Publication of Program for Reforming China's Financial Sector by 2015

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I. China announces 12th five-year plan for the financial industry

On 17 September 2012, China's State Council (cabinet) announced its 12th Five-Year Plan for the Development and Reform of the Financial Industry. The Plan was devised by five financial regulators: the People's Bank of China, the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC), and the State Administration of Foreign Exchange (SAFE), and is divided into nine chapters.

Specifically, it reviews the 11th five-year plan for the financial industry and provides seven core guidelines reflecting the opportunities and challenges faced by China's financial industry during the five-year period (2011-2015) covered by the 12th five-year plan: (1) establishing controls of the financial industry, (2) optimizing rules for financial institutions, (3) building diverse financial markets, (4) deepening financial reforms, (5) promoting reform and opening of the financial industry, (6) maintaining the stability and safety of the financial industry, and (7) strengthening the infrastructure for the financial industry. Lastly, it seeks to guarantee the mechanisms to achieve these aims (Figure 1).

In this paper, we look at the Plan in detail and consider the opportunities it presents for foreign financial institutions and investors.

II. Establishing quantitative and qualitative targets

1. Establishing quantitative targets

1) Setting a target for the financial sector's share of GDP

The Plan includes two numerical targets to be achieved by 2015.

The first is for the financial sector's share of GDP to be raised to around 5% during the period covered by the Plan.

Figure 1: Composition of 12th five-year plan for development and reform of the financial sector

Preamble	
Chapter 1	Accelerating the reform and opening of the financial sector and promoting change in China's growth model
Section 1	Main achievements from financial reform and development under the 11th Five-year Plan
Section 2	Opportunities and challenges under the 12th Five-year plan
Section 3	Guidelines
Section 4	Main objectives
Section 5	Policy focal points
Chapter 2	Improving macro controls and promoting stable and sound economic development
Section 1	Establishing a robust macroprudential policy framework for the financial sector
Section 2	Enhance systems for controlling monetary policy
Section 3	Expand financial support to under-served sectors
Section 4	Further strengthening of macro-economic policy coordination
Column 1	Macroprudential policy framework for the financial sector
Chapter 3	Optimize income distribution and build modern financial organizations
Section 1	Improving the banking industry's organizational structures
Section 2	Promote the rules-based development of the securities industry
Section 3	Encourage innovation in and development of the insurance industry
Section 4	Continue proactively and steadily promoting experimentation with universal banking
Chapter 4	Encourage innovation and accelerate the establishment of a multi-layered financial market architecture
Section 1	Focus on improving the stock market
Section 2	Proactively developing the bond market
Section 3	Continue to develop money, foreign exchange, and gold markets
Section 4	Proactively nurturing the insurance market
Section 5	Promoting development of the futures and financial derivatives markets
Column 2	Instruments to mitigate credit risk in the interbank market
Chapter 5	Reforming and continuously improving financial operational mechanisms
Section 1	Gradually implement market reforms for (deregulate) interest rates
Section 2	Improve mechanisms for forming yuan exchange rates
Section 3	Gradually achieving convertibility of the yuan in capital accounts
Section 4	Further improving the management of foreign currency reserves
Section 5	Continuing reform of financial institutions
Section 6	Encouraging and guiding the participation of private-sector capital in the service industry
Chapter 6	Further opening the financial sector on a win-win basis
Section 1	Making the financial sector more open to overseas participation
Section 2	Gradually expanding the yuan's cross-border use
Section 3	Strengthening financial cooperation between Mainland China and Hong Kong, Macau and Taiwan
Section 4	Enhancing international and regional financial cooperation
Column 3	Cross-border trade and investment settled in yuan
Chapter 7	Strengthening regulatory oversight for financial stability and security
Section 1	Continuing to strengthen financial oversight
Section 2	Raising the effectiveness of financial regulatory coordination
Section 3	Strengthen mechanisms to prevent and provide early warning of systemic financial risks
Section 4	Establishing and improving deposit insurance and market exit mechanisms for financial institutions
Section 5	Improving the financial oversight of local governments
Section 6	Guiding and regulating the sound development of private lending
Column 4	Deposit insurance
Chapter 8	Strengthening foundations and optimizing the environment for development of the financial sector
Section 1	Continue with and enhance improvements in the financial sector's legal framework
Section 2	Strengthen payments systems, social credit mechanisms, and anti-money laundering programs
Section 3	Improve accounting standards and data collection in the financial sector
Section 4	Improve the leverage of IT in the financial sector
Section 5	Strengthening protections of financial consumers
Section 6	Raising the level of research in the financial field
Section 7	Developing pools of financial industry professionals
Section 8	Promoting the establishment of industry self-regulatory organizations
Chapter 9	Improving mechanisms for assuring plan implementation
Section 1	Organizing and strengthening direction of plan implementation
Section 2	Enhancing harmonization and integration with other plans
Section 3	Establishing and improving mechanisms for evaluating the plan
Annex	Indicators of financial sector development during the 12th Five-year Plan and their explanation

