Chapter II

Banking Sector

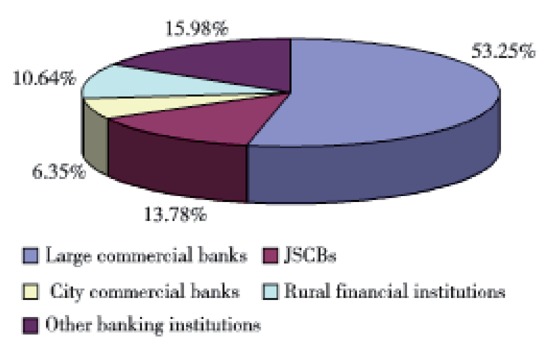
In 2007, the reform and opening up of China's banking sector continued to advance, with the total assets and efficiency steadily enhanced and its resilience to risks further strengthened. Confronted with the increasingly complicated financial situations both at home and abroad, financial institutions in the banking sector continued to deepen their internal reform, expand business channels, and improve management. Meanwhile, to support macroeconomic policies, banking institutions have taken steps to strengthen credit management, optimize credit structure and improve services, and played an important role in promoting the sound and rapid development of the national economy.

Recent Developments

Total assets and liabilities grew steadily. As of the end of 2007, total assets of banking institutions increased by 19.68% to RMB 52.6 trillion yuan on a y-o-y basis, and total liabilities grew by 18.84% to RMB 49.57 trillion yuan. The outstanding deposits denominated in both domestic and foreign currencies reached RMB 40.11 trillion yuan, up by 15.2% y-o-y; the outstanding loans in both domestic and foreign currencies amounted to RMB 27.77 trillion yuan, up by 16.44% y-o-y.

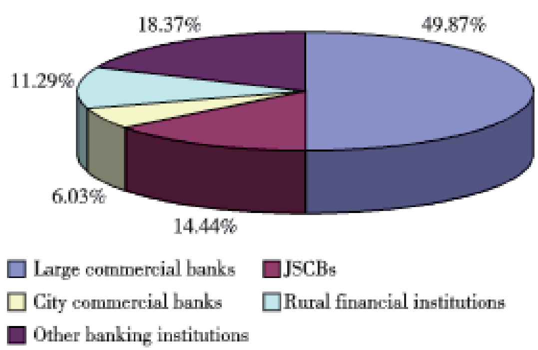
The competitiveness of the banking sector further enhanced. In 2007, the development of JSCBs, city commercial banks and rural financial institutions accelerated, featuring steadily increased assets. The competition of banking sector is deepened. As of the end of 2007, the assets of the big five commercial banks accounted for 53.25% of the total assets of banking institutions, down 1.95 percentage points over the previous year, while the assets of JSCBs, city commercial banks and rural financial institutions (including rural commercial banks, rural cooperative banks and RCCs) accounted for 13.78%, 6.35% and 10.64% respectively, up by 1.42, 0.45 and 0.58 percentage points (Figure 2.1). In terms of market share of loans, the share of the big five commercial banks decreased 1.60 percentage points to 49.87%, and the share of JSCBs, city commercial banks and rural financial institutions rose by 0.50, 0.28 and 0.18 percentage points to 14.44%, 6.03% and 11.29% respectively (Figure 2.2).

Figure 2.1 Proportion of Assets of Banking Institutions



Source: PBC, CBRC.

Figure 2.2 Market Share of Loans of Banking Institutions



Source: PBC, CBRC.

Asset quality steadily improved. In 2007, the NPL ratio of commercial banks continued to decline. As of the end of 2007, the outstanding NPLs of commercial banks registered RMB 1.27 trillion yuan, and the NPL ratio recorded 6.17%, down 0.93 percentage points y-o-y.

Capital adequacy continued to increase. In 2007, the capital base of banking institutions was replenished through various channels. Commercial banks issued a total of RMB 37.7 billion yuan of subordinated bonds and hybrid capital bonds, and raised RMB 137.465 billion yuan through IPOs. As of the end of 2007, the number of commercial banks meeting the CAR requirement of 8% reached 161, increased by 61. The assets of these banks accounted for 79% of the total assets of commercial banks, up by 1.6 percentage points.

Profitability was improved significantly. In 2007, the net profit of banking institutions after tax recorded RMB 446.7 billion yuan, among which net profit of major commercial banks (including the big five commercial banks and 12 JSCBs) after tax totaled RMB 303 billion yuan. The ROE and ROA of banking institutions reached 16.73% and 0.92% respectively.

Monetary policy achieved initial effects. In 2007, monetary policy control was further strengthened, with 10 times increase in reserve requirement ratio from 9% to 14.5%. Lax liquidity in the banking system was drained, reflected by a decrease in excess reserve ratio from 4.8% at the end of 2006 to 3.5%. The deposit and lending rate was raised 6 times in a row, with one-year benchmark deposit rate lifted from 2.52% to 4.14% and one-year benchmark lending rate escalated from 6.12% to 7.47%, suggesting a squeezed spread in banking institutions.

