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How China can achieve sustainable social and economic success by fostering a new financial infrastructure

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Jiang Zemin emphasized the importance of “keeping pace with the times”. For Deng Xiaoping, “seeking truth from facts” was essential. Today China is on the cusp of becoming a world economic super power. To fulfil its destiny, China must continue to introduce significant changes in the governance of business – although it should be noted that many of the critical issues are already being seriously discussed and addressed by the Chinese government.

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Foreword

Reforming the financial sector is perhaps the most important initiative so that China's current accelerated growth can continue in an orderly fashion. Indeed, a more robust financial infrastructure will help to ensure both sustainable economic growth and social progress. The government has already proposed measures to improve corporate governance. In this report, we seek to extend the discussion – bearing in mind the advice of Deng Xiaoping and Jiang Zemin – and address the cost and priorities for enhancing a financial system appropriate for the potentially largest economy of the twenty-first century.

It is important to acknowledge that the financial and governance arrangements that ultimately emerge in China will surely be unique. After all, the legacy of China's social, economic, and political systems is embedded in a history that has seen several waves of sweeping change since the People's Republic was founded in 1949. In contrast to many national financial systems, which typically evolved through a series of economic crises, China has the rare opportunity to build a robust and flexible financial system in good times and thereby limit the cycles of boom and bust.

"China has the rare opportunity to build a robust and flexible financial system in good times and thereby limit the cycles of boom and bust."

This report examines some of the practical elements of forging the new financial system in China and of building on the current foundations developed by the government. It also proposes a balanced set of initiatives for the requisite regulatory authorities and financial institutions and furnishes insights and a high-level blueprint for extending the new financial architecture.

This report represents part of Deloitte's commitment to participating in, and helping to shape, the discussion on the future of China's capital markets, financial institutions, and economy. As a leading global professional services firm with a unique integrated, multidisciplinary approach to providing business solutions, Deloitte appreciates the scale and significance of the economic and business developments currently unfolding in China. Indeed, the implications of these events will be far-reaching not only for business worldwide but also for the economies of countless nations and the well-being of people everywhere. These are exciting and momentous times, and we are happy to make our modest contribution as the Chinese government charts a new course.

Bill Parrett
CEO

Executive summary

Foundations of success

Investing in a robust and flexible financial system is a top priority for China's government as it works to ensure sustainable long-term economic growth. China's financial architecture needs to reflect both its "one-of-a-kind" economic and social circumstances as well as global best practices. Whatever shape the final system takes, it is in the best interests of China that it be built on two widely-accepted fundamentals: accurate, accessible, and objective information; and the upholding of property and shareholders rights. The cost of building a new governance and financial architecture is likely to be significant.

A price worth paying?

Upgrading corporate risk-management and governance systems within China's major financial institutions could cost in excess of US$1.2 billion (RMB9.84 billion) over the next three to five years. Investment is also needed to enhance the capabilities of China's financial regulators, especially in terms of attracting and retaining top talent. The creation of an International Financial Advisors group for by both the banking and securities regulator is a significant step in the right direction.

"Reforming the banking sector will enable China to properly prepare for the opening of its banking markets by the end of 2006 in accordance with the WTO timetable."

Addressing a central challenge

Forging a successful financial infrastructure in China hinges on reforming the banking sector – a most important and challenging link in the current system. Moreover, reforming the banking sector will enable China to properly prepare for the opening of its banking markets by the end of 2006 in accordance with the WTO timetable.

We have identified two areas for immediate action. First, we propose clearer and more stringent corporate governance practices for the "big four" banks[1] as a prerequisite to their transformation into joint-stock companies. As part of this shift, we propose that a new body be created to represent the state as a shareholder. Second, we encourage the Chinese government to adopt an explicit deposit insurance system and necessary controls.