Note: Published on 17 September 2012.
Source: Nomura Institute of Capital Markets Research, based on data from the People's Bank of China

That share of China's GDP was 4.46% from 1990 until 2000 and 4.42% from 2001 until 2010. In setting these targets for the financial sector's share of GDP, China referenced its own calculations for those shares in the US (3.22% in the 1950s, 5.59% in the 1980s, and 8.01% in the 2000s) and Japan (5.79% in the 1980s and 6.53% in the 2000s) at relative stages of their economic development. We note that statistics from Japan's Cabinet Office show that the financial and insurance sector had a 4.9% share of Japan's GDP in 2010.

The Chinese government is targeting average annual growth in real GDP of 7%, and even faster growth for the financial sector, during the period covered by the 12th five-year plan.

2) Targets for total social financing

Another numerical target is to increase the percentage of total social financing accounted for by direct financing by nonfinancial corporations to at least 15% by end-2015.

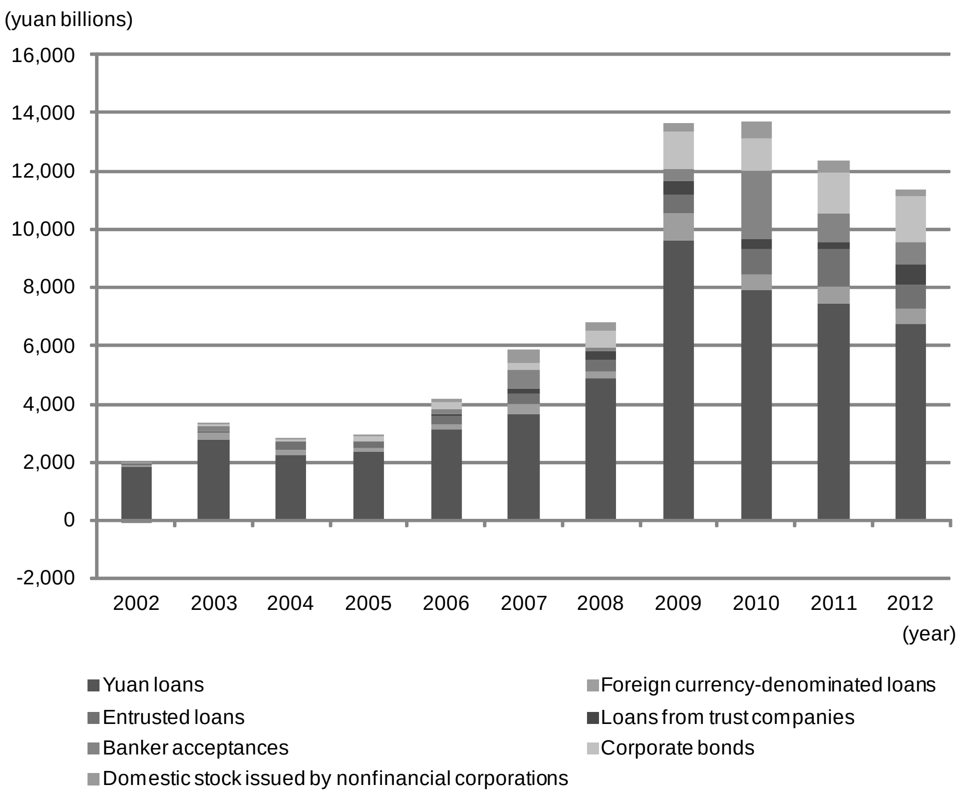
Total social financing is a monetary policy indicator established by the People's Bank of China and refers to the total amount of funding in the real economy within a specified time period. Total social financing includes yuan-denominated loans, foreign currency-denominated loans, entrusted loans, loans from trust companies, banker acceptances, corporate bonds, and domestic stock issued by nonfinancial corporations.

