



Chapter II

Banking Sector

In 2006, reform and restructuring of China's banking sector made big breakthroughs, leading to the obvious improvement of the overall strength of the sector. Banking institutions featured better corporate governance, strengthened capital requirement, stable performance increase, enhanced innovation and service capabilities, and improvement of risk-resistance capabilities. With the further reform of financial industry, banking sector will consolidate the achievements and achieve sustained, healthy, and stable development.

Recent Developments

Total assets and liabilities grew steadily. As of the end of 2006, total assets of banking institutions amounted to RMB 43.95 trillion yuan, a y-o-y growth of 17.30%; total liabilities were RMB 41.71 trillion yuan, up by 16.50% y-o-y; the total outstanding deposits (in both domestic and foreign currencies) reached RMB 33.89 trillion yuan, up by 15.50% y-o-y; and the total outstanding loans (in both domestic and foreign currencies) were RMB 23.85 trillion yuan, up by 14.70%.

Outstanding NPLs kept declining. As of the end of 2006, total outstanding NPLs of commercial banks were RMB 1.25 trillion yuan, RMB 71.31 billion yuan less than the previous year; NPL ratio was 7.1%, 1.5 percentage points lower y-o-y.

Capital adequacy significantly increased.

As of the end of 2006, the number of commercial banks meeting the 8% CAR requirement reached 100, 47 more than that by the end of 2005. Their total assets accounted for 77.4% of the total assets of commercial banks, up by 2.3 percentage points.

Profitability was enhanced steadily. As of the end of 2006, all Chinese domestic banking institutions realized a pre-tax profit of RMB 332.152 billion yuan, 33.07% higher than the previous year. Among them, SOCBs and JSCBs combined a pre-tax profit of RMB 240.91 billion yuan, up by 30.25% y-o-y.

Innovation and service capabilities kept improving. In 2006, banking institutions accelerated their innovation and provided increasingly diversified financial service. As of the end of 2006, 62 Chinese and foreign banks had been granted qualification for derivatives trading and had introduced various derivative instruments; 14 bank QDII products were successfully launched; the collaboration between banks and securities companies as well as between banks and insurance companies continued to be deepening. Banking sector had made relatively significant progresses in serving small enterprises and agriculture, rural areas and farmers. As of the end of 2006, outstanding small enterprise loans amounted to RMB 5.35 trillion yuan, and the loans related to agriculture, rural area, and farmers reached RMB 4.5 trillion yuan.

Opening-up progressed orderly. In 2006, banking sector fulfilled the commitment made at the accession to WTO by lifting client and regional restrictions on foreign banks

when they conduct RMB business. As of the end of 2006, foreign banks had established 14 legal person institutions, 200 branches, 79 tier-2 branches, and 242 representative offices; another 9 legal person institutions have also been approved to start preparation for establishment. Total assets of foreign banks reached USD 103.3 billion, 1.8% of the total assets of Chinese banking institutions, including outstanding loans of USD 61.6 billion; and a total liability of USD 108.1 billion, including outstanding deposits of USD 39.7 billion. In addition, 21 Chinese banking institutions introduced 29 overseas investors with a total investment value of USD 19 billion.

Regulatory framework increasingly improved. In 2006, the legal framework of prudent supervision on banking sector has been further improved. Amendment to *Banking Regulation and Supervision Law* and revised *Regulations on Administration of Foreign-funded Banks* were promulgated and implemented. Regulatory authorities also formulated 32 regulations and guidance on risk management. Meanwhile, supervision on accession in banking sector witnessed new breakthrough; accession restrictions of banking institutions in rural areas have been adjusted and relaxed.

Reform and Achievement

In 2006, reform of banking sector proceeded successfully; reform and restructuring of commercial banks made great breakthroughs, re-

form of RCCs achieved fruitful results, banking institution further improved their corporate governance and internal control, and reforms of other banking financial institutions also progressed smoothly.