The road ahead

To ensure that the government will achieve rapid and robust progress, we recommend enhancing China's financial system in a way that will foster greater transparency, build international investor confidence, and reduce the likelihood of conflicts of interest. Forging a new system should also be built around five priorities:

1. Reforming corporate governance.

2. Enhancing regulatory authorities and supervisory practices.

3. Establishing an entity to represent the State as shareholder in state-owned commercial banks.

4. Creating a deposit insurance system and authority.

5. Upgrading the compliance, corporate governance, and risk management systems within Chinese financial institutions.

Foundations for success

During its first 200 years, the United States witnessed as many as 10 boom-to-bust cycles along the path to global economic ascendancy. Frequent disconnects between supply and demand, investment bubbles, and hesitant international investors all featured prominently, especially in the late nineteenth and early twentieth centuries.

Today China is building a physical, social, and market infrastructure of an unprecedented scale. It is now the world's sixth-largest economy with a GDP of US$1.4 trillion (RMB11.48 trillion). Steel output, for instance, has already eclipsed the combined production of Japan and the United States. And it is still growing at a breakneck speed. Some equate China's growth with the quarter century of 8 percent average growth experienced by Japan after 1945. There may be some similarities, but China is clearly operating on a scale of magnitude far greater than its neighbor.

All this raises a major question. Is China's current boom, similar to that of late nineteenth century America, merely a harbinger of a boom-to-bust cycle? Or can this remarkable surge of economic activity give way to sustained and stable prosperity?

The basis for continued success lies in the creation of a new financial architecture founded on a strong blend of governmental, regulatory and risk management frameworks. China's government has created an enviable record of economic growth, averaging around nine percent over the last decade. The government is now addressing the challenge of how to maintain a high growth rate without lapsing into the boom-to-bust cycles that might provoke undesirable economic and social consequences or that could, in the worst of circumstances, derail the current locomotive of growth. As the authorities are well aware, the trend toward more stringent financial oversight in a number of other emerging economies has in a number of cases stifled economic growth in the name of financial stability.

"The basis for continued success lies in the creation of a new financial architecture founded on a strong blend of governmental, regulatory and risk management frameworks."

China's financial system – the facts

- China's rate of savings is 40 percent of GDP, one of the highest in the world; in 2002, total savings passed the US$ 1 trillion (RMB 8.2 trillion) mark.
- Four big state-owned commercial banks with 1.4 million employees and 116,000 branches (2001) hold 65-70 percent of deposits of Chinese citizens.
- China's domestic banking sector is composed of 11 nationwide joint-stock banks (including the Bank of Communications, China Minsheng, Shanghai Pudong), 112 municipal commercial banks (with business restricted to home city) and tens of thousands of small-scale credit cooperatives in neighbourhoods and small communities across China.
- Foreign banks maintained 151 branches and 211 representative offices in China. Official figures report total assets of US$ 48.4 billion (RMB396.9 billion) at the end of 2003, up 21.5 percent from December 2002, but still just 1.4 percent of total bank assets in China.
- Stock markets are relatively small with 10 million or so active retail investors.

Source: Deloitte China Services Group, 2004.

It is important to acknowledge that the financial and governance arrangements that China is developing will be unusual for two reasons. First, as the world's most populous nation, the financial system must be sufficiently flexible and strong to accommodate the pressures inherent in what is surely to be the largest transformation in history from an agrarian/industrial to a modern technologically-driven society. In addition, China enjoys different social, political and economic traditions that may well affect arrangements.

The key to the future lies in accommodating these important legacies to the demands of operating in a global economy where international investors demand accessible, accurate, and objective information. Indeed, China is already establishing a raft of new technology standards that are international and domestic hybrids. The challenge is to fashion similar standards in the area of finance[2].