Regulatory framework was increasingly improved. In 2007, the legal framework of banking supervision was further improved. Administrative rules on TICs, finance leasing corporations and enterprise group finance companies were revised and promulgated, the behaviors of commercial banks were regulated in internal control, information disclosure, transaction of derivatives and credit extension to key customers, *New Basel Capital Accord* was implemented in an orderly manner in the banking sector, and the new *Accounting Standard for Business Enterprise* would soon come into force in all commercial banks. Relevant authorities intensified their efforts to clamp down on the irregularities of commercial banks, curb credit extension to industries with high energy consumption or heavy pollution, and impose penalty on those financial institutions that failed to effectively manage credit funds. In addition, banking institutions saw an evident decrease in criminal cases with the funds involved sharply reduced, and their capability of guarding against serious criminal cases was remarkably enhanced.

Reform and Achievements

In 2007, the reform and restructuring of banking institutions advanced at a steady pace, as reflected in enhanced capability of serving "agriculture, rural areas and farmers", strengthened market disciplines, accelerated the pace of pilot programs of integrated financial services and increased opening up to the outside world.

Reform Was Steadily Pushed Forward

In 2007, according to the guidelines set in the National Financial Work Conference, the reform and restructuring of banking institutions were further promoted.

Fundamental works on the reform of ABC were continued. In line with the principle of supporting "agriculture, rural areas and farmers", carrying out overall reform, conducting commercial-based operation and listing at a proper time, ABC steadily promoted the fundamental works of the reform, with external audit producing preliminary results and asset appraisals, legal due diligence, and checking of non-performing assets being underway. Meanwhile, positive efforts have been made to advance the building of corporate governance and internal reform, accelerate the design of legal person governance structure, promote the comprehensive reform of human resources, formulate policies and institutional arrangements to improve financial services at the county and village levels, build up county-wide and agricultural business database, and further improve the overall risk management system. Under the guidance of the National Financial Work Conference, relevant authorities are making efforts to conduct further feasibility study on the share-holding reform of the bank.

Box 1 The Share-holding Reform of ABC Advanced Steadily

The National Financial Work Conference held at the beginning of 2007 set the principle of supporting "agriculture, rural areas and farmers", carrying out overall reform, conducting commercial-based operation and listing at a proper time for the reform of ABC, and required the bank to strengthen and develop its outlets and business in rural areas through the reform, further intensify its responsibility of supporting rural economic development and make full use of its advantages in funds, network and expertise at the county level to provide better services for "agriculture, rural areas and farmers" and county economy and become the backbone of rural financial system.

According to the guidelines of the National Financial Work Conference, relevant authorities established the working group on the ABC reform in March 2007. Over the past year, the working group made field visit and survey, extensively solicited views on the reform of ABC, studied major issues in the design of the reform and actively urged the bank to concretely promote the preparation of the reform. At present, the preparation for share-holding reform of ABC has made significant progress. External auditing has achieved preliminary results with the asset appraisals, legal due diligence, and checking of non-performing assets being underway. Internal reform was vigorously promoted, and mechanism and institutional arrangements on serving "agriculture, rural areas and farmers" and county economy were under research. Meanwhile, the working group was making active efforts to study the share-holding reform plan of ABC.

As the next step, on the basis of the overall external auditing and asset verification of the bank, it is necessary to formulate the overall reform plan of ABC, advance financial restructuring including the disposal of NPLs and capital injection by the state, etc, and promote the establishment of share-holding company in a steady and orderly manner with reference to the experiences of the three state-owned commercial banks which have already completed the reform. Efforts should be made to deepen the internal reform of ABC, promote the reform of organizational structure, explore new business patterns, and improve the financial services to "agriculture, rural areas and farmers" in line with the principle of serving "agriculture, rural areas and farmers" and conducting commercial-based operations.

The restructuring of CEG and CEB was broadly accomplished. In 2007, according to the reform and restructuring plan approved by the State Council, and under the promotion and coordination of relevant authorities including PBC, the restructuring of CEG launched, centering on the financial restructuring of CEB and the establishment of China Everbright Industrial Company and China Everbright Financial Holding Ltd. On November 30, 2007, Central Huijin Investment Co. Ltd (referred as Huijin Company below) injected an amount being equivalent to RMB 20 billion yuan in USD in CEB. At present, the Bank was making active preparation for IPO. China Everbright Industrial Company and China Everbright Financial Holding Ltd were also operated soundly.

The reform of policy banks advanced at a steady pace. The National Financial Work Conference held in early 2007 clearly pointed out the direction of the reform of policy banks, and decided to first reform CDB aiming at turning the bank into modern financial enterprise that conducts commercial-based and independent operation, takes risks on their own, is self-responsible for loss and profit and mainly engages in medium and long-term business. Currently, the reform of CDB achieved fruitful results. Under the approval of the State Council, Huijin Company injected USD 20 billion in CDB on December 31, which will remarkably enhance the bank's CAR and its resilience to risks, is conducive to carrying out commercial-based operation, and marked a fundamental and important step in the reform of CDB. The EIBC and ADBC continued to deepen their internal reform, strengthen the building of risk management and internal control mechanism and steadily developed new business so as to create conditions for the overall reform. At present, relevant authorities are in deliberation of the reform and development of the two banks.

