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China's financial reform roadmap unveiled at Third Plenum

Takeshi Jingu

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Nomura Research Institute, Ltd.

Executive Summary

The reform agenda unveiled at China's Third Plenum places priority on market forces. Market-led financial liberalization, already well underway, will be able to continue. Financial liberalization is likely to also pave the way for other nonfinancial reforms.

Takeshi Jingu
Chief Researcher
Nomura Research Institute (Beijing), Ltd.

Third Plenum reforms place priority on market forces

At its Third Plenum (held on November 9-12, 2013), the 18th Central Committee of the Communist Party of China (CPC) adopted a Decision on Major Issues Concerning Comprehensively Deepening Reforms (the "Decision"). The Decision covers a wide range of issues, but one key focal point is its pledge to "deepen economic reforms by allowing the market to play a decisive role in resource allocation." While placing more priority on market forces, the Third Plenum's financial reforms include further opening the financial sector both inwardly and outwardly, establishing privately owned small banks, increasing direct finance's prevalence, improving renminbi exchange rate formation through market forces, accelerating interest rate liberalization and renminbi capital account liberalization, developing a deposit insurance scheme and improving financial institutions' market exit mechanism (see table). Such reforms were expressed more ambitiously than in the past[1].

NOTE

1) The CPC's November 2012 18th National Congress and the Chinese government's March 2013 Work Report stated that China will "steadily liberalize and reform interest and exchange rates and gradually proceed with renminbi capital account liberalization."

CPC Central Committee's Decision on Major Issues Concerning Comprehensively Deepening Reforms

Key points regarding financial market reforms
• Open up the financial sector further both inwardly and outwardly. Authorize establishment of small privately owned banks and other financial institutions that meet certain conditions. Reform policy financial institutions.
• Optimize multi-tier financial market structure. Reform equity issuance registration system. Promote equity finance via many channels. Develop and regulate bond markets. Increase direct finance's prevalence.
• Improve insurance's economic compensation mechanism. Develop mega-disaster insurance scheme.
• Develop inclusive finance.
• Encourage financial innovations. Diversify financial market strata and products.
• Improve renminbi exchange rate formation mechanism through market forces. Accelerate interest rate liberalization. Improve the government bond yield curve to better reflect the market's supply-demand balance.
• Open up capital markets both inwardly and outwardly. Further liberalize cross-border capital and financial transactions.
• Establish and optimize a regulatory system for external debt and capital flows under a macroprudential regulatory framework. Accelerate renminbi capital account liberalization.
• Steadily implement financial regulatory reforms and moderation standards. Improve regulatory coordination. Clarify financial regulation and risk mitigation responsibilities between national and sub-national governments.
• Develop deposit insurance scheme. Improve financial institutions' market exit mechanism.

Source: NRI, based on CPC Central Committee's Decision on Major Issues Concerning Comprehensively Deepening Reforms

The intent behind the Third Plenum's focus on market forces is to improve the efficiency of resource allocation by allowing market forces to play bigger role in setting factor prices (including interest rates). Potential financial reforms include liberalization of interest and exchange rates, but market-led liberalization of interest rates in particular is already well underway[2].

2) Interbank market interest rates and banks' lending rates have already been liberalized. The only rates that remain to be liberalized are de facto deposit rate caps.

3) Alibaba's Alipay was established in 2004 as a third-party payment platform (escrow service) for settlement of Taobao Marketplace's C2C transactions. With *Yu'E Bao*, Alipay Account holders can purchase money market funds with a minimum investment of only one renminbi and redeem their fund holdings at any time. The funds are managed by Tianhong Asset Management.

One hot topic in China's financial and IT industries in 2013 was *Yu'E Bao* , a new product offered by Alipay[3], an online payment service. *Yu'E Bao* allows Alipay account holders to invest their idle cash balances in money market funds (redeemable at any time). Alipay account holders are said to be mainly younger consumers who make online purchases. Although the average money market fund investment per account is small, the total amount invested has grown rapidly since *Yu'E Bao*'s launch in late June 2013, surpassing RMB100 billion by November. *Yu'E Bao* is an example of liberalized interest-rate products becoming more accessible. It also competes with bank deposits to some extent. The advent of new financial products that erode banks' conventional deposit base may prompt banks to increase their dependence on wealth management products not subject to deposit rate caps.