Second, recent economic history clearly shows that the vast majority of reforms to corporate and financial governance have followed periods of crisis. Indeed tougher rules have tended to come in the wake of financial crashes. The two best examples are to be drawn from the U.S. experience, where the Glass-Steagall Act (which stipulated changes in governance and banking) followed the Great Crash of 1929, and the Sarbanes-Oxley Act was passed in the wake of the collapse of Enron, Tyco, and WorldCom. Improved supervisory regimes can, however, have dramatic effects in stabilizing the operating environment for financial institutions. For example, new rules in the U.S. adopted after the savings and loans crash of the early 1990s have drastically cut the number of banks facing the threat of failure (Exhibit 1). China, however, has the rare opportunity to build a robust and flexible financial system in good times and thereby limit the cycles of boom and bust.

At a market level, it is best to begin with the basics. Perhaps the greatest single threat to stability in any (developing) financial system is conflicts of interest. A framework for evaluating policies that remedy conflicts of interest is essential. Key considerations should be: reliance on market discipline, increased transparency, and supervisory oversight.

Exhibit 1 – U.S. banking and savings institutions' failures 1985-2004

Year	Total Institutions
2004	3
2003	3
2002	11
2001	4
2000	7
1999	8
1998	3
1997	1
1996	6
1995	8
1994	15
1993	50
1992	181
1991	271
1990	382
1989	534
1988	470
1987	262
1986	204
1985	180

Source: Federal Deposit Insurance Corporation, 2004.

The other large challenge may well be addressing the nexus between state-owned commercial banks (SOCBs) and state-owned enterprises (SOEs). China's current financial system has not yet reached the point where it allocates capital in an optimal fashion. That the banking system is a core challenge seems clear: it provides Chinese business with over 90 percent of its funding, a situation that the Chinese government regards with concern and which is significantly different from current international practices (Exhibit 2). In a similar way, the performance of China's stock markets has been uneven in good part because the SOEs raise more capital than private companies. As Chinese officials are quick to recognize, of even greater significance is the question of non-performing loans (NPLs). They have been estimated at around US$ 487 billion (RMB4 trillion)[3].

Clearly, shoring up the banking system must lie at the heart of any reform of the financial system. Yet, as with other issues in the financial arena, the best resolution will require a careful balance of regulatory and institutional initiatives.

Against the background of these realities, government officials have repeatedly spoken of the need to enhance corporate governance in state-owned, public and private companies[4]. Current corporate governance practices have been framed by two events: first, the opening of the economy to market forces in 1992 and, second, the "Code of Corporate Governance for Listed Companies" that was promulgated in 2002. To their credit, Chinese authorities are consistently looking abroad for best practices.

Many other developments point to the fact that China is moving in the right direction. For instance, the Tenth National People's Congress amended the Constitution on March 14, 2004 to protect private property and enshrine human rights. It also clarified compensation for expropriated properties even when done for the sake of public interests. Such developments suggest that we are seeing a movement to provide a solid framework for future regulation and corporate governance in the financial industry.

Exhibit 2 – Bank loans to corporate sector as a % of all corporate funding

	1990	1992	1994	1996	1998	2000	2002
China	100	100	99	97	96	93	91
United States	50	47	49	48.5	47	46	41
United Kingdom	78	75.5	72	70	67	62	61
Japan	76	75.5	72	70	70	67	62.5

Source: Bank for International Settlement; Deloitte Research estimates, 2004.

"We are seeing a movement to provide a solid framework for future regulation and corporate governance in the financial industry."

The 2002 code, for example, draws heavily on the Principles of Corporate Governance crafted by the Organization for Economic Cooperation and Development (OECD), first published in 1999 with an update in early 2004. That China has made consistent progress in corporate governance over the last decade cannot be in doubt. Accomplishments include: systematic improvement in the general regulatory framework for corporate governance; the growing independence of boards; and increased adherence to international accords, notably in terms of narrowing of the differences between China's accounting practices and International Financial Reporting Standards. Still, as the Chinese government is the first to concede, significant challenges remain. These include: enhancing legal protections for investors and creditors, addressing issues of insider control, and improving the quality of information that domestic firms must disclose to their shareholders.

Price worth paying?

