stable development and the efficient and safe operation of capital markets.

China Insurance Regulatory Commission

The legal system of China's insurance regulation is a four-layer system which consists of the *Insurance Law*, administrative regulations, rules and guidelines.

The *Insurance Law*, the basis of the legal framework of insurance regulation, was enacted in 1995 and revised in 2002 and 2009.

There are three administrative regulations in insurance regulation, i.e. the *Administrative Regulations on Foreign-invested Insurance Companies*, the *Regulations on Mandatory Third Party Liability Insurance*, and *Regulations on Agricultural Insurance*.

Fifty rules on insurance regulation are in force, covering market player management, product specification, asset management rules, suitability of persons, solvency regulation, and legal regulation.

Supervisory guidelines, set by the CIRC and its branches, state specific provisions of insurance operation and regulation.

As stated in Article 9, 134 and 135 of the *Insurance Law*, the mandate of the CIRC includes regulating domestic life insurance, property insurance, reinsurance, insurance intermediary markets and insurance asset management; formulating the development strategy, business planning and policies for the insurance sector; developing insurance supervisory rules; drafting relevant laws and administrative regulations.

Other major regulatory reforms

Banking sector

Major reforms in the banking sector include: 1) allowing qualified private capital to launch financial institutions such as small and medium-sized banks; and 2) establishing a deposit insurance system and improving the market-oriented exit mechanism of financial institutions. With respect to the former, CBRC has already licensed 5 banks sponsored by private capital and will carry out on-going supervision.

Capital markets

It is necessary to develop a multi-tiered capital market, accelerate the GEM reform, improve the National Equities Exchange and Quotations for SMEs, incorporate regional equity markets into the multi-tiered capital market system, establish a sound system of local government bonds, coordinate the development of qualified asset-backed securities, create and improve an IPO system focused on information disclosure, promote the reform of stock issuance and registration, expand capital market liberalization, facilitate cross-border investment and financing of domestic and foreign entities, extend the scope of qualified domestic and foreign institutional investors, increase their investment quota, and foster the connection between domestic and foreign exchange markets.

Insurance sector

Major reforms in the insurance sector include boosting the reform and innovation of the market, focusing on the reform of pricing mechanism, the reform of asset management system and the reform of market entry/exit mechanism.

Annex 2: Macroprudential bodies in selected countries

	Netherlands*	UK*	Germany*	US
Macroprudential body	Financial Stability Committee (FSC)	Financial Policy Committee (FPC) under the Bank of England (BoE)	Financial Stability Committee (FSC)	Financial Stability Oversight Council (FSOC)
Date of establishment	November 2012	April 2013 (an interim FPC in place since February 2011)	January 2013	July 2010
Legal status	Ministerial Decree	Law	Law	Law
Membership	7 members: 3 from the central bank (DNB) (including the President as FSC chair) and 2 each from the MOF and the conduct regulator (AFM). Each representative attends in a personal capacity. There are no formal independent external members, although external experts can be invited to attend as required.	10 voting members: Governor (who chairs the FPC); the Deputy Governors of the BoE for financial stability, monetary policy and prudential regulation (the latter is also the Chief Executive Officer of the Prudential Regulation Authority (PRA)); the BoE's Executive Director responsible for Financial Stability; the CEO of the Financial Conduct Authority (FCA); and four external members appointed by the Chancellor of the Exchequer. A representative of HM Treasury is a non-voting member of the FPC.	9 members: 3 each from the MOF (including the FSC Chair and Deputy Chair), Bundesbank and the prudential regulator (BaFin). Each representative attends in a personal capacity. The chair of the Federal Agency for Financial Market Stabilisation attends as a non-voting member, while third parties may be invited to attend meetings as appropriate.	10 voting and 5 non-voting members. The 10 voting members are the Secretary of the Treasury (Chair), Chair of the Federal Reserve Board, the heads of the OCC, SEC, CFPB, FDIC, CFTC, FHFA and NCUA, as well as an independent member (with insurance expertise) appointed by the President. The nonvoting members, who serve in an advisory capacity, are: the Director of the Office of Financial Research (OFR); the Director of the Federal Insurance Office; a state insurance commissioner; a state banking supervisor; and a state securities commissioner (or officer performing like functions).

Mandate	Forum in which the Dutch authorities with a responsibility for financial stability can meet to identify and discuss potential issues affecting the stability of the Dutch financial system and ways to mitigate the related risks.	Its primary objective is to identify, monitor and take actions to reduce or remove systemic risks so as to protect and enhance the resilience of the UK financial system. Its secondary objective is to support the economic policy of the government, including its objectives for growth and employment.	• Strengthening cooperation amongst institutions in the event of a financial crisis • Discussing the factors that are key to financial stability • Issuing warnings and recommendations • Advising on the handling of warnings and recommendations issued by the ESRB Reporting annually to the lower house of Parliament (Bundestag)	Statutory objectives are: to identify risks to the financial stability of the US; to promote market discipline; and to respond to emerging threats to the stability of the US financial system.
Decision-making	FSC does not take policy decisions; decision making responsibility remains with the relevant agency. Where consensus is not possible, decisions are made on a two-third majority of votes cast (MoF representatives have no voting rights with regard to decisions on warnings and recommendations).	The FPC is a statutory decision making body. If a consensus cannot be reached, then a decision will be taken by a vote of those voting members present at the meeting, with the FPC Chair having a casting vote.	Where consensus is not possible, FSC decisions generally require a simple majority. However, decisions on warnings and recommendations and on the submission of the FSC's annual report should be taken unanimously; the law confers veto power to the Bundesbank representatives with regard to these decisions.	Where consensus is not possible, decisions are based on majority voting (non-bank SIFI designations require a two-thirds majority vote, including that of the Chair).
Public communication	A summary of each meeting is published on the FSC website. Warnings and recommendations are generally made public. An annual report is produced for the Minister of Finance and sent to Parliament.	Decisions (including voting results) are announced via the semi-annual FSR or in an official statement shortly after a meeting.	Thus far, only 1 press release has been issued following its inaugural meeting. The authorities have expressed a preference for the FSC to only engage in public communication when necessary (e.g. to announce a warning or a recommendation) in order to maximise its impact. The FSC also reports annually on its activities to the Bundestag.	Minutes following each meeting, and the annual report, public announcements, studies and reports (often requested by Congress), and the website. FSOC sessions that discuss individual institutions or other market-sensitive information are not publicly disclosed.
Meeting frequency	At least twice a year	Quarterly	Quarterly	At least quarterly (but on an almost monthly basis thus far)