Reform and restructuring of commercial banks made breakthroughs

BOC and ICBC were successfully listed on both Hong Kong and Shanghai stock exchanges. After CCB and BOCOM's listing in Hong Kong in 2005, BOC offered H-shares and A-shares on June 1, 2006 and July 5, 2006 respectively, and was listed in both Hong Kong and Shanghai stock exchanges; through a concurrent A + H share offering, ICBC was listed in both Hong Kong and Shanghai stock exchanges at the same time on October 27, 2006. IPOs of BOC and ICBC were priced reasonably, both the P/E and P/B multiples of the offer prices approaching or even exceeding multiples of advanced international banks. Through public listing, the aforementioned four banks have established market-oriented capital supply mechanism, standardized information disclosure, and strengthened restrictions on the performance of senior management. So, the capital market played an increasingly prominent role in establishing efficient operation mechanism of modern financial enterprises. In addition, the consecutive listing of BOC and ICBC on the A share market also enhanced the overall investment value on the market.

Preparation of ABC shareholding reform was pushed forward steadily. In 2006, relevant authorities conducted further

feasibility studies on the shareholding reform scheme of ABC, taking into the consideration of building new socialist countryside and making the master plan for rural area financial reforms. Financial administration authorities have taken measures to urge ABC to manage its credit risks. Meanwhile, ABC sped up its internal reform, and started a comprehensive human resources reform, due diligence plan of post-loan management, and ownership verification of fixed assets. Furthermore, ABC launched external audit in an all-round manner.

PSBC was approved to set up. According to the reform scheme of the postal system, PSBC completed its preparation and was approved to open in December 2006. As of the end of 2006, outstanding deposits of PSBC exceeded RMB 1.6 trillion yuan with a market share of 9.91%, only after the big four state-owned commercial banks, ICBC, ABC, BOC, and CCB, in terms of scale. PSBC has 36 000 outlets, with 60% deposit outlets and 1/3 outstanding deposits in the vast rural areas; therefore, it is the retail financial service network with the largest coverage area in both urban and rural areas in China. Meanwhile, capital utilization capability of PSBC are also increasingly improved. At the end of 2006, the total fund under its own utilization reached about RMB 900 billion yuan, and the pilot projects of micro loans pledged with deposit certificates were introduced to 13 provinces.

Pace of other commercial banks' reform and restructuring has been accelerated.

In 2006, a consortium of both Chinese and overseas investors led by Citigroup is introduced to GDB, thus taking a significant step forward in GDB's reform and re-structuring; financial restructuring plan for CEB was approved at the end of 2006, and will be launched soon. In 2006, initiated by CITIC Group and CITIC International Financial Holdings Limited, CITIC Bank was reconstructed as CITIC Bank Corporation Limited, and the restructuring of the bank witnessed substantial progress. 10 city commercial banks in Jiangsu province carried out merger and restructuring for the establishment of Jiangsu Bank, which was approved at the end of 2006. Bank of Shanghai and Bank of Beijing opened their branches in Ningbo and Tianjin respectively, beginning to pursue a cross-region business operation.

Reform of RCCs attained significant achievements

In 2006, reform scheme of Hainan RCCs was formally approved, signifying the beginning of RCC reform all over China. As the reform proceeded, more achievements were registered in various aspects.

Ownership reform pushed forward steadily. By specific situations, different localities chose to adopt such ownership arrangements as joint-stock or joint-stock cooperative to establish rural commercial banks, rural cooperative banks, and unitary legal entities at the county level (including county-level city) in recent years. By the end of 2006, 93 rural banking institutions had been established with another 15 approved to establish in future; and 1201 unitary legal entities at the county level

(including county-level city) had been incorporated.

Business performance improved further. In 2006, RCCs, rural commercial banks, and rural cooperative banks continued to grow. As of the end of 2006, the total assets of the aforementioned institutions reached RMB 4.42 trillion yuan, up by 18.82% y-o-y, and total liabilities were RMB 4.22 trillion yuan, up by 18.54% y-o-y. Total deposit balance was 3.89 trillion yuan, 19.33% higher than the same period of the previous year; total outstanding loans amounted to RMB 2.62 trillion yuan, up by 19.09% y-o-y. Total book profit for the whole year was RMB 28.086 billion yuan, up by 56.22% y-o-y.