Banking Institutions' Capability of Serving "Agriculture, Rural Areas and Farmers" Further Enhanced

In 2007, banking institutions continued to play an important role in promoting the building of Socialist New Countryside and the construction of rural financial system, with their ability of serving "agriculture, rural areas and farmers" further enhanced.

ABC and ADBC strived to explore ways of providing better services to "agriculture, rural areas and farmers". In 2007, the ABC formulated the *Action Plan of ABC in Serving "Agriculture, Rural Areas and Farmers"*, which was implemented in eight provinces on a pilot basis. The Plan clearly stated that funds raised by the branches of ABC at the county level will in general be used to support "agriculture, rural areas and farmers" and county economy, and financial services provided to the rural sector will focused on farmers, SMEs, modern agriculture, infrastructure and the building of villages. ADBC took positive steps to expand business, with its credit support covering wider rural economic fields, such as the production and processing in farming, forestry, animal husbandry, sideline production and fishery, and agricultural technology. In addition, agricultural supporting pattern has taken shape, denominated by grain, cotton and oil purchasing loans and supplemented by agricultural and sideline product loans as well as medium and long-term agricultural loans. The two banks were playing an increasingly backbone role in the rural financial field.

The RCCs continued to intensify financial support to the agricultural sector. The reform of RCCs was steadily advanced in a commercially sustainable manner. As of the end of 2007, there were 17 rural commercial banks and 113 rural cooperative banks, which were established from the restructured RCCs. Some of the banks were introducing or have introduced strategic investors both from at home and abroad, with their corporate governance gradually improved and overall strength further enhanced. Meanwhile, since the RCCs could enjoy a preferential reserve requirement ratio policy, their support to the rural economy further strengthened. As of the end of 2007, agricultural loans of the RCCs reached RMB 1.35 trillion yuan, accounting for 56% of their total credit. The outstanding balance of loans to farmers amounted to RMB 927.3 billion yuan, and more than 78 million rural households obtained such loans, with the loan coverage for rural household reaching 32.8%.

Pilot programmes of new-type rural financial institutions gradually expanded. In October 2007, new-type rural financial institution experiments were conducted extensively, with the experiment area expanded from 6 provinces and autonomous regions to 31 provinces, autonomous regions and municipalities. By the end of 2007, 31 new-type rural financial institutions had been established, including 19 village banks, 4 loan companies and 8 rural credit cooperatives. These three types of institutions raised a total of RMB 310 million yuan of equity contribution, accepted RMB 430 million yuan of deposits and extended RMB 230 million yuan of loans, playing a preliminary role in introducing social funds into rural areas to support rural economic development.

Market Discipline for Commercial Banks Obviously Strengthened

In 2007, commercial banks steadily increased capital market financing. CCB and BOCOM have listed successively in Shanghai Stock Exchange, and raised RMB 58.05 billion yuan and RMB 25.204 billion yuan respectively. After completing the reform, four large commercial banks have listed both in Hongkong and Shanghai. The Industrial Bank and China CITIC Bank have listed in the Shanghai Stock Exchange, and raised a total of RMB 28.785 billion yuan. 7 of 12 national JSCBs have become listed companies. Bank of Ningbo, Bank of Nanjing and Bank of Beijing raised a total of RMB 25.426 billion yuan after their IPOs on Shanghai Stock Exchange and Shenzhen Stock Exchange respectively, and became the first few listed city commercial banks. Moreover, many small and medium-sized commercial banks (including some rural commercial banks) were making active preparation for IPO. At the end of 2007, a total of 14 domestic banks went public. ICBC, CCB and BOC have become the global top ten banks in terms of market capitalization, and BOCOM was among the world's 20 largest banks.

Through public offering, commercial banks saw a significant increase in CAR and steady improvement in ownership structure and corporate governance. Meanwhile, market discipline for commercial banks was evidently strengthened and information disclosure steadily improved. Commercial banks focused more on the shareholder return, their profitability and risk management greatly enhanced, and the role of market in supervision was strengthened. In addition, with the acceleration of domestic and overseas listing, commercial banks participated more in the international financial market.

Pilot Programmes of Integrated Financial Services Were Sped Up

In 2007, with conditions matured, relevant authorities strived to push forward pilot programs of integrated financial services of commercial banks and gradually improved relevant rules and regulations. The promulgation of the *Administrative Rules on Trust and Investment Companies* and *Administrative Rules on Finance Leasing Companies* removed the legal restrictions on commercial banks for setting up or investing in non-banking financial institutions; and equity holding of insurance companies by commercial banks was substantively promoted.