Authority	The FSC does not control any macroprudential policy tools. However, it can issue warnings to whoever it deems necessary, and may also issue alerts or recommendations to authorities or market participants in cases where they have a major influence on financial stability. Warnings or recommendations issued by the FSC are of a cautionary and advisory nature and are hence non-binding, with no requirement to 'act or explain', but FSC can monitor how addressees react to its warnings and recommendations.	The FPC has Direction powers over sectoral capital requirements, and has responsibility for setting the countercyclical capital buffer. The FPC can issue Directions and Recommendations to the PRA and FCA, and can make Recommendations to other bodies. The FPC Recommendations to the PRA and FCA can be made on a 'comply or explain' basis. The FPC reviews progress against previous recommendations and directions in its FSR, published twice a year.	The FSC does not control any macroprudential policy tools, although it may play a role in the calibration of tools provided under CRD IV/CRR and could make a recommendation on their deployment. The primary policy instrument at the disposal of the FSC is its ability to issue warnings or 'comply or explain' recommendations to public sector authorities. The responsibility for monitoring the follow-up of recommendations is assigned to the Bundesbank.	The FSOC does not control any macroprudential policy tools. However, it is authorised to determine systemically important non-bank financial companies (to be supervised by the Federal Reserve). The FSOC can also make "comply or explain" recommendations for heightened prudential regulatory standards in areas within the purview of a member agency, and it can impose them in limited situations. Although member agencies are encouraged to use the FSOC to coordinate and consult on their own regulatory initiatives, they are not obliged to incorporate the feedback they receive from the FSOC in finalizing their rules and regulations.
Supporting infrastructure	DNB Secretariat works with staff from other member agencies to prepare the meetings. Given its explicit financial stability mandate and analytical capacity, DNB carries out most of the risk assessment work discussed by the FSC. *Ad hoc* working groups can be formed as needed to support particular projects.	There are no standing subcommittees supporting the FPC, which is supported by a broad range of staff. A dedicated FPC Secretariat, housed within the BoE, is responsible for coordinating the wide-ranging inputs to the FPC, as well as supporting the Committee's outputs, including some of its public communications.	Logistical and secretarial support for the FSC is provided by the MOF, with coordination units at Bundesbank and BaFin. There are no standing committees of deputies or technical staff from member agencies to discuss issues in advance of FSC meetings. This is because the analytical support for the FSC's activities (including for risk assessments) is provided predominantly by the Bundesbank.	The FSOC is supported by: a Secretariat and the OFR within the US Treasury; and several standing committees, including the committees of Deputies, Systemic Risk (Institutions and Markets sub-committees), Designations of Nonbank Financial Companies, Designations of Financial Market Utilities, Heightened Prudential Standards, and Data.

Sources: FSB peer review reports (http://www.financialstabilityboard.org/publications/peer-review-reports/), national websites.

* *The ESRB issued a recommendation in 2011 calling upon EU member states to "designate in the national legislation an authority entrusted with the conduct of macro-prudential policy, generally either as a single institution or as a board composed of the authorities whose actions have a material impact on financial stability. The national legislation should specify the decision-making process of the governing body of the macro-prudential authority" (see http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf).*

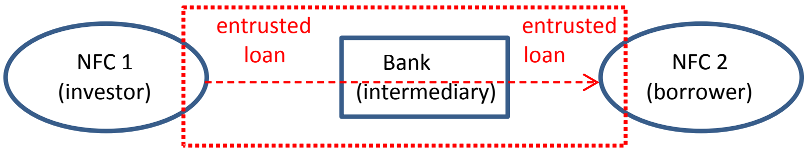
Annex 3: Entrusted loans, trust companies and WMPs

Entrusted loans

Entrusted loans is a form of lending used by non-financial firms as well as securities firms and insurance companies, which are not allowed to engage in lending business since 1996. It typically involves lending by bigger companies – with easy access to funding – to their subsidiaries or to smaller companies for commercial (e.g. supplier/trade credit) or financial (i.e. profit-making) reasons. The demand for these types of loans is particularly high in sectors subject to credit or window guidance, such as those with excess capacity (e.g. real estate, LGFVs).This form of lending has experienced strong growth in recent years, with an estimated annual growth rate of about 40% since 2009. Its size was estimated to be around RMB 9.3 trillion as of end-2014, or 15% of GDP.

An entrusted loan transaction is a deal between a borrower and a lender using a bank as an intermediary. The transaction is structured as follows: i) the borrower and the lender agree on the terms of the contract (size, maturity, interest rates); ii) both apply to the bank to initiate the transaction; and iii) if the bank approves the transaction, it will disburse the funds to the borrower on behalf of the lender, supervise the utilization of those funds, and help with their repayment at the end of the term. Graph 1 describes a simple entrusted loan structure.