The function to support agriculture was further strengthened. As of the end of 2006, outstanding agriculture loans of RCCs, rural commercial banks, and rural cooperative banks were RMB 1.3 trillion yuan, up by 16.07% y-o-y; outstanding loans to farmers reached RMB 919.7 billion yuan, a y-o-y growth rate of 22.69%; 70.72 million rural families (accounting for 31.2% of the total number of rural families in China) were granted small-amount rural family credits and rural family joint collateral loans.

Corporate governance and internal control of banking institutions have been continuously improved

In 2006, with banking sector reform deepening, corporate governance of banking institutions was continuously improved, and an independent and effective internal control mecha-

nism was gradually established. Particularly, after reform and restructuring, these commercial banks have preliminarily established a basic framework of sound corporate governance in accordance with the requirement of modern enterprise system.

Corporate governance was continuously improved. By introducing strategic investors and through public listings, banks witnessed obviously improved shareholding structure, strengthened market restrictions and transparency as well as gradually standardized information disclosure. Corporate governance of listed banks was further improved; the relation among the shareholders' general meeting, board of directors, board of supervisors and senior management gradually formed a mechanism of clear-cut responsibilities and obligations, effective check and balance, and coordinated operation; composition of board of directors became more and more professional and international, and operation and management capabilities saw continuous improvement.

Internal control mechanism was gradually enhanced. After the reform and restructuring, commercial banks continued to improve their internal control and risk prevention systems. The construction of internal control and risk prevention programs, such as data consolidation and internal rating, were sped up to raise IT level and to consolidate the foundation of management. The consolidation of business flows was pushed forward vigorously by carrying out vertical consolidation of audit, asset security, credit authorization, and

internal control systems, and the reform of risk management system was also implemented actively to realize the vertical risk management.

As of the end of 2006, 21 commercial banks have introduced reputable financial institutions as strategic investors. To improve corporate governance and enhance operation and management capabilities, the banks continued to work on financial innovation and cooperated with strategic investors in areas of corporate governance, risk management, internal control, and so on. For example, ICBC cooperated with Goldman Sachs Group and Allianz Group, BOC with Royal Bank of Scotland, CCB with Bank of America, and BOCOM with HSBC.

Risk disposal of some small- and medium-sized banking institutions has achieved significant improvements

In 2006, the risk disposal of some small- and medium-sized banking institutions, such as UCCs and TICs, achieved prominent progresses. UCCs devoted more attention to rectification and consolidation by acquisition, restructuring, merger and so on; the year 2006 saw the completion of the disposal of 240 institutions in the disposal waiting list and exit of 102 institutions which had been ordered to stop operation for rectification. In addition, over 10

sole institutions were approved to be transformed to city commercial banks; KingHing Trust Investment Corp. , Ltd and Jilin Pan-Asia Trust Investment Corp. , Ltd were forced to suspend operation for rectification in accordance with the law, thus making risks in relation to trust companies under effective control.

Soundness Evaluation¹

Soundness evaluation of banking sector aims to assess the soundness of the banking system with a series of quantitative indicators and qualitative information reflecting performance of the banking sector. FSIs recommended by IMF make soundness evaluation from the following aspects: asset quality, capital adequacy, management, income and profitability, liquidity, market risk sensitivity, etc.. With reference to the indicators recommended by IMF and based on our experience, we selected indicators of asset quality, CAR, profitability, liquidity and so on to assess domestic Chinese commercial banks in a quantitative manner, and conducted comprehensive evaluation on the impact of financing structure on systemic risks of the banking sector as well as the crisis prevention mechanisms of banking sector.²

¹ Data used in this section are from data reported by commercial banks to PBC, there might be differences between indicators calculated from these data and data disclosed in annual reports of commercial banks.