Pilot programmes of integrated financial services made important strides, and the cooperation between banks and securities firms as well as between banks and insurance companies further deepened. Based on the establishment of pilot fund management companies, commercial banks began to invest in TICs and finance leasing companies. For instance, BOCOM restructured Hubei International Trust and Investment Co. Ltd into Bank of Communications International Trust Co. Ltd, and China Minsheng Banking Corporation invested in Shaanxi International Trust and Investment Co. Ltd. Moreover, CCB, ICBC, BOC and CMBC were approved in succession to set up joint-venture or wholly-owned finance leasing companies.

The Opening-up of the Banking Sector Further Enhanced

In 2007, foreign banking institutions achieved rapid development in China and domestic banks also accelerated their paces in overseas investment. The banking sector further opened to the outside world.

Foreign banks developed at a fast pace in China. While China removed the restrictions on customers and regions of RMB business conducted by foreign banks, foreign banks rapidly expanded their business, providing diversified products and services. As of the end of 2007, 29 foreign banking institutions have been established upon approval. Other than that, 117 branches and 242 representative offices of foreign banks were set up in China. The assets of foreign banks totaled RMB 1.25 trillion yuan, accounting for 2.38% of the total assets of banking institutions, up by nearly 0.3 percentage points y-o-y.

Meanwhile, foreign financial institutions who have become strategic investors of domestic banks further deepened their cooperation with those banks. At the end of 2007, foreign financial institutions, as strategic investors, invested in 25 domestic banks, including large commercial banks, JSCBs, city commercial banks and rural cooperative banks. Foreign banks positively contributed to China's banking sector in terms of the reform and innovation, corporate governance, risk management and internal control mechanism, and the building of brand names of the Chinese banks.

The overseas investment of domestic banks expedited. While introducing foreign capital, domestic banks accelerated to go abroad, with overseas investment more diversified. Large commercial banks played a leading role in overseas investment, and the investment was mainly conducted through establishing branches or sub-branches, setting up joint-ventures with foreign counterparts, directly purchasing financial institutions, and setting up fund or fund management companies together with financial institutions overseas.

In November 2007, China Merchants Bank was approved to establish branch in New York, which was the first operational office established by China's commercial banks in the US over the past more than ten years. BOC, ICBC, and CCB also respectively set up branches in the UK, in Russia, and in Vietnam and Australia in succession. Meanwhile, the Chinese banks invested in an evidently growing number of overseas financial institutions, with ICBC purchasing 20% of shares of the Standard Bank of South Africa, CDB investing in Barclays Bank, and CMBC investing in United Commercial Bank, which triggered widespread attention. The overseas investment of the Chinese banks will be conducive to expanding income channels, promoting business innovation and enhancing competitiveness, and will better support the investment and development of the Chinese enterprises overseas.

Box 2 Merger and Acquisition (M&A) of International Banking Sector

Since 1990s, financial globalization steadily deepened, and international banking sector faced increasingly fierce competition. With an aim to expand operation, enhance competitiveness, and satisfy the needs of cross-border development, banks conducted large-scaled M&A within and across the border, which has the following features: first, previously M&A were mainly the merger of two small institutions or large institution acquiring the small one, but now it was more often the merger of two large institutions. Second, previously M&A took place among institutions in the same sector, but now it happened cross-sector, with universal banking and large multinational financial group emerged. Third, M&A covered larger areas and cross-border M&A became vibrant. Fourth, M&A were more oriented towards strategic purpose. Through M&A, banks were steadily expanded with lower operating costs and stronger competitiveness, which to a certain extent helped to maintain the stability of the banking system. However, attentions should be paid to potential risks in super scale operation, differences in countries' legal system, development strategies, and consolidation and management after M&A.

With regard to international practice, most of the M&A of banks were led by the market, and were launched according to market-based principles. However, given the inherent problems of M&A as mentioned above, governments and regulatory authorities set down relevant rules and regulations to regulate and guide M&A of domestic banks in the consideration of protecting competition and safeguarding financial security of the country. First, in order to strengthen the international competitiveness of domestic financial institutions, governments provided vigorous legal and tax support to domestic banks' overseas M&A, and meantime adopted relevant measures to prudentially approve foreign financial institutions to merge domestic banks for their own economic and political interests. For instance, the US had once restricted the cross-state M&A of domestic banks but had never restricted the cross-border M&A by domestic banks, and large banks such as the Citibank have a larger coverage overseas than in the US. Second, regulatory authorities exercise responsibility of examining and approving M&A cases but make no assessment of their commercial value. For instance, the EU enacted rules on banking M&A in 2007, listing several criteria that may be used by supervisory institutions in assessing M&A transactions, including the reputation of the purchaser and its manager, its financial status, and whether the purchaser was involved in money laundering and terrorist financing, etc.

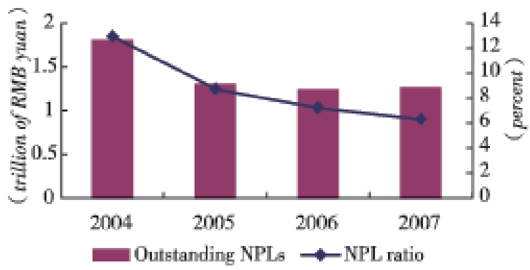
With the rapid development and increased opening-up of China's banking sector, the M&A of banks will be increasingly active. Efforts should be made to vigorously support qualified commercial banks to conduct M&A and create favorable policy environment based on international experiences, and foster them to improve their decision-making and management in M&A and conduct M&A according to market principles.