Graph 1: Entrusted loan structure



A non-financial counterparty (NFC) 1 provides funding for NFC 2 through a bank that acts as an intermediary. The bank receives a commission fee, while the NFCs agree on terms of the loan (amount, tenor, interest rates).

As entrusted loans are not on the bank's balance sheet, this type of transaction does not involve prudential requirements. The bank charges a commission fee for the service it provides to the borrower and the lender. It also examines the use of loans as specified in the loan agreement and evaluates the total indebtedness of the borrower in credit decision-making. Although the bank is not exposed to credit risk, it may be responsible for any operational risk to the extent that it did not act in accordance with the terms of the contract.

The authorities have taken measures in recent years to better monitor the evolution of entrusted loans and limit associated risks. In addition, the CBRC will issue guidance to banks that prohibits on-lending, i.e. using bank loans to fund entrusted loans, and clarify the rights and obligations of the parties involved in entrusted loans. To improve monitoring, the PBC is developing a more refined statistic that excludes intra-group lending (i.e. parent company lending to its subsidiaries, which does not represent true intermediation) from entrusted loans.

Trust companies

Trust companies conduct asset management businesses on customers' behalf and are supervised and regulated by CBRC. Their shareholders comprise financial institutions, non-financial companies and individuals. As of end-2014, there were 68 trust companies.

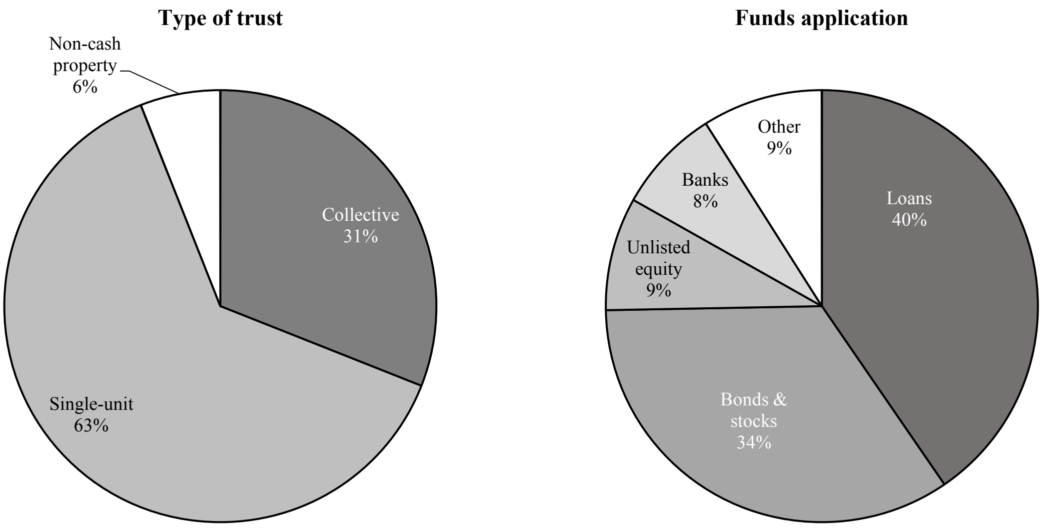
Trust companies manage different types of trusts by investing in financial assets such as bonds and equity, and by extending loans. Trust products are sold to investors, and resemble closed-ended funds with a maturity of at least 1 year (in practice, most trusts have a maturity of 1-3 years). Although these products cannot generally be redeemed, rights to the underlying cash flows can be transferred in the secondary market through instruments called trust beneficiary rights. Trust companies can also invest on a proprietary basis, but their assets must be segregated from the assets of the trusts that they manage, with separate book-keeping and management requirements. According to the law, trust companies have should not provide guarantees. In addition, banks cannot provide any direct or indirect, explicit or implicit guarantees on the performance of such products.

As of end-2014, proprietary assets of trust companies amounted to RMB 359 billion, while their assets under management were RMB 14 trillion (22% of GDP), of which RMB 5.3 trillion (more than 8% of GDP) represented trust loans.

The business model of trust companies can be divided into two main types (see Graph 2):

- *Single-unit trusts* (almost two-thirds of total assets under management) have one investor. The trust product is typically tailored to the investor's requirements.
- *Collective trusts* (almost one-third of total assets under management) involve more than one investor. These are developed by the trust company that sells the trust product to a group of qualified investors.

Graph 2: Trust types and assets under management (end-2014)