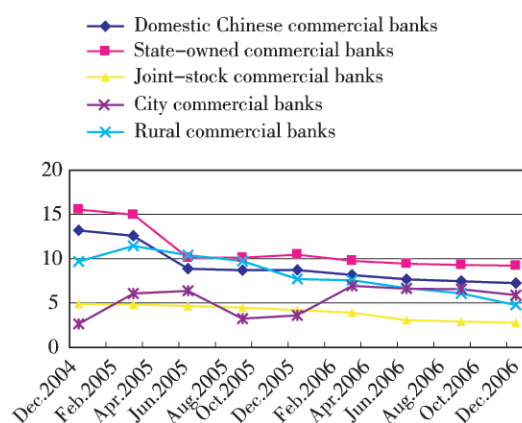
² At present, there is no uniform requirement on asset quality, capital adequacy ratio and other indicators for different institutions in banking sector, and there are still certain discrepancies in statistical methodologies, and therefore the analyses are not comparable. Statistical methodologies for domestic Chinese commercial banks (including state-owned commercial banks, joint-stock commercial banks, city commercial banks, and rural commercial banks) have almost been unified, and total assets of those banks amounted to RMB 32.77 trillion yuan by end 2006, or 74.58% in total assets of all banking financial institutions. The section aims to reflect soundness of general operation of banking sector via quantitative soundness assessment of these banks.

NPL ratios of domestic Chinese commercial banks continued to decline with asset quality significantly improved. As of the end 2006, outstanding NPLs of domestic Chinese commercial banks were RMB 1.25 trillion yuan, RMB 71.31 billion yuan lower than the end of 2005; NPL ratio was 7.1%, down by 1.5 percentage points y-o-y, featuring a “double decline” (Figure 2.1) for five years in a row. After restructuring, ICBC, BOC, CCB, and BOCOM (referred to as “big four commercial banks” in this chapter) recorded a NPL ratio of 3.67%, down by 0.64 percentage points. These demonstrate that risk management capabilities of commercial banks were prominently enhanced.

CAR and Provision Coverage Ratio witnessed fast growth and risk-resistant capabilities were further enhanced. Domestic Chinese commercial banks continued to increase their CAR by carrying out financial restructuring, introducing strategic investors, and going public on domestic and overseas stock markets. At the end of 2006, the number of commercial banks with CAR at or above 8% increased from 30 at the end of 2004 to 100; the percentage of assets of banks meeting CAR requirement in total assets of commercial banks in the same period increased from 47.5% to 77.4%; provision coverage ratio grew from 14.19% at the end of 2004 to 35.45% (Figure 2.2); CAR of the big four commercial banks after restructuring reached

Figure 2.1 NPL Ratio of Domestic Chinese Commercial Banks

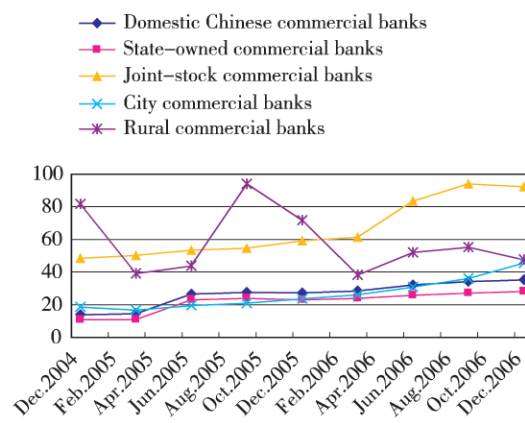
(percent)



Source: PBC.

Figure 2.2 Provision Coverage Ratio of Domestic Chinese Commercial Banks

(percent)



Source: PBC.

13.29% while their provision coverage ratio was as high as 84.49%. All these demonstrate that reform of commercial banks achieved prominent results, strict capital requirement and risk resistance mechanisms began to take shape, and banks were more resilient to risks.

Profit grew steadily and revenue structure was still in need of optimization. As of the end of 2006, domestic Chinese commercial banks realized a pre-tax profit of RMB 263.09 billion yuan, up by 31.56% y-o-y; pre-tax return on assets was 0.87% and pre-tax return on equity was 18.22% (Figure 2.3); the pre-tax return on assets and on capital of the big four commercial banks after restructuring were 1.07% and 17.45% respectively, both

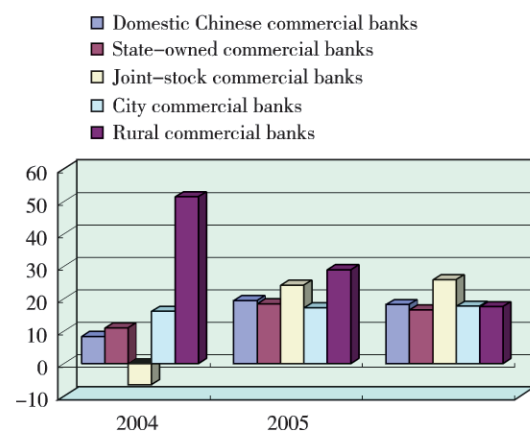
higher than the average of commercial banks. It is well reflected that financial status of domestic Chinese commercial banks was significantly improved, and the capability of transforming profits to capital was enhanced.