Before the Plan was announced, the government announced the amount of total social financing and the specific breakdown. The amount of total social financing increased from 2.0112 trillion yuan in 2002 to 12.8286 trillion yuan in 2011 (Figure 2). Much of this growth came in response to the Chinese government's 4 trillion yuan stimulus package in 2008, which caused total social financing to nearly double, from 6.9802 trillion yuan in 2008 to 13.9104 trillion yuan in 2009.

By category, in 2011 yuan-denominated loans accounted for 58.2% of the total, foreign currency-denominated loans 4.5%, entrusted loans 10.1 %, loans from trust companies 1.6%, banker acceptances 8.0%, corporate bonds 10.6%, and domestic stock issued by nonfinancial corporations 3.4% (Figure 3).Compared with 2002, the share of yuan-denominated loans declined substantially, while the share of bank-brokered loans, banker acceptances, and bonds increased. It appears that the growth in bonds was helped by the introduction in 2005 of commercial paper (CP) in the interbank bond market, and the introduction in the same market of medium-term notes (MTN) in 2008[1].

[1] See Eiichi Sekine, *Chugoku no Shasai Hakkou Seidou Kaikaku—Chuugokuban MTN no Toujou* (Reform of China's corporate bond issuance market—The advent of Chinese MTN), Capital Market Quarterly, Spring 2009 issue (in Japanese).

Figure 2: Total social financing (2002 to September 2012)



Note: Figures for 2012 are as of September.
Source: Nomura Institute of Capital Markets Research, based on data from the People's Bank of China

Figure 3: Composition of total social financing (2002 to 2012)

(Units: %)

	Total social financing	Yuan loans	Foreign currency-denominated loans	Entrusted loans	Loans from trust companies	Banker acceptances	Corporate bonds	Domestic stock issued by nonfinancial corporations
2002	100.0	91.9	3.6	0.9	—	-3.5	1.8	3.1
2003	100.0	81.1	6.7	1.8	—	5.9	1.5	1.6
2004	100.0	79.2	4.8	10.9	—	-1.0	1.6	2.4
2005	100.0	78.5	4.7	6.5	—	0.1	6.7	1.1
2006	100.0	73.8	3.4	6.3	1.9	3.5	5.4	3.6
2007	100.0	60.9	6.5	5.7	2.9	11.2	3.8	7.3
2008	100.0	70.3	2.8	6.1	4.5	1.5	7.9	4.8
2009	100.0	69.0	6.7	4.9	3.1	3.3	8.9	2.4
2010	100.0	56.7	3.5	6.2	2.8	16.7	7.9	4.1
2011	100.0	58.2	4.5	10.1	1.6	8.0	10.6	3.4
2012	100.0	57.3	4.6	7.3	6.0	6.5	13.3	1.9

Note: Figures for 2012 are as of September.
Source: Nomura Institute of Capital Markets Research, based on data from the People's Bank of China

The share of direct financing (the total of corporate bonds and stock) averaged 5.03% from 2002 until 2005, when the 10th five-year plan was in effect, and averaged 11.08% from 2006 until 2010, when the 11th five-year plan was in effect. Because measures to increase the share of direct financing remained in place during the 12th five-year plan, a direct financing share of at least 15% by end-2015 is posited as an achievable target in that plan.