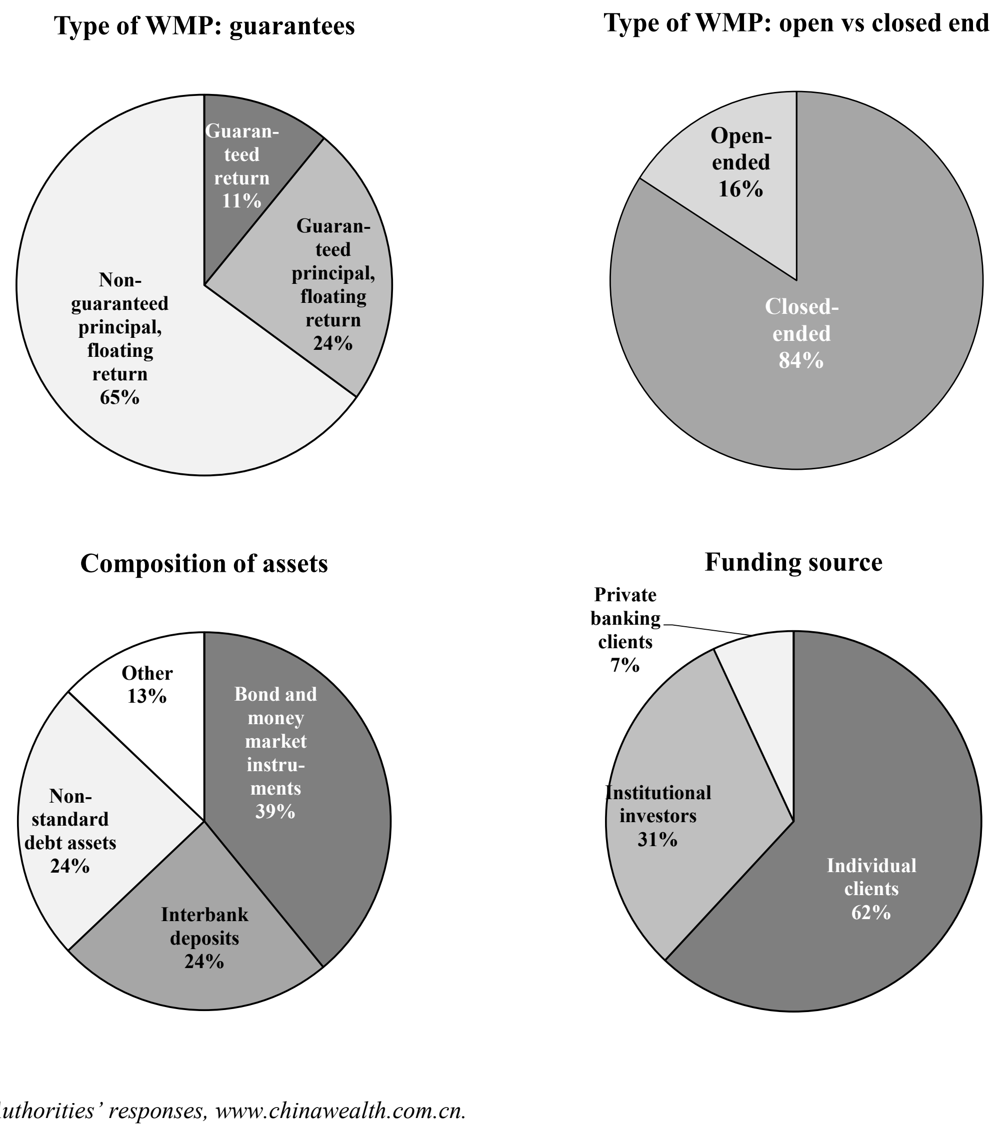


Source: China Trustee Association.
Note: The figures are based on the proportion of total trust assets under management.

Wealth Management Products (WMPs)

WMP is a generic term for investment products issued by financial institutions. These can be issued by banks, trust companies and asset management subsidiaries of securities, futures, funds and insurance companies. These products are generally closed-end and their maturities are predominantly short-term (the main exception being those issued by insurance companies). WMPs can also invest in WMPs issued by other companies, but bank WMPs cannot invest in WMPs provided by banks.

Graph 3: Banks' Wealth Management Products (end- 2013)



Source: Authorities' responses, www.chinawealth.com.cn.
Note: The figures are based on the proportion of total bank WMP assets.

Bank WMPs (see Graph 3):[49] Introduced in 2005, bank WMPs are short-term products with a maturity generally less than one year.[50] At the end of June 2014, bank WMPs amounted to RMB 12.7 trillion (22% of GDP). At the end of 2013, the bulk of these products were closed-ended products sold to individual clients and institutional investors. Their average return in 2013 was 4.5%, compared to the one-year benchmark rate (3%) for bank deposits.

Bank WMPs are not permitted to grant loans, although they can invest in trust products that provide loans. In March 2013, the CBRC required that the proportion of non-standard credit assets invested by bank WMPs must be less than 35% of their balance and less than 4% of the bank assets. At the end of 2013, bank WMPs had invested in trust loans in the amount of RMB 2.8 trillion.

Non-guaranteed bank WMPs, which comprise two-thirds of total assets, are off-balance sheet and not counted as deposits. By contrast, guaranteed products are on-balance sheet and are therefore included as deposits in the calculation of relevant regulatory requirements (e.g. liquidity coverage ratio, loan-to-deposit ratio, reserve requirements). These can either have guaranteed principal and returns, or only guaranteed principal with floating returns.

WMPs issued by trust companies: Trust companies sell WMPs to HNW individuals and institutional investors. The total number of investors in each WMP cannot exceed 50. While retail clients are not permitted to invest directly in trust products, other financial products (including bank WMPs) can also invest in these products. Trust companies and other financial institutions can distribute trust products; however, public marketing is not allowed.

Generally, investors hold trust WMPs until they mature. It is not possible to redeem these products prior the redemption date. However, the trust beneficiary rights can be transferred to another investor, i.e. a trust product can be sold in a secondary market.

WMPs issued by securities, futures and fund firms: WMPs issued by the asset management subsidiaries of these firms are sold to individual and institutional investors. At the end of 2013, assets under management amounted to about RMB 5 trillion for the TAM business, RMB 1 billion for the futures asset management business and RMB 0.9 trillion for the fund asset management business.

WMPs issued by insurance companies: The asset management subsidiaries of insurance companies also sell WMPs to investors. The funds collected can be invested directly in financial assets or in other financial products, such as trust products. These funds can be used to grant loans in the form of fixed income investment plans, which are capped at 30% of the insurance asset management companies' investments. These plans, with an average maturity of around 7 years, invest in infrastructure such as transportation, energy, communications, municipal services and environmental protection and commercial estate.

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[49] See the Annual report on China's Banking Wealth Management Market 2013 and the Semi Annual Report on China's Banking Wealth Management Market for the first half of 2014 (available at http://www.chinawealth.com.cn).