Although profits have been growing, revenue structure of domestic Chinese commercial banks still needs further optimization. Interest income is still the major income source of domestic Chinese commercial banks, accounting for over 90% in operating income. Meanwhile, net fee income witnessed certain increase; contribution of net fee income in domestic Chinese commercial banks in 2006 was 8.31%, up by 1.45 percentage points y-o-y. Although intermediate businesses of domestic Chinese commercial banks have achieved some development, profit generation still depends too much on traditional businesses. The business scope needs to be further expanded, income structure needs to be optimized, and financial sustainability needs to be further enhanced.

Asset liquidity was adequate but loan duration structure was not optimal. In 2006, domestic Chinese commercial banks continued to maintain adequate liquidity, the ratio of short-term current assets to short-term current liabilities was 54.76% (Figure 2.4), up by 9.30 percentage points y-o-y and 29.76 percentage points higher than the bottom line of regulation (25%); RMB loan to deposit ratio was 56.90%, almost the same as the previous year and 18.10 percentage points lower than upper limit of regulation (75%); total amount of deposit reserve amounted to RMB 3.36 trillion yuan with a reserve ratio of

Figure 2.3 Pre-tax ROE of Domestic Chinese Commercial Banks

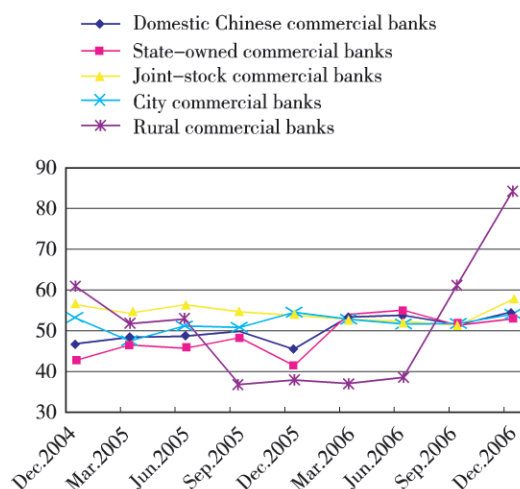
(percent)



Source: PBC.

Figure 2.4 Liquidity Ratios of Domestic Chinese Commercial Banks

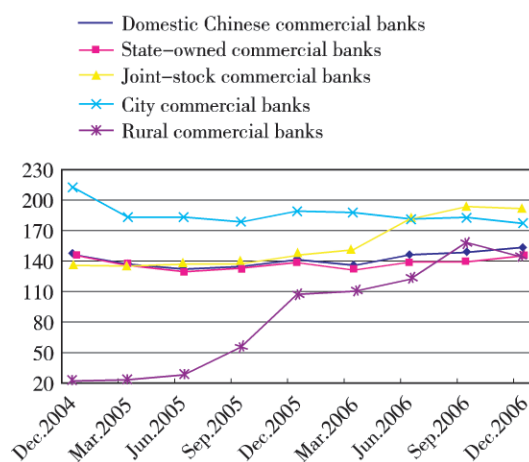
(percent)



Source: PBC.

Figure 2.5 Mid- and Long-term Loan to Deposit Ratios of Domestic Chinese Commercial Banks

(percent)



Source: PBC.

12.33%. All these have reflected that domestic Chinese commercial banks have relatively strong capabilities of cashing assets and urgency payment, but excess liquidity also exerts pressure on capital utilization.

Since capital market in China has not yet developed, mid- and long-term capital is allocated mainly through banking sector, leading to high mid- and long-term loan to deposit ratio¹ in domestic Chinese commercial banks (Figure 2.5); the ratio has been exceeding upper limit of regulation (120%) since 2004. Therefore, duration mismatch between loan and deposit is rather serious in domestic Chinese commercial banks, and enough attention should be given to potential risk thereof.