2. Establishing qualitative targets

1) The main targets set

In addition to the two quantitative targets noted above (total growth and structural adjustments), the Plan also set qualitative targets, namely, (1) a further strengthening of the market's fundamental role in distributing financial resources, (2) a further deepening of the reform of financial institutions, (3) an extension of financial services to basically cover all sectors, and (4) an enabling of the overall control of financial risk.

2) Main policy emphasis

The Plan uses the above-noted quantitative and qualitative targets to establish the main policy emphasis. Specifically, the Plan focuses on (1) providing for macro financial control, (2) promoting structural economic adjustments, (3) promoting a trend toward general equilibrium in the balance payments, (4) deepening reforms in those sectors that are key to finance, (5) promoting financial innovation, (6) leveraging the investment and financing functions of financial markets, (7) improving the overall risk management capabilities of financial institutions while constantly improving the efficiency of financial oversight, and (8) strengthening consumer protection in the finance sector.

III. Opportunities for overseas financial institutions and investors

Chapter 6 of the Plan, Further opening the financial sector on a win-win basis, suggests a number of opportunities for overseas financial institutions and investors.

Its policies to open the financial sector to overseas participation include, first of all, a look at integrating its two major agencies dealing with domestic and international, while adhering to the principle of "prioritizing domestic needs while allowing competition and cooperation in a gradual, safe and controllable manner toward a win-win result," and also a look at combining inbound and outbound internationalization to further open the financial sector to overseas. Secondly, it will strictly define the timing, degree, and pace of this financial opening to the outside to ensure that it is commensurate with China's level of economic development, market sophistication, and financial oversight capabilities.

Next, we examine some key sections of the text in chapter 6 of the Plan. Of these, the increased cross-border use of the yuan and strengthening of financial cooperation between the Chinese mainland and Hong Kong should help overseas financial institutions to increase their offshore yuan services (including bonds, loans, forex, and hedging products).

1. Making the financial sector more open to overseas participation

1) Inbound (from overseas into China)

First, referencing international conceptual and empirical rules of advanced financial administration, set up mechanisms for, then gradually raise the level of, the corporate governance of China's financial sector.

Second, encourage financial institutions to utilize foreign capital in various ways and develop deeper cooperative relationships with overseas financial institutions.

Third, make effective use of preferential government loans overseas and international commercial loans and set up mechanisms for managing foreign debt.

Fourth, establish mechanisms for the formation of the yuan exchange rate and ensure that steps toward the transition to yuan capital account convertibility and expanded cross-border use of the yuan occurs at the proper pace and in the correct sequence.

Fifth, further open money markets, capital markets, foreign exchange markets, and the gold market to overseas participation.

2) Outbound (Chinese firms going global)

First, establish mechanisms relevant to financial institutions going global, guide financial institutions into adopting global development strategies based on methods proven by experience to be effective, strengthen the development of professionals with global skills, and take gradual steps to develop China's large global financial institutions.

Second, encourage financial institutions to steadily develop international business, raise the international expertise of management, and expedite the development of international financial services conducive to upgrading the level of export products and helping firms go global.

Third, improve the regulation of the overseas subsidiaries (including branches and business offices) of financial institutions and facilitate the building of financial institutions' cross-border risk management mechanisms.

2. Gradually expanding the yuan's cross-border use

First, promote the cross-border use of the yuan while adhering to the principles of meeting actual needs, allowing the easy transactions first and difficult ones later, improving oversight, and ensuring the controllability of risks.

Second, promote the following types of cross-border yuan-denominated settlement.