Investor interest in China is surging. Bank lending is exploding. The insurance business is at record levels. Yet as the Chinese market continues to power ahead, greater scrutiny of governance and management practices seems inevitable.

A country's IPO market is one barometer of investor confidence in the governance of the economic system, along with steady flows of foreign direct investment. Recent events attending the IPOs of China Life and Minsheng Bank challenged confidence for the first time. As the government works to ensure that China's solid progress is not derailed by such events, it is paramount that a new and well-funded financial regulatory architecture be put in place – a price worth paying to ensure the foundations for success.

It is recommended that China adopt a two-pronged agenda for building a new financial architecture as the World Trade Organization (WTO) emerges over the horizon. This agenda would enable the government to push forward reforms within both regulatory and financial institutions at the same time. Only by pursuing reform on both of these fronts can China construct the new financial architecture it wants and needs. At the same time, this agenda must respect the role that the state continues to perform in both the social and economic spheres.

China, WTO and financial services

China's accession to the WTO in December 2001 set out a five-year transition for removing impediments to operations of foreign banks in China. The original schedules for banking can be summarized as follows:

- Upon accession – foreign financial institutions were permitted to provide foreign currency services without client (domestic/foreign, retail/corporate) or geographic restrictions. Foreign banks could also provide local currency services to foreign clients in Shanghai, Shenzhen, Tianjin and Dalian as of that date.
- December 2002 – Foreign-funded banks were further allowed to do RMB business in Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan.
- December 2003 – Jinan, Fuzhou, Chengdu and Chonqing added and RMB service to Chinese enterprises began in these 13 cities as well.
- December 2004, foreign companies will be able to participate in local currency business in Beijing; Kunming and Xiamen, raising the total number of cities open to this service to 16.
- After December 2006, foreign and domestic banks should be able to provide the same products to the all customers in China throughout the country. RMB business with Chinese individuals permitted.

Source: Deloitte China Services Group, 2004.

Let us begin with regulatory matters. In recent years, China has successfully created several regulatory authorities with a mandate to supervise domestic financial institutions. The Chinese Insurance Regulation Commission (CIRC) is the regulatory body responsible for the Chinese insurance market. Along with China's central bank– the People's Bank of China (PBOC) – the Chinese Banking Regulation Commission (CBRC) was formed in 2003 to oversee the commercial banking and trusting business. Likewise, the government created the Chinese Securities Regulation Commission (CSRC) to oversee the securities and fund management business. Each of these bodies is an essential part of an emerging and well-balanced financial regulation system in China. Unlike Japan, South Korea, and Singapore, which have opted for a single regulatory authority, we concur with the government vision that sees China's interests as best being served by a more diverse regulatory structure. This will balance a number of different interests and concerns, which in turn will foster the creation of a world-class financial system.

"While borrowing from best practices worldwide can be a commendable course of action, there is no one model or recommended level of spending for supervisory bodies of financial institutions."

Well-compensated supervisors and staff who know best practices are central to enhancing regulatory operations. While borrowing from best practices worldwide can be a commendable course of action, as Exhibit 3 illustrates, there is no one model or recommended level of spending for supervisory bodies of financial institutions. While freely acknowledging that we are not comparing countries of similar economic output, it is noteworthy that in 2003 Hong Kong spent US$103.4 million (RMB847.9 million) for regulation compared with just US$56 million (RMB459.2 million) in Germany. For its part, the United States spent around US$5 billion (RMB 41 billion).

Exhibit 3 – Comparison of international regulatory regimes and financial markets

	Australia	France	Germany	Hong Kong	UK	U.S.
Total costs	£95.8m	£7711m	£35m	£64.6m	£249m	£3008.8m
Total staff	1,788	887.5	901	761	FSA: 2,313; FOS: 550; FSCS: 108	30,215.39
Total banking assets	£259.7bn	£1,508.8bn	£2,658.1bn	£489.5bn	£2,871.8bn	£6,241.7bn
Total equity market capitalization	£251.8bn	£962.7bn	£432.9bn	£299.7bn	£1,013.6bn	£6,889.1bn
Total insurance premiums	£23.9bn	£86.9bn	£94.7bn	£6.7bn	£151.5bn	£581.4bn

Source: UK Financial Services Authority – Annual Report 2003; CRIC 2004; EIU 2003

"To complement the regulatory reforms, China's financial institutions understand that they must also undertake a number of wide-ranging changes."