Additionally, shadow banking, which has gained prominence in China over the past few years, is a form of circumventive finance. That is, banks utilize off-balance-sheet accounts to circumvent regulations. At the same time, Chinese shadow banking is another example of market-led liberalization of deposit rates because it involves the sale of wealth management products that offer unregulated interest rates to banks' retail customers.

Because shadow banking and some of the wealth management products used therein are intended to circumvent regulations, they pose problems, including inadequate information disclosure and accumulation of risk. If the regulatory authorities crack down on shadow banking with piecemeal measures, they are liable to merely spur further circumvention of regulations. Consequently, regulatory authorities seem to have no alternative but to deregulate.

In other words, the fundamental aim of financial reform, particularly interest rate liberalization, is to give free rein to market forces, but the regulatory authorities currently appear to be forced to choose between taking the initiative to deregulate in an orderly manner and allowing continued market-led liberalization, which is liable to result in a buildup of risk. The regulatory authorities have no alternative but to implement reforms.

Regulatory response and key to future interest rate liberalization

In fact, the regulatory authorities' recent measures to regulate market-led liberalization appear to semi-ratify market-led liberalization. According to media reports[4], the China Banking Regulatory Commission (CBRC) in September 2013 designated 11 banks authorized to sell wealth management products and utilize direct funding tools on a pilot basis. To circumvent lending restrictions, banks have hitherto provided financing to local governments' financing platforms and other borrowers through trust companies and securities firms. Under the new pilot program, banks will lend funds without such circumvention by utilizing direct funding tools (for borrowers) and wealth management products (for investors). The pilot program apparently aims to increase the transparency of banks' off-balance-sheet lending.

4) Most notably an October 10, 2013 article in the Guangzhou Daily.

One key point in terms of prospective interest rate liberalization is development of a deposit insurance scheme. China must establish a deposit insurance scheme and bank resolution mechanism to prepare for bank failures that could occur once interest rates are liberalized or private banks have been established. Additionally, China's lack of deposit insurance has recently given rise to a society-wide, tacit assumption that bank deposits are fully guaranteed by the state. On the basis of this assumption, banks and investors are engaging in morally hazardous behavior.

Deposit insurance has been under discussion in China for the past 20 years, but a consensus has yet to be reached on the deposit insurance coverage cap, among other matters[5]. If the deposit insurance cap is set at RMB500,000 per depositor, nearly all depositors would reportedly be fully covered. If so, China should be able to maintain its current de facto 100% deposit guarantee from the standpoint of the number of depositors.

5) Another unresolved issue is whether the deposit insurance premium rate should be uniform for all banks or vary based on risk.

A second point is the importance of improving the monetary policy transmission mechanism in terms of macroeconomic adjustment via the markets (interest rates). Among recent developments, banks' lending rates were de facto liberalized in July 2013 and in October China unveiled a new benchmark interest rate, the Loan Prime Rate (LPR), calculated based on the prime rates offered by nine reporting banks[6]. Whether the LPR is able to take over the role of existing benchmark lending rates published by the People's Bank of China bears watching[7].

6) Currently, the only LPR being published is for one-year loans (www.shibor.org). The nine banks are Industrial & Commercial Bank of China, China Construction Bank, Agricultural Bank

7) In terms of deposit rates, the key issue is whether Shibor (Shanghai Interbank Offered Rate) or repo rates likewise replace existing benchmark rates.

If banks and investors' mindset toward risk changes as China develops deposit insurance and bank resolution schemes, local governments' financing platforms, for example, would likely have to become more transparent disclosure-wise. In such an event, China would have to implement fiscal reforms on the local government level also. If banks' net interest margins shrink due to interest rate liberalization, banks may focus more on lending to SMEs, in which case the current dearth of financing available to SMEs may improve[8]. While the authorities have little choice but to proceed with interest rate liberalization, such deregulation could lead to other reforms.

In sum, the CPC Central Committee's Decision is not merely a list of reforms but a program of interrelated reforms. This is presumably why its title includes the words "comprehensively deepening reforms[9]."

8) Such an outcome is all the more likely if direct finance becomes more prevalent, thereby enabling high-quality companies to raise more funds directly from capital markets, and if small privately owned banks are established, in accord with the Decision.

9) We mainly cited examples of economic (financial) reforms herein, but from a broader standpoint, the words "comprehensively deepening reforms" in the Decision's title reflects a recognition that China will not be able to resolve the many issues it currently faces through reforms in only one sphere and must simultaneously implement comprehensive, interrelated reforms across many spheres, including the economy, politics, culture, society and the natural environment.

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Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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