(1) Ensure cross-border, yuan-denominated trade settlement is done properly.
(2) Steadily increase the cross-border, yuan-denominated settlement of foreign direct investment.
(3) Support domestic banks' use of yuan-denominated lending for overseas projects.
(4) Encourage the gradual use of cross-border, yuan-denominated settlement by individuals.
(5) Consider how to build a framework for administering the yuan's external debits and credits.
(6) Continuously expand channels for overseas institutions' use of yuan funds.

Third, steadily promote the issuance by domestic institutions (residents) of yuan-denominated bonds in Hong Kong, while encouraging overseas institutions (nonresidents) to continue issuing yuan-denominated bonds in China. This will provide support to the relevant countries for holding some of their international reserves in yuan.

Fourth, improve the mechanisms for collecting data on and monitoring the cross-border and overseas movement of the yuan, and build the mechanisms required for preventing and managing risk.

3. Strengthening financial cooperation between Mainland China and Hong Kong, Macau, and Taiwan

1) Financial cooperation with Hong Kong and Macau

First, expedite the building of Shanghai's international financial center, while strengthening Shanghai's financial cooperation with Hong Kong.

Second, provide support for developing a financial cooperation region headed by Hong Kong's financial system, primarily using financial resources and services from cities in the Pearl River Delta.

Third, provide support to help Hong Kong become a center for offshore yuan transactions and international asset management, while consolidating and improving Hong Kong's position as an international financial center.

Fourth, build mechanisms to deepen financial cooperation between Guangdong province, Hong Kong, and Macau and also strengthen market, institutional, transactional, regulatory, and think-tank cooperation among the three regions.

2) Financial cooperation with Taiwan

Strengthen cross-strait (mainland China-Taiwan) financial cooperation, promote the establishment of a suitable cross-strait currency settlement mechanism, and expedite the creation of a cross-strait regional financial services center in Xiamen (Amoy).

4. Enhancing international and regional financial cooperation

First, proactively participate in global economic governance, deepen bilateral and multilateral economic and monetary policy dialogue and cooperation, and enhance macroeconomic and monetary policy coordination with major economies.

Second, proactively advance reform of the international financial system and promote rationalization of the international currency regime.

Third, actively participate in the revision and development of financial standards led by such international organizations as the Financial Stability Board and Basel Committee on Banking Supervision, and thereby play a greater role in international economic and financial organizations.

Fourth, deepen multi-lateral financial and monetary cooperation while guiding and promoting the process of financial cooperation at the regional level.

Fifth, consolidate cooperation with overseas central banks and regulatory authorities and improve information sharing mechanisms.

IV. The path to domestic financial deregulation

The opening of the finance sector to overseas participation has to be done in conjunction with domestic financial deregulation. Chapter 5, "Reforming and continuously improving financial operational mechanisms," first calls for driving reform in key financial areas and critical process in a market-oriented direction, to continuously work on perfecting financial operation mechanisms, bring out the vitality of market agents, and give full rein to the market's fundamental role in allocating financial resources. Second, further delineate the boundaries within which the government has a role while reducing government intervention in financial activities at the micro level.

Below, we examine specific key sections of the text in Chapter 5 of the Plan. The gradual achievement of yuan convertibility in the capital account should contribute to the growth in the inbound investment in Chinese securities by nonresident investors using the qualified foreign institutional investors (QFII) regime, while improvement in the investment of foreign reserves should lead to an increase in outbound securities investment from China. In addition, continued reforms of financial institutions should lead to their providing such investment banking services as IPOs and M&A.

1. Phasing in the market-oriented reform (liberalization) of interest rates

1) Basic thinking

Promote the development of a benchmark interest rate system for financial markets that further reinforces the benchmark role of the Shanghai interbank offered rate (SHIBOR), including by expanding its use with market-based rate products.

2) Method of moving toward market-based interest rates

First, improve the medium- and long-term market yield curves so as to provide an effective benchmark for financial institutions to price product.