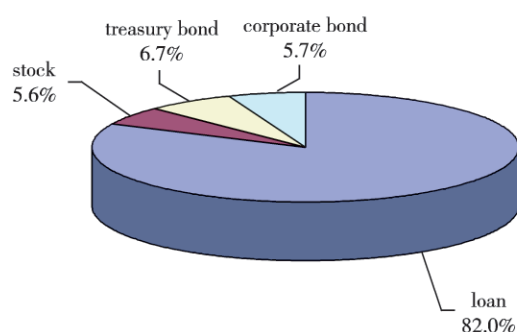
Indirect financing continued to play a major role, potential risks with imbalanced financing structure need to be addressed. For many years, the banking sector has been playing a major role in satisfying financing demands of the society. In 2006, new loans extended by banks accounted for 82.0% in total net increase of financing value raised by domestic non-financial institutions (Figure 2.6), up by 1.8 percentage points y-o-y, and it has effectively supported the sustained, healthy, and rapid development of national economy. However, indirect financing is over weighted, functions of direct financing have not been fully played, and financial risks are concentrated in the banking system, which is not conducive to the long-

¹ Mid- and long-term loan to deposit ratio = outstanding loan with over one year till maturity/outstanding deposit with over one year till maturity $\times 100\%$.

term healthy development of the banking sector. From a long-term perspective, we should improve financing structure, vigorously develop capital markets, raise the proportion of direct financing, diffuse risks within the banking sector, and maintain financial stability.

financial burden and weakened the market function. As the market economy develops, the disadvantages thereof become more and more obvious; in particular, it tends to lead to moral hazard. Therefore, we should establish an explicit deposit insurance system, and improve market-oriented financial risk compensation mechanism and long-term crisis prevention mechanisms.

Figure 2.6 Financing Structure of Domestic Non-financial Institutions in 2006



Source: PBC.

Current crisis management mechanism operated smoothly, deposit insurance and other long-term mechanisms need to be established as soon as possible.

For a long time, risk disposal and market exit of banking institutions in China adopted a “case by case” administrative settlement method; the state took the responsibility of compensating natural persons’ full deposits, which played an important role in protecting depositors’ interests and maintaining financial and social stability. However, this implicit guarantee method left the state with more fi-

Aspects Worth Attention and Reform Measures

In 2006, China’s banking sector experienced significant improvement in overall strength and risk-resistant capabilities through reform, innovation, and development. At the same time, we should be aware of the fact that the extensive growth mode of banking sector has not been fundamentally changed. Corporate governance is far from perfection, innovation and service capabilities are still weak, and there is a long way to go in reform and development. In future, banking sector should further promote reform and opening-up, accelerate the pace of establishing modern banking system, enhance the capabilities of innovation and risk management, improve service qualities, increase core competitiveness, and realize sustainable development.

Continue to deepen the reform of commercial banks and accelerate the pace of establishing modern banking system

Banking sector is the major component of

Chinese financial industry, and meanwhile commercial banks play dominant roles in the banking sector. Although remarkable achievements have been attained in reform and restructuring of commercial banks, corporate governance and internal control mechanisms are not yet well-developed, basic management is still relatively weak, reforms of branches and outlets lag behind, financial service capabilities are not desirable, and there is a large gap with the modern banking system. Meanwhile, as financial sector opens wider to the outside world, commercial banks are confronted with fiercer competition. It is necessary to deepen commercial bank reform and accelerate the pace to build modern banks with adequate capital, strict internal control, safe operation, high quality service, good performance, strong innovation capabilities, and outstanding international competitiveness.

We should continue to deepen the reform of ICBC, BOC, CCB, and BOCOM to improve corporate governance, promote effective check and balance mechanism, consolidate basic management, internal control, and risk prevention. Commercial banks should change their business concept, improve operation mechanism, adopt new growth modes, and continue to enhance efficiency and capability of serving national economic development via introduction and innovation. It is necessary to deepen the reforms of branches and outlets to achieve coordinated development, and promote effective operation of new mechanisms and systems in the banking system. Commercial banks should operate orderly and maintain

steady improvement of asset quality as well as profitability according to international regulatory standards.