Soundness Assessment

In 2007, major indicators reflecting the sound performance of the banking sector remained favorable, featuring improved asset quality, enhanced capital adequacy and profitability, and abundant liquidity. Meanwhile, close attention should be paid to the distinctly increased proportion of demand deposits in total deposits, excessively fast growth of loans and inappropriate credit structure.

The NPL ratio continued to decline while the outstanding NPLs increased slightly. As of the end of 2007, outstanding NPLs of commercial banks totaled RMB 1.27 trillion yuan, representing a y-o-y growth of RMB 13.1 billion yuan; NPL ratio stood at 6.17%, down by 0.93 percentage points y-o-y (Figure 2.3). In particular, outstanding NPLs of major commercial banks recorded RMB 1.20 trillion yuan, RMB 30.8 billion yuan more than that recorded at the end of 2006, with the NPL ratio decreasing by 0.78 percentage points to 6.72%; outstanding NPLs of city commercial banks fell by RMB 14.72 billion yuan y-o-y to RMB 51.15 billion yuan and the NPL ratio recorded 3.04%,

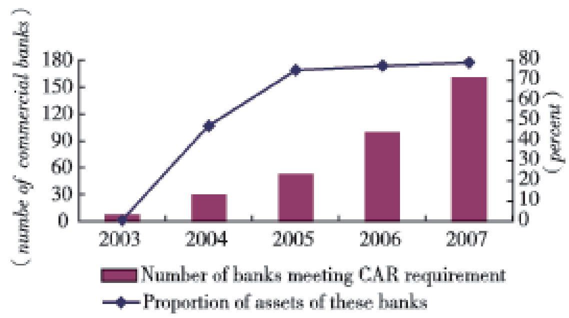
Figure 2.3 NPLs and NPL Ratio of Chinese Commercial Banks



Note: aggregate data of domestic institutions.

Source: PBC, CBRC.

Figure 2.4 Number of Commercial Banks Meeting CAR Requirement and the Proportion of Their Assets



Source: CBRC.

down by 1.76 percentage points; outstanding NPLs of rural commercial banks amounted to RMB 13.06 billion yuan, a decrease of RMB 2.37 billion yuan and the NPL ratio was 3.97%, down by 1.93 percentage points.

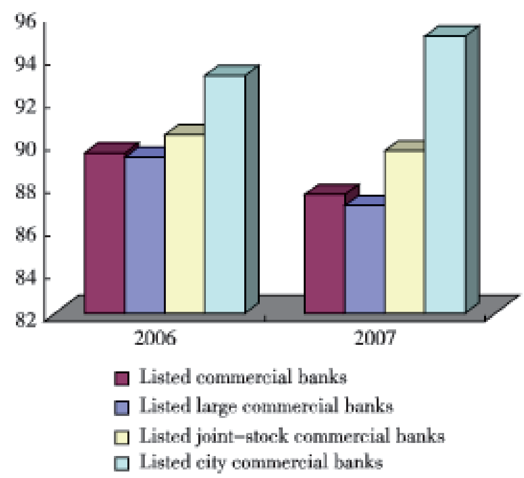
CAR and provision coverage ratio escalated year by year with capability of resilience to risks further strengthened. As of the end of 2007, the number of commercial banks with CAR at or above 8% increased from 8 at the end of 2003 to 161, and the proportion of assets of banks meeting CAR requirement increased from 0.56% to 79% of the total assets of commercial banks (Figure 2.4). The provision coverage ratio of major commercial banks grew for consecutive years, increasing from 14.19% at the end of 2004 to 39.2%. In particular, provision coverage ratio of the big four commercial banks after restructuring reached 109.32%, while that of JSCBs registered 114.46%. However, the provision coverage ratio of small and medium-sized banking institutions including city commercial banks, UCCs and rural financial institutions remained low and was yet to be increased.

Profitability steadily enhanced and revenue structure improved. In 2007, banking institutions realized a net profit of RMB 446.7 billion yuan after tax, indicating a large increase in profits; ROE and ROA reached 16.73% and 0.92% respectively, both witnessed an evident increase over the previous year. In particular, the ROE and ROA of major commercial banks recorded 17.34% and 0.93% respectively, higher than the average level of the sector.