Second, interest rates can be made more market based as conditions mature, through such methods as eliminating regulations on the pricing of alternative financial products.

Third, continue to improve central bank systems for regulating interest rates and facilitate interest rate transmission channels. Based on the above, guide financial institutions to continuously strengthen their ability to measure risk, and establish a self-regulating mechanism for pricing interest rates based on SHIBOR. At the same time, steadily pursue market-based reform of interest rates in accordance with the principles of easing the ceiling and floor requirements for the benchmark rate, letting the market form the benchmark rate, and propagating an impact on central bank market operations.

2. Improving mechanisms for forming yuan exchange rates

1) Basic thinking

In accordance with the principles of subjectivity, controllability, and gradualness, steadily reform the mechanism for forming the yuan's exchange rate.

2) Approach to exchange rate reform

First, improve the market-based managed floating exchange rate regime that currently operates with reference to a basket of currencies, make changes in the yuan exchange rate more flexible in both directions, and ensure the basic stability of the yuan exchange rate at a reasonable equilibrium.

Second, develop the foreign exchange market in a coordinated manner while increasing the number of tools available to manage exchange rate risk.

Third, conduct further research on establishing a bilateral direct exchange mechanism between the yuan and emerging market currencies, and actively promote the listing of the yuan's exchange rate with the currencies of emerging market economies and neighboring countries on the foreign exchange market.

3. Gradually achieving convertibility of the yuan in capital accounts

1) Basic thinking

Further relax the controls on cross-border capital flows in accordance with the overall principles of emphasizing priorities, making overall progress, adapting to the market, reducing distortions, exploring proactively, and leaving leeway. At the same time, improve the systems for balancing capital inflows and outflows and for managing external debt and debt claims. Through the above, steadily, and in an orderly manner, advance the convertibility of the yuan in capital accounts.

2) Ways to achieve convertibility in capital accounts

First, generally allow for convertibility of direct investment as a way to facilitate that investment.

Second, further increase the level of convertibility for securities investments, with an emphasis on opening up domestic capital markets and expanding investment in overseas securities.

Third, expedite reforms of foreign exchange management for the loan business and deepen reforms of external debt management systems, with an emphasis on facilitating cross-border lending, while also regulating the management and oversight of external debts and debt claims.

Fourth, emphasize increasing individuals' discretionary use of foreign currencies by further relaxing rules on cross-border transactions by individuals under other capital accounts.

4. Further improving the management of foreign exchange reserves

1) Basic thinking

Proactively explore and develop multi-level channels and ways to use foreign exchange reserves, while improving mechanisms for managing and administering foreign exchange reserves.

2) Paths toward improvement

First, further research and assess the capacity to bear risks from managing foreign exchange reserves, expand research on the different investment segments, products, and tools, adhere to long-term, strategic investment principles as well as scientific and effective investment model criteria, and make steady inroads toward diversified investing based on prudent assessment. During this process, optimize the allocation of currencies and assets and increase investment returns, with the objectives of keeping foreign exchange reserves secure, liquid, and profitable.

Second, reform methods of managing foreign exchange reserves so as to support and harmonize with national development strategies and contribute to the nation's goal of sustainable development.

5. Continuing reform of financial institutions

1) Large financial institutions and state-owned financial institutions

First, continue to deepen the reform of large financial institutions, further improve their corporate governance, and clarify the division of responsibility among the general shareholders' meeting, board of directors, board of auditors, and senior management, while developing effective mechanisms for making and implementing decisions and providing checks and balances on those decisions.

Second, promote more diverse equity ownership of financial institutions, review reasonable shareholding levels of financial institutions in which the government is the controlling shareholder, and improve the system for administering state-owned financial assets.

Third, build a mechanism for selecting, recruiting, and placing talent and make incentives more scientific and rational.