Regardless of the sum, what is critical is the quality of the staff[5]. The regulatory authorities in Hong Kong have already begun addressing this issue by compensating their most senior regulators with salaries of US$0.64 to 1.28 million (RMB5.25 to 10.5 million). Compare that with the US$128,000 (RMB1.05 million) paid to the chairman of the U.S. Federal Reserve[6]. China has begun to recruit global financial expertise for its new financial architecture by appointing such leading figures as Gerry Corrigan, former President of the New York Federal Reserve Bank, Andrew Crockett, former General Manager of the Bank for International Settlements, and Sir Howard Davies, former Chairman and CEO of the Financial Services Authority in the United Kingdom, to the new International Financial Advisors Panel at both the CSRC and the CBRC.

Let us now consider the second prong, financial institutions. To complement the regulatory reforms, China's financial institutions understand that they must also undertake a number of wide-ranging changes. Corporate level reforms, for example, should focus on building management information systems, retraining personnel and, above all, instituting new risk management systems.

"We estimate that the minimum cost for aligning financial institutions in China with international standards at approximately US$1.2 billion (RMB9.84 billion) over a three to five year period."

In addition, upgrading corporate governance procedures will not doubt entail further investments. Top officials realize this may well include the cost of attracting new (foreign) experience to the boardroom and to executive management. While new technology may result in a reduction in headcount, the government faces certain constraints and obligations as the big four banks currently employ around 1.5 m staff.

Given all these objectives, we estimate that the minimum cost for aligning financial institutions in China with international standards at approximately US$1.2 billion (RMB9.84 billion) over a three to five year period (Exhibit 4). The largest investments would be made in the banks as their renewed health is paramount to China's future economic and social prosperity. We estimate the cost of that process at over US$650 million (RMB5.33 billion), with nearly two-thirds of that sum allotted to upgrades in the "big four" banks.

Exhibit 4 – The cost of upgrading the governance and risk management infrastructure of financial institutions in China (US$m)

	Corporate Gov & HR	MIS	Risk	Total
Banking	56	246	360	**662**
Insurance	29	174	174	**377**
Securities	16	75	75	**166**
Total	**101**	**495**	**609**	**1205**

MIS = Management Information Systems
Risk = Risk Management Systems

Source: Deloitte Research, 2004.

The insurance industry faces similar challenges and opportunities. We estimate the industry-wide cost of refurbishing the insurance industry at around US$375 million (RMB 3 billion), with the top 10 players investing over US$200 million (RMB 1.64 billion) in new systems. The securities sector, although still in the early stages of development, can also benefit from an investment in upgrading processes which we estimate at around US$ 166 million (RMB1.36 billion). Our experience suggests, however, that enhancing the risk management systems alone will not be enough to address the broader scope of challenges. This initiative needs to be combined with investments in new management information and training. Again, the banking sector should command the greatest attention.

Addressing a central challenge

It is fitting in the Year of the Monkey that the Chinese government has resolved to move with speed and agility to address its banking system. At stake is not only the stability of the state banks – in the face of anticipated international competition in 2007 – but also continued, smooth economic expansion. As noted previously, the banking system presents the largest challenge. While spending on certain key processes reforms is certainly part of the answer, crucial institutional reforms are equally paramount. Here we outline two critical areas that should be attended to: corporate governance issues arising from the changing legal status of SOCBs; and the implementation of a deposit insurance system – what we call China Depositary Insurance Body (CDIB).