With profits growing fast, the share of net interest income of commercial banks steadily declined, reflecting an improved revenue structure (Figure 2.5). As of the end of 2007, net interest income of commercial banks accounted for 84% of the operating income, down by 3.4

Figure 2.5 Share of Net Interest Income of Listed Commercial Banks

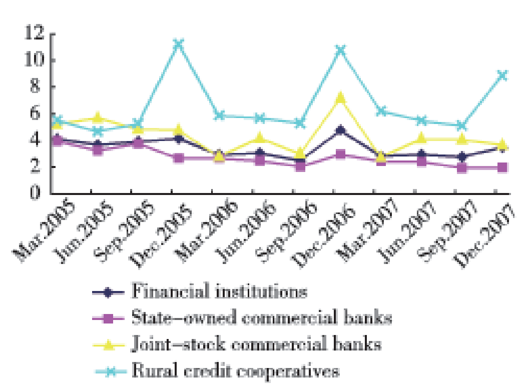
(*percent*)



Source: Annual report of listed banks.

Figure 2.6 Excess Reserve Ratio of Financial Institutions

(*percent*)



Source: PBC.

percentage points y-o-y. However, interest income was still the major source of banks' revenue, and hence vigorous efforts should be made to promote innovation and expand business channels so as to further optimize revenue structure.

Liquidity tightened to a certain extent but remained adequate. The liquidity of banking institutions was tightened to a certain extent, as the excess reserve ratio of financial institutions fell by 1.3 percentage points y-o-y to 3.5% at the end of 2007, and all institutions experienced a decline in excess reserve ratio over the previous year (Figure 2.6).

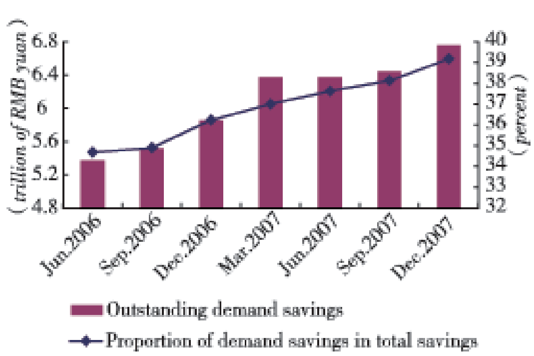
As of the end of 2007, the liquidity ratio of banking institutions decreased over the previous year to 40.35%, with that of major commercial banks decelerating by 2.16 percentage points to 36.27%, and that of small and medium-sized institutions including city commercial banks, UCCs, and RCCs maintaining at above 40%, down by 2.94, 7.69 and 4.91 percentage points respectively. Although the liquidity ratio was on a declining trend, it was still higher than the lower limit of regulatory indicators (25%) and the overall liquidity remained abundant in the banking system.

The growth of deposits decelerated, but demand deposits increased more. As of the end of 2007, the outstanding deposits of banking institutions denominated in both domestic and foreign currencies totaled RMB 40.11 trillion yuan, increasing by 15.24% y-o-y. Affected by the vibrant transactions in the capital market, stock market in particular, the growth of RMB deposits decelerated by 0.74 percentage points. Outstanding household savings rose by 6.77% to RMB 17.26 trillion yuan, an deceleration of 7.79 percentage points; corporate deposits grew by 22.46% to RMB 13.87 trillion yuan, 4.68 percentage points higher than the increase recorded in same period of previous year.

The proportion of demand deposits increased evidently in RMB deposits, especially in household savings. As of the end of 2007, outstanding RMB demand savings reached 6.76 trillion yuan, accounting for 39.18% of the total savings (Figure 2.7), an increase of RMB 0.90 trillion yuan from the beginning of the year and accounted for 82.33% of the new savings in 2007. Demand savings accounted for an increasingly larger share in total savings, indicating a more fluctuated source of funds in banking institutions.

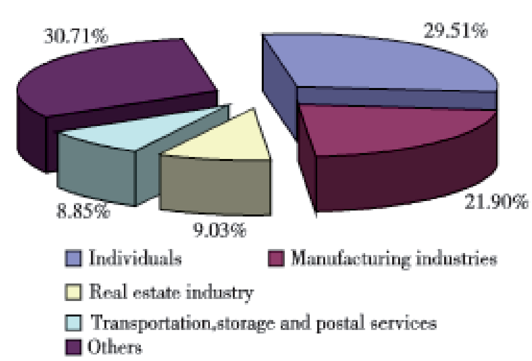
Loans of financial institutions grew faster than desired with the credit structure yet to be improved. As of the end of 2007, outstanding loans of all banking institutions amounted to RMB 27.77 trillion yuan, representing a growth of RMB 3.92 trillion yuan or 16.4% y-o-y, an acceleration of 1.8 percentage points over the previous year. In particular, new loans to individuals, manufacturing industries, real estate industry, and transportation, storage and postal services amounted to RMB 1161.159 billion yuan, RMB 861.54 billion yuan, RMB 355.091 billion yuan and RMB 348.328 billion yuan respectively, accounting for nearly 70% of the total new loans (Figure 2.8).

Figure 2.7 RMB Demand Savings and Its Proportion in Total Savings



Source: PBC.