2) Policy banks and financial institutions

First, consolidate and deepen commercial reforms of the China Development Bank, while properly addressing problems with the credit of its bond issues, funding sources, and regulatory standards.

Second, continue to push forward with reforms at the China Import and Export Bank, China Agricultural Development Bank, and the China Export Credit Insurance Co., Ltd., while improving their governance frameworks.

Third, promote the transformation of financial asset management firms into commercial enterprises.

3) Insurance companies

Improve the corporate governance of insurance companies and continue with reforms toward turning state-owned insurance companies into joint stock companies. Support the public listing of qualified insurance companies.

V. Conclusion

1. No change in direction of financial sector reforms under new leadership

The process of drafting the 12th five-year plan for developing and reforming the financial sector was put together, as well as the Chinese government's overall 12th five-year plan covering until 2015, began in September 2010, based on surveys, research, and seminars held by the relevant departments, and while collecting outside opinions. The financial sector plan reflects work done by the Central Financial Work Commission, which has been held by the CCP Central Committee and State Council every five years since 1997, and last met in January 2012.

The year 2012 marked the holding of China's Communist Party Congress, which is done once every five years, and was also the final year of the Hu Jintao/Wen Jiabao administration. The 18th National Party Congress that opened on 8 November 2012 named seven new member to the Politburo standing committee, with Xi Jinping at the top, thus marking the start of the Xi Jinping/Li Keqiang administration. The new President and Premier were chosen at the National People's Congress held in March 2013, but the new leaders should carry on from the previous administration in implementing the Five-year Plan that runs to 2015. Accordingly, we expect financial reforms to follow the path laid out in the 12th five-year plan for development and reform of the financial sector discussed in this paper.

The new administration will keep an eye on progress in implementing the 12th five-year plan and reflect that in their 13th five-year plan, which will cover from 2016 until 2020.Although we see no risk of a major change in financial sector policy brought by the change in leadership, it appears fairly certain that the results of their efforts over the next three years plus will determine the key issues that define the next set of financial sector reforms.

2. Overseas financial institutions and investors' participation as principals

That being said, however, the Plan includes some fairly difficult reform programs. Among the different components of domestic financial deregulation, the deregulation of interest rates will impact the profit structure of deposit-taking institutions, and this makes it necessary to do such deregulation in conjunction with improvements in the rules governing the bankruptcy resolution of financial institutions and in deposit insurance. Irrespective of the political system, such reforms will take time, given the need to resolve the domestic conflicts of interest. Accordingly, depending on circumstances there is a possibility that China will not complete these reforms before the end of the current five-year plan, and thus will have to carry them over to the next five-year plan that begins in 2016.

In addition, if a supervisory body similar to the State-owned Assets Supervision and Administration Commission (SASAC), which was established in 2003 to supervise nonfinancial state-owned enterprises, were to be established to manage ownership in state-owned financial institutions, it would probably be effective in managing the state's ownership of financial assets and exercising its shareholder rights, but this would inevitably create the need for resolving conflicts of interest between state-owned financial institutions and the central government, regional governments, and related agencies.

That being said, the new administration's ability to strike a balance between opening up the financial sector to overseas participation and deregulating the domestic financial sector should not only directly help satisfy the demand for funding in China's real economy, it could also be a deciding factor on whether resources are allocated efficiently enough to change China's growth model to one reliant on domestic demand instead of external demand. Overseas financial institutions and investors will likely play a principal role in the process of writing the next chapter of the history China's financial sector reforms.

With China's GDP having now slowed down for a seventh consecutive quarter, to 7.4% YoY in July-September 2012 (the figures announced on 18 October 2012), the immediate challenge is to achieve the goals set out in the State Council's Executive Meeting held on 17 October, which are to (1) maintain reasonable levels of market liquidity and new lending volume while making initial adjustments to total social financing and (2) optimize the lending structure, expand bond issuance volume, and promote the stable and sound development of capital markets. The true value of the 12th five-year plan for development and reform of the financial sector is already being questioned.