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Corporate governance in banks

The Chinese banking sector currently includes the four main state-owned commercial banks that represent around 65 percent of a total of US$1.34 trillion (RMB10.99 trillion) deposits; 11 nationwide joint-stock banks with US$401 billion (RMB3.29 trillion) in deposits; 112 municipal commercial banks with US$142 (RMB 1.17 trillion) in deposits; plus thousands in smaller communities. Our focus here is on the major banking institutions.

The government's decision to transform the legal status of the SOCBs to joint-stock form has important implications for enhancing corporate governance across the financial system. The conversion to joint stock status will entail important changes that, when implemented thoroughly and sustained by the enforcement of applicable laws, have the potential to significantly enhance corporate governance in China. This transformation will involve four principal stages:

1. Establishing formal international corporate governance mechanisms.

2. Clarifying property rights and responsibility for historical losses (as noted above)[7].

3. Transfer to limited liability status.

4. Commercialization of business operations.

The reform of the SOCBs, as the government understands, needs to be comprehensive given their importance to the SOE sector. In the past, the overwhelming majority of SOCB lending has been to SOEs at various national and regional government levels. Although many of these borrowers currently face problems in servicing the loans, the SOCBs nevertheless have limited legal recourse. Any action would probably meet with opposition from local interests and officials and might even result in increased unemployment, reduction in tax revenues, and otherwise unwelcome consequences. The preferential treatment enjoyed by the SOEs also manifests itself in continued interest rate controls that limit the ability of SOCBs to price loans in line with their own credit analysis.

To support the SOCBs' ongoing commercialization, to foster shareholder structure transformation, and to maintain growth and stability, the government might consider consolidating and concentrating the authority for implementing reforms in an entity charged with representing the state in its capacity as shareholder. It has already done just that with the SOEs through the successful creation of the State-Owned Assets Supervision and Administration Commission (SASAC) in the spring of 2003.

The government should then consider vesting the appropriate authority and power to implement reform in this agency that can efficiently facilitate all necessary decisions. The head of this agency should be a senior official with significant resources at his or her disposal. The primary duties of this agency would be:

1. Clarification of the state's objectives as owner.

2. Implementation of a new corporate governance model.

3. Decision-making related to SOCB reform.

4. Reform of shareholder structure.

Whatever agency the government entrusts with these duties, it should possess the following characteristics:

- Ability to drive reform – An agency established for this purpose should have clear institutional power and the resources necessary to discharge its duties.

- Authority – It is important that the agency have the institutional strength and capacity to fulfill its duties and to isolate SOCBs from interference by state stakeholders during the transition period.

- Accountability – A dedicated team with managerial accountability is best suited for driving the reforms.

- Independence – The agency envisioned has the difficult task of integrating all stakeholder interests. It should therefore be independent of any single or particular stakeholder.

"At present, the Chinese government has made no final decision about creating an explicit deposit insurance system although the establishment of such a system has been under discussion for some years now."

Deposit insurance system

Banking crises around the globe over the past 20 years have spurred wider recognition that the stability of a national banking system ultimately rests on three institutions:

1. A central bank acting as the lender of last resort.

2. A prudential regulator.

3. A deposit insurance system.

We touched on the first two of these issues earlier.

At present, the Chinese government has made no final decision about creating an explicit deposit insurance system although the establishment of such a system has been under discussion for some years now. During this period, the big four banks raised a number of concerns about and objections to the notion since, with 65 percent of deposits, they would be the main contributors to any such fund.

According to the International Association of Deposit Insurers, about 80 countries now operate some form of explicit deposit insurance system (DIS) since the U.S. enacted the first system in 1933. This number has expanded greatly in the last decade at the expense of implicit systems due to repeated financial crises in emerging market countries. The Chinese must draw on global best practice in developing an insurance scheme for deposits.

The absence of an explicit deposit insurance system has also served to inhibit the development of a private banking sector in China since the state banks in effect provide an indirect form of insurance: they are simply "too big to fail." However, with the WTO-mandated opening of the banking sector, the government is aware that sustaining public confidence in deposits held in domestic banks is becoming increasingly urgent.