[50] As of end-2013, around 74% of bank WMPs had a maturity of less than 3 months, while products with a maturity of more than 1 year represented less than 1% of total assets.

Annex 4: Follow-up of other key FSAP recommendations

This Annex presents the follow-up actions reported by the Chinese authorities to key FSAP recommendations that are not covered in sections 2 and 3. The actions mentioned below have not been evaluated as part of the peer review and are presented solely for purposes of transparency and completeness.

Recommendations	*Steps taken to date and actions planned (including timeframes)*
Improving commercialization	
Continue to advance the process of interest rate and exchange rate reform, while ensuring that appropriate credit risk management practices in financial institutions are in place.	**Interest rate reform** ● The deposit rate cap of financial institutions was increased from 100% to 110% of benchmark deposit rate，and the lending rate floor was decreased from 90% to 70% of benchmark, respectively on 8 June and 6 July 2012. In Nov. 2014, the deposit rate cap was further increased to 120% of the benchmark. ● On 20 July 2013, the PBC removed the lending rate floor for banks. ● A self-regulatory mechanism for market interest-rate pricing by financial institutions was created and improved. Centralized quotations and release mechanisms for loan prime rates were launched. ● On 8 December 2013, *The Interim Provisions for Administration of Interbank Negotiable Certificates of Deposit* was published. The issuing and trading of these instruments is steadily advancing. ● For the next stage, the market-based interest-rate reform will be promoted by gradually increasing the market pricing range of liability products, building a fairly complete market-based interest-rate system, and improving the central bank interest-rate adjustment framework and the transmission mechanism. **RMB exchange-rate regime reform** ● On 17 March 2014，the RMB's trading band against the U.S. dollar was widened to 2% from 1% in the interbank spot foreign exchange market. ● Innovations in exchange-rate risk management were promoted. ● The market-based RMB exchange-rate regime reform will be furthered to enhance the flexibility of the exchange rate and to keep it basically stable at an adaptive and equilibrium level.
Clearly delineate the roles and functioning of policy financial institutions from commercial financial institutions.	● The reform plan of China Export & Credit Insurance Corporation was approved in May 2011. ● The reform plan of the Agriculture Development Bank of China was approved in 2014. The reform of the Export-Import Bank of China was approved in 2015. These two institutions will be more policy oriented with clear business classification, and their policy function will be strengthened after the reform.
Transform the four Asset Management Companies (AMCs) into commercial	● China Cinda Asset Management Co., LTD and China Huarong Asset Management Co., LTD completed shareholding reform respectively in 2010 and 2012.

entities and, as a first step, require them to publish periodic financial statements and management reports.	● China Cinda Asset management Co., LTD. got listed in Hong Kong in December 2013, and the annual reports including financial statements and management reports will be released periodically. ● China Huarong Asset management Co., LTD has introduced strategic investors to optimize ownership structure in August 2014. Reform of China Orient Asset Management Corporation and China Great Wall Asset Management Corporation is underway.
Increasing efficiency of the institutional, regulatory, and supervisory framework	
Empower the PBC and three supervisory commissions with focused mandates, operational autonomy and flexibility, increased resources and skilled personnel, and strengthen interagency coordination to meet the challenges of a rapidly evolving financial sector.	● As for regulatory resources, the authorities kept deepening the reform of the management system of officials and personnel, improved the requirement for new employees, imported high-end overseas talents, strengthened employee training and international exchange, and stabilized the skilled by optimizing salary system. Meanwhile, the authorities have further enhanced the off-site surveillance system and on-site system, and improved the risk early warning system, by which the supervision effectiveness has been maintained without increasing headcount. ● As for interagency coordination, the authorities held meetings on the balanced development of capital market and other areas of financial market in 2012, published *Memoranda on Jointly Maintain Financial Stability by Strengthening Cooperation of Supervision on Securities and Futures.* In August 2013, the State Council agreed to establish the Financial Regulatory Coordination Joint Ministerial Committee led by the PBC.
Develop a framework for regulation and supervision of financial holding companies (FHCs), financial conglomerates, and informal financial firms. In the interim, acquisition of a regulated institution should be approved by the regulatory commission responsible for the underlying financial institution.	● The PBC is making a push to clearly define the regulatory body of FHCs as well as formulate relevant regulatory rules. The rules are aimed to: 1) strengthen capital adequacy regulation, avoid multiple calculations of capital and capital arbitrage, and effectively control leverage; 2) enhance the regulation on affiliated transaction in line with the fair value pricing principle and the transparency principle, enhance risk concentration regulation, so as to reduce the possibility of cross-sector risk contagion; 3) improve corporate governance, reinforce the qualification criteria for shareholders and management, in order to prevent the controlling shareholders from abusing the power to infringe the legitimate rights and interests of small shareholders and clients. ● The CBRC has further improved its regulation and supervision of banking groups. The CBRC issued the Guidelines on Consolidated Banking Supervision in 2008, which provides a comprehensive framework for consolidated supervision of banking groups, including the scope, elements and methods of consolidated supervision, requirements for consolidated supervision of cross-border activities, and guidance on banking groups' own management activities on a consolidated basis. In 2013, the CBRC started to amend the Guidelines, and has issued the amended version at the end of 2014, with the purpose of adapting to the new financial regulatory requirements after the financial crisis. The amended version enhanced the framework for consolidated supervision of the banking groups, including the scope of consolidation, corporate governance, comprehensive risk management, capital, concentration, intro-group transactions, ring-fencing, as well as requirements for supervisors.