It is necessary to speed up shareholding reform of ABC. We will stick to the principles of serving “agriculture, rural areas and farmers”, conducting bank-wide restructuring, adopting commercial operation, and choosing best timing for listing. We will draw the experience of ICBC, BOC, and CCB, carry out financial restructuring by disposing of NPA and government capital injection, and establish joint-stock company based on all-round external auditing and verification of all assets of ABC. We should strengthen its market orientation of serving “agriculture, rural areas and farmers” to provide better services for “agriculture, rural areas and farmers” as well as county-level economies.

While deepening reform of large commercial banks, we should also promote reform of other commercial banks and AMCs in good timing to accelerate the establishment of modern financial system.

Accelerate rural financial reform and better serve “agriculture, rural areas and farmers”

In recent years, although rural financial reform has achieved some positive results, rural finance still remains weak in the whole financial system. For example, the number of outlets is limited, products and services are monotonous, supporting function to agriculture is weak, and there is serious outflow of rural capital. Therefore, there are still relatively large gaps in meeting financial service demands of “agricul-

ture, rural areas and farmers”.

At present, it is necessary to speed up the establishment of a rural financial system with multi-layer, wide coverage, and sustainability to enhance serving capabilities to “agriculture, rural areas and farmers”. Firstly, we should continue to deepen reforms of RCCs, bring its roles as major rural financial serving force into full play, and transform RCCs into community financial institutions serving rural areas and farmers. Secondly, we should bring the backbone role of ABC and ADBC in rural financial system into play. On the one hand, ABC’s network and businesses in rural areas should be expanded to support industrialization of agriculture and infrastructure construction in rural areas, on the other hand, the operation mechanism of ADBC should be improved further by expanding its business scope to certain

extent, improving its service capabilities and raising its profitability. Thirdly, PSBC should continue to provide basic financial services such as deposit, exchange, payment and settlement. PSBC should be encouraged to adopt various measures to commercially utilize capital in rural areas, supporting the buildup of new socialist countryside. Fourthly, it is necessary to encourage and guide other financial institutions to provide services for “agriculture, rural areas and farmers” and county-level economic development. Fifth is to lower accession criteria, adjust and relax accession policies of banking financial institutions in rural areas, and promote innovation of financial organizations, financial product and service in rural areas. Meanwhile, innovate the mode of micro-credit and mutually guaranteed loan for rural households.

Box 4 Organization Innovation of Rural Finance

In recent years, China has continued to explore organization innovation of rural finance. While bringing the role of banking institutions in promoting rural economic development into full play, some measures have been taken to try to establish rural financial organizations with various ownership structures, in order to optimize the structure of rural financial organizations, increase financial supply in rural areas, and enhance the capabilities of rural finance to serve “agriculture, rural areas and farmers”.

In 2005, pilot practice of commercial micro-credit was launched in Shanxi, Sichuan, Guizhou, Shaanxi, and Inner Mongolia. As of the end of 2006, 7 micro-credit companies were formally established and put into operation. Micro-credit company, explicitly defined as micro-credit organization with “only loan extension, no deposit function”, is a legal person established and operated in accordance with relevant provisions in the *Company Law*, and the legal person can only carry out businesses within the territory of county where the company is

located. For the company, the loans can only be granted to rural households, self-employed, and mini-enterprises, which shows the company's operation principle of serving "agriculture, rural areas and farmers" with stand on rural areas. Establishment of micro-credit companies is a successful trial in innovation of rural financial organizations, and is conducive to the improvement of rural financial services.

In December 2006, *Proposals on Adjusting and Relaxing the Market-entry Policies for the Banking Institutions in Rural Areas to Better Support the Construction of the New*

Socialist countryside was promulgated, allowing establishment of three types of new banking institutions in rural areas, namely, village bank, community credit cooperatives, and subsidiary of only loan business to satisfy the effective capital demands in rural areas. The proposals also made adjustment and relaxation to capital requirement, business requirement, and personnel requirement of rural banking institution. This policy further promotes innovation of rural financial organizations, which is conducive to the expansion of service channel and enhancement of service capabilities.