That being said, the government is now moving forward very rapidly with the process of establishing a deposit insurance system. Earlier this year, press reports indicated that the PBOC was awaiting State Council approval of a system that, in the words of one official, "would likely be implemented by year's end."[8] If that is indeed the case, the government will need to clarify several important details. These include: determining the scope of any deposit insurance entity's activities; its relationship to other institutions; and the cost of putting an effective system in place in short order. Here we sketch out some of the issues that the government will no doubt be considering as it implements a suitable deposit insurance system.

As we see it, there are six dimensions to building the China Deposit Insurance Bureau (CDIB) (Exhibit 5).

Exhibit 5 – Building a China Depository Insurance Body (CDIB)

Issue	Key success factors: CDIB	Comment: international best practice
Mandate	• Scope of mandate will drive cost. • Initial focus on deposits, followed by supervisory role.	• U.S. scheme has 40 percent ops budget & half of staff focused on supervisory role.
Independence	• Entirely independent body. • Distinct ties to PBOC. • Non-executive directors.	• Turkey & Argentina initially embedded in central banks.
Participation	• Mandatory scheme optimal. • Foreign banks also participate (As of 2007). • Threat of suspension main disciplinary tool.	• 90 percent international schemes including South Korea have mandatory participation. • Taiwan – voluntary scheme from 1985.
Funding	• Ex-ante funding. • Infusion of capital from central bank.	• India relies on central government. funding permanently. • Canadian system repaid Treasury 10 years after establishment.
Level of fund	• 5 percent total deposit fund. • Work to this level over 5 year 5 year period. • Monitor types of deposit holders.	• Brazil, Argentina use 5 percent level. • Developed countries fall to 1.25 percent ratio e.g. U.S. scheme.
Operations	• Dedicated staff up to 3,000. • Supplemented with MoF and PBOC staff. • Quality is key to success.	• Training in public awareness campaigns proved important. • Staff number varies from 475 in Turkey to U.S. FDIC staff number of close to 4,500.

Source: Deloitte Research, 2004.

First is setting the correct mandate for the CDIB. A central focus would be clarifying whether the body will either (or both) insure deposits and supervise deposit institutions. It is advisable that, over time, the CDIB also assume some auxiliary supervisory role.

Second, international experience suggests that the body be independent while maintaining strong links to the central bank or the designated regulatory authority as in the U.K.

Third, mandating the participation of all deposit-taking institutions is crucial to the success of such deposit insurance systems around the world.

Fourth, we suggest that ex-ante funding is most appropriate with an initial infusion of capital coming from the PBOC or Ministry of Finance. Arrangements can be made to repay these funds after the system becomes self-financing through the assessment of premiums.

Fifth, targeting an optimal level of funding, while not universal, seems appropriate given China's level of development. We recommend that the government consider a five percent level of the total deposit fund, again based on international comparisons.

Finally, to become operational the CDIB will need a dedicated staff, in addition to professionals from the main regulatory and supervisory entities.

The road ahead

"The gains for China can be huge. The creation of the world's largest economy in the twenty-first century is well within reach."

The gains for China can be huge. The creation of the world's largest economy in the twenty-first century is well within reach. The government continues to make and facilitate huge investments in the physical infrastructure as China hurtles toward modernity. In Beijing alone, some US$30 billion (RMB246 billion) will be invested in roads, buildings, and communication links by 2008.[9] All the government's successes and efforts can be at risk, however, without the continued reform of the financial and corporate governance system. Appropriate investment in this realm will help ensure that investment elsewhere has a good chance of paying off – a price well worth paying if it helps to ensure long-term economic success and social harmony.