	Under relevant rules and regulations, such as Supervisory Rules on Licensing Matters Concerning Commercial Banks, acquisition activities conducted by banks should be approved by the CBRC. ● The CSRC is developing measures for the license administration of financial institutions in securities and futures industry, actively piloting integrated financial operations in a steady manner, while formulating more specified regulations. Regulatory information has been communicated regularly among PBC, CSRC, CBRC and CIRC, to strengthen regular information exchange and regulatory cooperation. ● The CIRC is proactively improving supervision of insurance groups and non-insurance institutions. The CIRC is making the *Guidance of Consolidated Regulation of Insurance Groups* and the rules on the solvency of insurance groups, in order to implement the concept of group supervision and prevent risks associated with insurance groups. The CIRC is conducting research on the *Regulation of Non-Insurance Subsidiaries of Insurance Companies*, which will be formulated this year, to strengthen the regulation of the cross-sector investment of insurance companies and to avoid regulation arbitrage. *The Administrative rules on Merger and Acquisition of Insurance Companies* was issued in March 2014 and took effect on 1st June, to supervise the merger and acquisition activities of insurance companies.
Introduce a more forward-looking assessment of credit risk in the China Banking Regulatory Commission (CBRC) risk rating system and eliminate deviations from the capital framework for credit and market risk.	● The assessment of credit risk is more forward-looking. During ongoing supervision, the CBRC requires banks to strengthen the analysis of potential credit risks. Both bottom-up and top-down stress tests have been conducted to improve the forward-looking assessment of credit risk. Meanwhile, the CBRC has paid close attention to the impact of economic restructuring, asset price changes and other macroeconomic and financial market conditions on the risk of the banking sector, and strengthened guidance and risk warning. Actions have been taken to address the potential risks of the banking sector. ● In 2014, the CBRC revised the Internal Guidance of Supervisory Ratings of Commercial Banks (the new Guidance) to make the CAMELS+ based supervisory rating system more forward-looking and comprehensive to keep pace with the development of the banking institutions in China. Firstly, the assessment of credit risk is more forward-looking. It is required in the new Guidance that risk trend should be fully taken into account when assigning ratings. Supervisors should use their expert judgment to assess the extent that the asset quality of a bank may deteriorate when indicators show that credit risk is increasing. Meanwhile, the trend of non-performing loans and other non-performing assets should be assessed along with the current credit quality. Moreover, the weighting of the quantitative and qualitative assessment has been adjusted to emphasize the expert judgment of supervisors, to make the assessment more forward looking. Secondly, the assessment of credit risk is more comprehensive. In the new Guidance, a series of indicators such as the ratio of loans overdue more than 90 days over NPL, credit concentration ratio and provisioning coverage ratio are used for the quantitative analysis along with NPL ratio. The asset quality of both on and off balance sheet items is to be assessed to fully capture the risks on and off balance sheet. The quantitative assessment is based

	on the arithmetic average of the four quarter-end data rather than year-end figures, in order to smooth the fluctuation of the year-end data. In addition, a number of newly implemented supervisory standards such as the Liquidity Coverage Ratio are introduced into the quantitative assessment to reflect risk in a more comprehensive way. ● The deviations from the capital framework for credit and market risk are eliminated. The CBRC issued the Capital Rules for Commercial Banks (Provisional) (the new Capital Rules) on 8 June 2012, which became effective on 1 January 2013. The new Capital Rules removed the threshold of the market risk capital requirements in the previous rules (i.e. only banks with trading positions exceeding 10 percent of on-and off-balance sheet assets or more than RMB 8.5 billion are required to compute capital for market risk), and extended the market risk capital requirements to all commercial banks. It is stipulated in the new Capital Rules that "where a commercial bank uses standardized approach for credit risk, excess loan loss provisions can be included in Tier 2 capital subject to a limit of 1.25% of credit risk-weighted assets at maximum", which is consistent with the Basel framework.
Introduce a formal program whereby the China Securities Regulatory Commission (CSRC) conducts regular comprehensive on-site inspections of the exchanges to improve oversight.	● Recently, the CSRC has adopted on-site inspection in regulating stock and futures exchanges. On-site inspection of information systems, for example, has been conducted by the CSRC for several times, with experts conducting comprehensive on-site inspection to the information systems of stock and futures exchanges, formulating a set of forms and regulations. The latest information system security check carried out in August 2013, when the CSRC conducted a comprehensive examination on the IT-related management, the server room, the networks and information systems of the exchanges; ● The CSRC will explore specific on-site inspecting approach and frequency regarding the exchanges in fulfilling their self-regulatory functions and enforcing business rules, etc., with an all-inclusive and feasible plan and a formal system to promote on-site inspection to the exchange in an orderly manner.
Introduce a risk-based capital (RBC) solvency regime for insurance firms with suitable transition period and restrict new businesses by insurance companies operating below the 100% solvency level.	● In March 2012, the CIRC launched the project to establish the China Risk Oriented Solvency System (C-ROSS) and scheduled to make it compatible to the international standards and suitable to the national condition in 3-5 years. Now the work on C-ROSS is steadily advancing, and all the technical standards of C-ROSS and plans of switching to the new solvency system will be in place by end-2014.
Develop explicit and clear regulation for facilitating the exit of insurance companies from the market via run off or portfolio transfers.	● *The Interim Provisions for Administration of Portfolio Transfers of Insurance Companies* was enacted in 2011, which laid the foundation of the framework and procedure of portfolio transfers of insurance companies.
Enact a payment system law to give full protection to payments, derivatives and securities settlement	● The PBC has been actively promoting the formulation of *Regulation on Payment and Clearing Systems,* which could provide settlement finality of payment, securities and OTC derivatives transactions. As the formulation involves several authorities, the final publication still