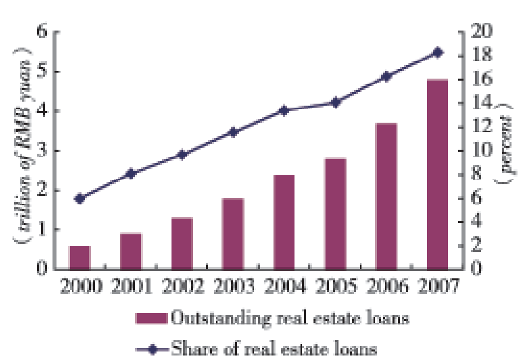
Figure 2.8 Sectoral Distribution of Loans



Source: PBC, CBRC.

The proportion of loans extended to real estate industry continued to increase. As of the end of 2007, outstanding commercial real estate loans totaled RMB 4.8 trillion yuan, a growth of 30.6% y-o-y. In particular, outstanding real estate development loans amounted to RMB 1.8 trillion yuan, increasing by 20.3%; home mortgage loans reached RMB 3.0 trillion yuan, up by 33.6%. The share of real estate loans grew rapidly to nearly 20% of the total RMB loans (Figure 2.9), and it is noteworthy that fluctuations in real estate prices may potentially give rise to credit risks in the banking sector.

Figure 2.9 Growth of Loans to Real Estate Industry



Source: PBC.

Issues Worth Attention and Reform Measures

In 2007, financial institutions in the banking sector carefully implemented macro management policies, played an active role in deepening the reform and supporting the development of national economy, and continued to maintain good growth momentum. Going forward, in an effort to implement the decisions of the Central Economic Work Conference and achieve further development, the banking sector will continue to advance the reform and opening up, improve financial services, promote innovation and enhance risk prevention capability.

Control Credit Extension and Improve Credit Structure

In 2007, new loans accounted for 78.9% of the total financing volumes of non-financial sectors, with bank loans growing faster than desired. Meanwhile, the geographical and industrial distributions of bank loans were still not appropriate.

As China will implement tight monetary policy in 2008, the banking sector should, in line with the new situations in macroeconomic management, control credit aggregates, improve credit structure and reinforce its role in guiding resource allocation and adjusting economic performance. First, commercial banks should be alerted of risks arising from an excessively rapid growth of loans, properly control the size and pace of credit extensions. Second, credit structure should be optimized. In response to the requirements of macroeconomic management, steps should be taken to intensify the support to economic restructuring, rein in the extension of medium and long-term loans to infrastructure sectors, impose strict restrictions on lending to enterprises in industries with high energy consumption, heavy pollution, or excess production capacity, and strengthen credit support to industries in energy conservation, environmental protection, and self-initiated innovation. Third, efforts should be made to strictly regulate real estate loans according to relevant requirements set in the *Notice on Strengthening Regulation over Credit for Commercial Real Estate* and *the Supplemental Notice on Strengthening Regulation over Credit for Commercial Real Estate*. Fourth, commercial banks should shift operational philosophy, increase loans to small enterprises, innovate credit products and patterns for these enterprises, and provide better services to them. Fifth, the role of banking sector should be further strengthened to support the development of rural economy and improve services to "agriculture, rural areas and farmers".

Strengthen Liquidity Management to Prevent Liquidity Risks

In 2007, the liquidity in the banking system remained abundant. However, liquidity tended to be tight in some areas and some small and medium-sized banking in certain periods of time, which posed new challenges to liquidity management in the banking sector. Continued efforts should be made to implement macro management policies and further strengthen liquidity management in the banking system. Meanwhile, attention should be given to the liquidity crunch in some institutions to prevent and mitigate potential liquidity risks. First, liquidity management should be reinforced to stabilize the source of funds in commercial banks and curb potential risks. Second, commercial banks should further expand funds use channels, adjust the structure of their assets and liabilities in a scientific approach, diversify off-balance sheet products, and timely fill in the liquidity gap. Third, the time changes in positions should be closely monitored and corresponding measures should be taken to improve liquidity management mechanism at the micro level. Derivatives market, including interest rate swap, currency swap, and financial futures, should be expanded gradually and various channels should be developed such as asset-backed securities and securities repo to mitigate pressures on the liquidity. Fourth, close attention should be paid to the changes in the liquidity of small and medium-sized banking institutions to mitigate risks timely.

Improve Credit Risk Management to Prevent the Rebound of NPLs

In 2007, the overall asset quality of banking institutions continued to improve, however, the NPLs and NPL ratio in some financial institutions increased in the fourth quarter. With the uncertainties increased, the credit default ratio may rise and commercial banks faced a larger pressure on the rebound of NPLs. Moreover, real estate loans grew rapidly, and some credit funds illegally invested in the stock market, resulting in higher credit risks in banks. Other than that, since credit funds of banks unduly concentrated in certain sectors and some conglomerates, risks of credit concentration should not be ignored.