As authorities fully accept, China cannot hope to fully insulate itself from boom-to-bust cycles. Still, if the government pursues the necessary course of action with sufficient resolve, China will significantly reduce the severity of future downturns. By doing this, the government will forestall the need for unpleasant decisions later on and at much greater cost. The government has already begun work in a number of areas discussed in this blueprint. Its accomplishments need to be both applauded and followed up with fresh initiatives.

The road ahead holds many challenges for China. The pace of change is sharpening the focus on a number of issues in the arena of corporate governance and financial reform. Given current pressures, it is essential that China continue prioritize its efforts. Here we provide a brief summary of priorities based on the recommendations made in this white paper:

1. Reforming corporate governance.

2. Enhancing regulatory authorities and supervisory practices.

3. Establishing an entity to represent the State as shareholder in SOCBs.

4. Creating a deposit insurance system and authority.

5. Upgrading the compliance, corporate governance, and risk management systems within Chinese financial institutions.

First, in the realm of corporate governance, continuing efforts should be made to improve the independence of boards. China can also leap-frog many of the hurdles other countries have had to overcome, notably in terms of ensuring the independence of boards and fostering the growth of an active institutional shareholder community.

Second, reform of China's regulatory infrastructure should continue apace. Investment in these bodies is paramount for the future of the Chinese financial sector as well as economic and social development. We suggest that a move toward a single financial regulator such as in Japan and South Korea is inappropriate at present. There are many other bigger challenges to address. Chief among these should be attracting and retaining the best financial supervisors.

Third, we propose an independent entity to represent the state in its commercial shareholdings. Clarifying the position of the state is critical if international investors are to include China in their portfolios. More specifically, the government should consider vesting appropriate authority and power in the entity and to facilitate all necessary decisions. The primary duties of this entity would be threefold: clarification of the state's objectives as owner; implementation of a new corporate governance model; and decision-making related to SOCB reform, and reform of shareholder structure.

Fourth, we propose the implementation of a depository insurance scheme. Press reports indicate that this is on the agenda. However, the impending WTO deadline means that establishing this body must be a top priority. Our point of view is that this body should combine both deposit insurance and a supervisory role drawing on the best of global best practice notably in the U.S. and the U.K.

Finally, to support the suggested reforms at a macro-level, micro-level reforms of internal processes within financial institutions are essential. Together corporate governance, compliance, and risk management procedures require upgrades to meet international standards. We estimate the cost of this to be upwards of US$1.2 billion (RMB9.84 billion). But perhaps equally important is a shift in strategic focus about how major financial institutions are to be governed.

The system China is building will in all likelihood be like no other in the world. However, the government and government agencies are drawing on international best practices to forge a new corporate governance and financial system that is in keeping with China's status as the world's next super-economy. The fact is China's economic welfare and success rest in good measure on the quality of its corporate governance practices and the recasting of its financial system. The importance of these reforms and the government's commitment to their success cannot be overstated if China is to "keep pace with the times."

Notes

[1] China's four biggest banks are: Industrial and Commercial Bank, Bank of China, China Construction Bank, Agricultural Bank.

[2] "Will China's technology standards dominate your industry?" Deloitte Research, August 2004.

[3] This calculation does not include RMB 250 billion of NPLs by the Bank of China in June 2004.

[4] OECD China Corporate Governance Report 2003.

[5] Note that there is a growing concern among the SOCBs that foreign competitors will hire top people away at salaries the SOCBs cannot match – mirroring the situation with the regulatory authorities.

[6] "The governance of the Hong Kong Monetary Authority and comparable authorities in Hong Kong and overseas jurisdictions", Hong Kong Legislative Council Secretariat Research Library, 30 April, 2003.

[7] This process has already started within some of the big four banks, "PBOC conducts audit of NPLs", Financial Times, 21 April, 2004.

[8] Xie Ping, Director of the Financial Stability Bureau of the PBOC, 15 March, 2004, as reported in Business Weekly, "Safety Line Nearing Final Stage", 16 March, 2004.

[9] Business Week, "Is China Headed for a Crisis?", 3 May, 2004.

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