finality.	need more time. ● Securities Law is being amended, which includes the articles of payments, derivatives, and securities settlement finality. The draft Securities Law (Amended) is expected to be sent to the Standing Committee of the NPC in April 2015.
Ensure that beneficial ownership and control information of legal persons is adequate, accurate, and readily accessible to competent authorities.	• *The AML Regulation of Designed Non-Financial Businesses and Professions,* which indicates Designed Non-Financial Businesses and Professions shall perform customer due diligence obligations, and know the beneficial ownership and control information of the legal person, is in consultation and expected to come out in three years.
Improve information sharing and coordination arrangements among the PBC and other agencies on anti-money laundering (AML) and other supervisory issues.	• The JMC has been established, which is responsible for guiding the national AML, making the AML policies, coordinating the departments, and mobilizing the whole society to supporting AML. • The information sharing mechanism among PBC, CBRC, CIRC and CSRC is being established.
Upgrading the framework for financial stability, systemic risk monitoring, systemic liquidity, and crisis management	
Enhance the sterilization of structural liquidity through market-based instruments and manage systemic liquidity spillovers via indirect monetary policy instruments.	• The PBC further improved liquidity management system, flexibly adjusted liquidity levels by using multiple policy instruments such as open market operations, strengthened dealing with short term liquidity volatility, and maintained the stability of banking system's liquidity and interest rates on the money market. • As for the structural shortage of banking system's liquidity, the PBC used policy instruments including central bank lending and central bank discounts, aiming to meet the reasonable liquidity requirements of financial institutions.
Introduce reserve averaging to facilitate liquidity management and enhance stability and efficiency.	• The PBC is researching reserve averaging and improving related data reporting and processing system.
Start targeting a short-term repo rate on a pilot basis, as a trial of indirect liquidity management, and commence daily open market operations.	• It's inappropriate to target a short-term repo rate now, because the liquidity in the banking system is relatively abundant. • The PBC does open market operations twice a week, which is basically enough for liquidity management. • The PBC created the Short-term Liquidity Operations to smooth the volatilities in liquidity of banking system from one open market operation to the next.
Ensure that PBC's standing facilities operate immediately and automatically, with specified collateral requirement identical across all domestically	• At the beginning of 2013, the PBC established the Standing Lending Facility (SLF), with specified collateral requirement identical across all domestically financial institutions with a legal person. In January 2014, some branch offices of the PBC conducted pilot SLF operations. • The PBC is doing research on enlarging the pilot areas of SLF

incorporated institutions.	operations by branch offices.
Introduce a deposit insurance scheme to assist in the orderly wind-down of financial institutions and to help clarify the contingent liability.	• China is actively making progress in establishing the deposit insurance system. Establishing a deposit insurance system to improve the market-oriented exit mechanism of financial institutions is one of China's major tasks in the financial reform area. China is ready for establishing the deposit insurance system and will carry it out in a timely manner.
Developing securities markets and redirecting savings to contractual and collective investment schemes	
Ensure regulations are consistent and clarify regulatory responsibilities to support fixed income market development.	• China's interbank bond market is supervised by the PBC, exchange traded market is supervised by CSRC and enterprise bonds are regulated by the NDRC. • The PBC introduced the coordination mechanism for credit bonds in 2012, involving the NDRC and CSRC. Under the mechanism, the three regulatory authorities have actively communicated, bolstered regulatory coordination, and clarified regulatory obligations; established information sharing mechanism in March,2012, to periodically exchange issuance and trading data of various bonds; added more qualified bonds to cross-market trading.
Continue to improve bond issuance strategies between Ministry of Finance (MOF) and PBC to help improve the existing market-making across all maturities of the yield curve.	• In 2011, the PBC and MOF jointly issued the announcement to introduce the market-making arrangement of on-the-run key-term treasury bonds. The PBC and MOF are jointly considering the implementation of a supporting mechanism for treasury bonds market-making. • In 2012, re-issue framework of tradable treasury was established to increase the liquidity of treasury market. • In 2013, when-issued trading of 7 years treasury was piloted on the Shanghai Stock Exchange. When-issued regime will be applied to all key-term treasury in 2014. • In 2013, trading of treasury futures was allowed.
Upgrade regulatory and operational repo market framework to increase market liquidity, enhance risk management and reinforce the money and bond market interest rate nexus.	• In 2013, permitted by the PBC, National Association of Financial Market Institutional Investors announced *China Interbank Market Bond Repo Master Agreement*. This master agreement combined the old pledged repo master agreement and buyout repo master agreement into one, meanwhile absorbing the merits of global repo master agreements, which is helpful for promoting the efficiency of repo market and enhancing the risk management. • In the near future, the PBC plans to modify the regulations of repo, and explore to optimize trading and clearing mechanism of repo, so that the repo market can further develop.
Ease the 40% of net assets limit applicable to corporation's market based debt issuance to expand their direct funding capacity.	• The regulatory authorities have proposed to the draft committee of Securities Law (Amended) on lifting the restriction that the accumulated public issuance of corporate bond cannot exceed 40% of net assets. The draft Securities Law (Amended) will be sent to the Standing Committee of the NPC in December 2014. • In May 2012, the pilot of SME private placement bond was officially launched. The bonds were issued through non-public offering, hence exempted from the limit for public issuance, which requires