Push forward the reform of policy banks and promote long-term healthy development of policy finance

As the socialist market economy in China develops, the market environment, tasks and business operation conditions faced by policy banks have changed greatly. At present, policy banks have been engaged in many commercial businesses, and some of the former policy businesses have changed to commercial businesses. Therefore, it is necessary to accelerate the reform of policy banks, gradually change the operation mechanism and mode of policy finance, and promote long-term healthy development of policy finance.

The reform of policy banks should be pushed forward according to the principle of categorized guidance and "One bank, one policy". The reform of CDB will be pushed forward according to commercial operation manner, making operation decisions and bearing

the responsibilities for risks, profits and losses by itself. CDB mainly conduct mid-and-long term businesses. To achieve the goal, we need thoroughly evaluate the asset quality and risk status of CDB according to international standards and regulatory requirements, and CDB should establish standardized corporate governance structure with Board of Directors and Board of Supervisors, faithfully perform cooperation agreements between banks and enterprises to ensure the continuity of credit-debt relationship of CDB. EIBC and ADBC should also deepen internal reform to create conditions for bank-wide restructuring.

It is necessary to reform the operation mechanism and mode of policy finance. From the perspective of our national conditions and status quo, policy financial business and policy banks are necessary for supporting all-round economic and social development. In the future, policy financial business should be con-

ducted via open and transparent bidding system, and be given certain discount for risk compensation. All banking institutions can engage in policy financial business in the principle of market competition.

Accelerate the risk disposal of some small- and medium-sized banking institutions and consolidate the foundation for steady operation of the banking sector

In 2006, institutional reform and risk disposal of small- and medium-sized banking institutions achieved significant progress; yet potential risks of certain institutions still need to be addressed. Some city commercial banks are still weak, and business operations of a few institutions have not been improved ultimately. The risk disposal task of UCCs is still arduous, and some rectified institutions have not fully exited from the market. In addition, the risks with certain non-banking institutions should not be neglected.

In the future, we should continue to pay attention to risk situations of city commercial banks, UCCs, and TICs, accelerate reform pace, and consolidate the results of reform and risk disposal. First, we should explicitly define the market orientation of UCCs, speed up the restructuring of certain banks, and pay attention to the business operations of highly risky UCCs. Second, we should promote the stable and orderly progress of UCCs reform, continue to work on the disposal of unrectified UCCs, and accelerate the exiting process of rectified UCCs. Third, we should continue to study the problems in the development of non-banking institutions, accelerate the pace of

risk disposal of TICs, and try to solve the problems left in the past.

Strengthen the innovation and risk management capabilities of banking institutions and enhance service capability and competitiveness

In recent years, although banking institutions saw improved innovation and management capabilities as well as enhanced capabilities of operation, management and risk control, they are still lagging relatively far behind when compared with the requirements of modern banking system and advanced international banks. In the future, we should continue to enhance innovation capabilities and risk management of banking institutions and maintain a sound development trend in banking sector. First, improve the management. We should establish a full-scale risk management system covering credit risk, market risk and operational risk, gradually introduce performance appraisal system based on risk-adjusted return on capital, and build and improve risk identification, risk evaluation, risk pricing, and risk control mechanisms. Second, enhance innovation capabilities. The startup should emphasize the system reform, mechanism transformation, and streamline rebuild; accelerate the organizational innovation, product innovation, and service innovation; and continue to strengthen the service of banking institutions for the public. Third, transform growth pattern and profit mode. We should optimize asset structure, especially pay more attention to the changes of loan quality in key industries, preventing the rebound of NPL. Fourth, steadily push forward pilot programs of inte-

grated financial services. The cooperation with securities and insurance sectors should be deepened to enhance banking institutions' ability to prevent cross-industry, cross-market financial risks. Fifth, large commercial banks

should take full advantage of the platform of listing in overseas capital markets, gradually implement "going abroad" strategy with cultivating advantages of their own, and enhance their international competitiveness.

(By Guo Dayong, Xiao Yuping, Xiong Lianhua,
Chen Jianxin, Lin Wenshun and Wang Nan)