The banking institutions should attach great importance on and correctly analyze macroeconomic situations, and adopt effective measures to prevent and mitigate credit risks, concretely enhance the capability of risk management and prevent the rebound of NPLs. First, the impact of economic cycles on the operation of relevant sectors and enterprises should be monitored to strengthen the management of credit funds and prevent the deterioration of loan quality. Second, attention should be given to the concentration of credit risks in the banking system to explore ways and means to diversify risks and alleviate the concentration of credit risks. Third, steps should be taken to further regulate credit monitoring and risk management, intensify the building of internal control, strengthen the examination before and during lending and management after lending, and take effective measures to monitor the use of loans so as to improve the overall capability of credit risk management. Fourth, the illegal flows of funds from banks to stock market and real estate market should be closely monitored to prevent risks from transferring and spreading to the banking system.

Accelerate Business Innovation and Improve Revenue Structure

In 2007, the profits of banking institutions rose by a large margin, with the proportion of fee-based business income and investment income increasing remarkably and revenue structure improved. However, spread income still played a dominant role, and the proportion of fee-based business income in total profits was less than 15%, which was far below the international average level. The fee-based business was undiversified, poorly structured and denominated by low value-added traditional products. As China fostered the building of multi-layer capital market system, the banking sector was confronted with the challenge of "financial disintermediation". Moreover, the adjustment of interest rate gradually narrowed the spread between deposit and lending rates, thus the overdependence on traditional deposit and lending business as well as the spread income will adversely affect the steady growth of revenue and hamper the sustainable development of the banking sector.

In the next phase, banking institutions should speed up business innovation, vigorously develop fee-based business and improve revenue structure. First, continued efforts should be made to change operational philosophy and expedite the transformation of business. Banking institutions should give high priority to fee-based business and transfer from fund intermediation to service intermediation. Second, business strategy should be adjusted to develop fee-based business in terms of organizational structure, marketing and risk management, and further raise the proportion of fee and commission income as well as the earnings from non-credit assets. Third, innovation capability should be enhanced. The banks should identify a proper position on the market according to their specific status and clients, learn from international advanced experiences, take advantage of various types of financial markets and diversified investment tools both at home and abroad to develop new products and business with distinctive features, and enhance the technology contents in products. Fourth, risk management should be improved. While strengthening the management of credit risks arising from traditional business, the banks should make efforts to improve the management of innovative business and fee-based business.

Focus on Global Economic and Financial Risks to Prevent the Effect of Uncertainties on the Sound Performance of the Banking Sector

With China further opened to the outside world, international economic and financial situations have a larger impact on the sound performance of China's banking sector. At present, the slowdown of global economy, continued depreciation of the US dollar and soaring prices of large commodities highlighted the global economic imbalances. In particular, larger uncertainties and potential risks brought by the continued spreading of the US sub-prime mortgage crisis and global financial market turmoil may hinder the sound development of the China's banking sector.

It is necessary to pay sufficient attention to the impact of the changes of international economic and financial situations on the development of banking institutions and improve risk management system. First, the monitoring and analysis of global economic and financial risks should be intensified to prudently weigh relevant risks and conduct overseas business and investment in a sound manner. Second, lessons should be learned regarding the failures of international financial institutions, and the building of internal control system and risk prevention capability should be strengthened so as to minimize the potential effects of external shocks. Third, efforts should be made to steadily advance financial innovation, properly design products, and formulate relevant measures on risk prevention. Fourth, the implementation of the *New Basel Capital Accord* should be actively promoted and new methods and experiences of international banking sector on risk management should be learned to improve the techniques and ability of risk management. Fifth, steps should be taken to strengthen financial supervision, especially the supervision of cross-sector and cross-market business, and improve the early-warning of risks.

Further Deepen the Reform and Comprehensively Enhance Competitiveness

After several years of financial reform, major commercial banks have preliminarily established appropriate corporate governance, enhanced CAR, improved asset quality, and strengthened profitability and risk control, with their operation management and competitiveness steadily improved. However, a lot more needs to be done for the Chinese banks compared with the requirement of modern banking system and international advanced banks.

Therefore, banking institutions should further deepen their reforms, steadily open to the outside world and actively promote innovation so as to enhance the competitiveness of the banking sector. First, corporate governance should be further improved and the building of modern financial enterprise system should be pushed ahead. Efforts should be made to optimize organizational structure, clarify the division of labor, identify decision-making rules and procedures, improve incentive and supervision mechanism, regulate information disclosure and undertake proper social responsibilities. Second, continued steps should be taken to push forward the reform of ABC and other institutions. The financial restructuring of ABC and the establishment of share-holding company should be steadily advanced. The functions and operating mechanism of policy banks should be further improved. Third, pilot programmes of integrated services in banking sector should be steadily promoted. The building of risks management system should be accelerated compatible with integrated financial services so as to prevent cross-sector and cross-market risks. Fourth, the extent and quality of opening-up should be enhanced. Measures should be taken to promote the fair competition between domestic and foreign banks in a gradual, controllable, cooperative and mutual beneficial way based on our own initiatives, and steadily implement the "going out" strategy to enhance the international competitiveness of the China's banking sector. Fifth, in line with the trends of integrating financial business, strengthening the international nature of financial activities, increasing the proportion of electronic transactions, and diversifying financial products, commercial banks should further promote innovation in development patterns, operating mechanism, financial products and service modes, and strive to improve financial services.

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