	cumulative balance of less than 40% of net assets.
Upgrade links between China Central Depository Trust & Clearing Co., Ltd (CCDC) and Securities Depository and Clearing Corporation Limited (SD&C) to enhance connectivity among Interbank Bond Market, Shanghai Stock Exchange, and Shenzhen Stock Exchange, support further development, and contribute to efficiency in all three markets.	• The PBC are adding more bonds of large scale high-quality issuers listed in exchange, in order to promote the interoperability in bond markets, such as cross-market trading, securities custody transfer, etc. In 2013, the PBC approved of China Development Bank's issuing RMB 30 billion bonds in exchange, of which RMB 26 billion has been successfully sold by the end of April, 2014. • From January to April 2014, securities custody transfer between the two markets totalled RMB 89.2 billion, rising by 56.9% over that from January to April of 2013. • The CCDC and SD&C are seeking extended scope of business cooperation, to enhance the efficiency of cross-market linkage.
Consolidate the multi-pillar pension system, with emphasis on the funded component.	• In March 2011, the State Council published *the Opinions on Promoting the Function-based Reform of Public Institutions*, putting emphasis on promoting social security system reform. • In February 2014, the State Council published *the Opinions on Establishing a Unified Pension System between Urban and Rural Residents*.
Improving alternative financing channels and access	
Review existing government programs to determine their effectiveness in promoting rural and micro and small enterprise (MSE) finance and formulate an integrated and coherent rural and MSE finance strategy.	**Rural Financing** • The combination of monetary, credit and other policy instruments was optimized. The PBC used various monetary policy tools, such as central bank lending and discounts for the agricultural sector and differentiated required reserve ratio, to expand the using of central bank lending to agriculture, encourage and guide financial institutions to beef up support to the agricultural sector, rural areas and farmers. The PBC has strengthened macro credit policy guidance, promoted the innovation in the interbank market, and broadened financing channels of the industrialization of agriculture leading enterprises. • Rural financial organization system was improved. The CBRC actively fostered the development of new type rural financial institutions such as rural village banks. By the end of 2013, 1,071 village banks, 14 lending companies and 49 rural fund mutual cooperatives had been established, of which the rural and MSEs loan accounted for 90% of their total loans, and the private capital accounted for 71% of all the capital. • The rural financial service of infrastructure construction was strengthened. The regulatory authorities have improved the rural non-cash payment and settlement services, by means of establishing the standard outlets, simple outlets, automated teller machines, point-of-sale machines and so on, to cumulatively filled the gap in 1249 towns without institutions and 708 rural towns without service. Credit ratings of peasant households have also been carried out. So far, credit files for 148 million peasant households have been established, and credit ratings for 97.8 million peasant households have been made. Rural financial knowledge has been popularized by organizing

	activities of "Sending Financial Knowledge to Countryside" • Innovation of the rural financial services was promoted. Since 2012, great efforts have been made to promote the financial services of rural small and medium-sized financial institutions into the villages and community, loan transparency, and financial innovation to enrich and benefit farmers. **MSE Financing** ● The authorities optimized the policy instruments and strengthened macro guidance of credit. Using differentiated required reserve ratio, central bank lending and discounts, the PBC encouraged financial institutions to increase credit for MSEs. The PBC promoted the innovation of credit products and services, improved the assessment of MSE credit policy, and guided financial institutions to seriously implement the policies and measures. ● The authorities guided commercial banks to innovate new financial service for MSEs. Small financial institutions are encouraged to set up to increase the financial supply for MSEs. It is also required that various malpractices such as unreasonable charges and high fees should be prohibited, in order to reduce the MSEs' financial cost effectively. ● The authorities has encouraged MSEs to raise funds through the issuance of non-financial corporate debt financing instruments, supported qualified financial institutions to issue financial bonds earmarked for MSE loans. ● The authorities promoted the construction of enterprise credit system and the financing guarantee system to create a favourable financial environment for MSEs.
Further reform the rural credit cooperatives to enhance their efficiency and sustainability as commercial providers of financial products and services.	• The equity base was fully consolidated. The authorities actively promoted the reform of property system of rural credit cooperatives (hereinafter as RCCs) by introducing high-quality corporate shareholders, effectively guiding some institutions to issue qualified capital instruments to improve capital quality. • The shareholding reform was steadily promoted. The CBRC pushed forward the reform of transferring RCCs to rural commercial banks (hereinafter as RCBs). At the end of 2013, there were 590 RCBs and rural cooperative banks with their assets, liabilities and owners' equity accounting for over 50% of all rural cooperative financial institutions. • The pace of transformation of internal management was accelerated. The CBRC urged rural financial institutions to improve their corporate governance, management mechanism, and internal controls; piloted construction of overall risk management and process management, and implementation of *the new Capital Rule;* pushed forward the establishment of modern financial enterprises system. • The agricultural financial services were continually increased. By innovating financial products and services, the rural financial institutions have preliminarily constructed a multi-level, wide-coverage, and sustainable agriculture financial service network system, resulting in a remarkable improvement in the overall agricultural financial service capability and quality. By the end of

	2013, outstanding agro-related loans and lending to rural households from rural cooperative financial institutions were RMB 6.2 trillion and RMB 3 trillion, respectively, a year-on-year growth of 18.3% and 14.5%, correspondingly. • By the continuous and deepening reform, the RCCs were significantly improved. Their management and operational capacity, capital quality and risk management were greatly enhanced. And their efficiency and sustainability in providing financial products and services were much better than before.
Complete the reform of the Postal Savings Bank (PSB) by optimizing equity ownership, overhauling the bank to become a corporation, and building effective corporate governance.	• In January 2012, the Postal Savings Bank of China Ltd (PSBC) was restructured from a limited liability company to a limited stock corporation， owned by China Post Group. • The PSBC has introduced independent directors and external supervisory directors to enhance professionalism of the board of directors and the board of supervisors. It also clarified the responsibilities of the boards and the senior managements to enhance the effectiveness of corporate governance.