RECOMMENDATIONS FOR CAPITAL MARKET DEVELOPMENT IN CHINA

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INTRODUCTION

China’s accession to the World Trade Organization (WTO) in 2001 began a process of opening China’s capital markets to foreign competition and expertise. Since accession, foreign financial institutions have been permitted to provide services in China without client restrictions for foreign currency business. For local currency business, foreign financial institutions were permitted to provide services to Chinese enterprises. Within five years of accession, foreign financial institutions will be permitted to provide services to all Chinese clients. Foreign non-life insurers are permitted to establish as a branch or as a joint venture with 51% foreign ownership. Foreign non-life insurers have been permitted to establish as a wholly-owned subsidiary. Upon accession, foreign life insurers were permitted 50% foreign ownership in a joint venture with the partner of their choice. For large scale commercial risks, reinsurance and international marine, aviation and transport insurance and reinsurance, upon accession, joint ventures with foreign equity of 50% were permitted; within three years of China’s accession, foreign equity share shall be increased to 51%; within five years of China’s accession.

These actions have and will create a large non-state sector under auspices of which domestic financial markets gain critical importance as a pillar of a market-based economy. Domestic financial markets mobilize savings, allocate risk, absorb external financial shocks, and foster good governance through market-based incentives. The development of local financial markets also reduces the risks associated with excessive reliance on foreign capital, including currency and maturity mismatches. As such, they contribute to more stable investment financing, higher economic growth, lower macroeconomic volatility, and greater financial stability. Financial markets are hierarchically ordered (figure 1) starting with money markets, followed by foreign exchange, treasury bill and bond markets, and ultimately crossing over into what constitutes capital markets; markets for corporate bonds and equity, and asset-backed securities and derivatives. Markets and financial institutions are also complementary, with equity and debt markets as well as banking and non-banking financial institutions complementing one another. The hierarchy reflects the degree and complexity of risks to financial stability posed by the development of each market, and the technical interaction between markets that link the depth of one market as a determinant of the depth of another.

The liberalization of financial transactions and capital flows aimed at deepening capital markets increases risks that often result in financial distress and crisis. Domestic policy actions ensure that the institutions, instruments and infrastructure that are necessary to develop capital markets also develop the capacity to manage the risks associated with a wider range of permissible financial transactions, instruments, and funds.
Capital market development hinges on a careful policy action which follows this hierarchy and
minimizes opportunities for excessive risk-taking and possible loss of macroeconomic control created by
financial reforms.

Only 5% of China's population owns stocks and coupled with a high savings rate, 38% of GDP
China's capital markets are emerging as the proverbial "Sweet Spot". This growth is driven by
household demand for new investment products for two reasons; household savings which have been
increasing at over 10% annually, and, bank deposit rates which are likely to stay low. Therefore
potential demand for low to medium risk investment products for both retail and institutional segments
is significant. Pension reforms are underway and pension funds being the most important institutional
investors are likely to lead explosive growth of assets and the asset management industry. Insurance
penetration is very low yet total premiums are expected to grow at more than 20% annually. Official
statistics reveal that China's mortgage market has more than doubled on average each year since 1997
which may be an exaggeration, but it is still an exciting market. The interesting thing about mortgages

Figure 1. The Hierarchical Order of Domestic Financial Markets

in China is that to date just 0.5% of home loans have gone bad, compared with 25% of company loans
which is yet again very encouraging for this market.
With the WTO providing more opportunities with joint venture funds and securities firms being allowed to be established and the government’s plans to build the role of institutional investors, international asset managers are interested in China because there are large pools of capital that traditionally have sat in bank accounts, but will soon be invested in a broader array of instruments. Among international financial institutions there has been a corresponding land rush mentality - a feeling that the last great unconquered market is opening, and this is an opportunity not to be missed.

China’s domestic securities market history is short but the growth in the last 12 years has been impressive. Market Capitalization accounted for 50% of GDP in 2002, with much room to grow considering the worldwide averages (see figure 2). GDP grew at 8% in the year 2002 exceeding 10 trillion Yuan and is expected to grow at least 7 percent annually. A total market capitalization of RMB 4.4 trillion, about half of the GDP, from about a dozen listed companies in 1990 there are now 1,700 listed companies, 124 securities firms, 100,000 practitioners and 68 million investor accounts. RMB 854 billion worth of funds were raised through public offerings in 2002.

**Figure 2: Market Capitalization as % of GDP (2001)**

![Market Capitalization Chart](image.png)

*Source: FIBV and stock exchanges' websites*

The same growth has engendered a great sense of urgency among China’s banks, insurance companies, and securities firms as they prepare for an onslaught of competition from global institutions with much stronger management, financial resources and technology.

The true story is not as simple though. The China Syndrome - a.k.a how to meltdown a movement, follows anything related to China everywhere. The lack of investment alternatives
available to investors, restricted common shares in Chinese companies being traded, the bond market
being small and negligible options or derivatives available for trading makes one question the possibility
of China’s financial sector thriving as supposed. Other chronic issues which beset China are the very
large volume of Non Performing Loans and the legacy of the State Owned Enterprises.

Against this backdrop and with a view to exploring viable policy options for Capital Market
Development, this report studies in greater detail the Institutional, Functional and Infrastructural
factors.

I. INSTITUTIONS

Disintermediation in the Financial Services Industry

Although it has been argued that there are three natural stages of development in a country’s
financial system; (a) internal finance (b) intermediation of finance (c) securitization, it is important to
relativize this development pattern with the observation that in most countries, internal finance,
financial intermediation and securities markets co-exist simultaneously.

In a number of countries the norm has become for financial institutions to form large groups
that offer the full range of financial services, with institutional structures to support it. Japan has
authorized banks and securities houses to expand into each other’s primary line of business. In the US,
although there exists a legal separation, banks and securities firms offer close substitutes. The
universal banking systems appear to be intact in Germany but they are rapidly moving towards
international practices. The question of whether any particular regime would come to be dominant
seems irrelevant since change and adaptation is in process for each type of system.

China’s financial services industry integration began from the late 1980s to early 1990. China
had a mixed financial system where banks and trust companies heavily engaged in the securities
business. The 3 largest securities firms then were set up by 3 state banks. Trust Cos. were allowed to
engage in a full range of banking, securities and investment business. But this resulted in substantial
flow of bank funds to securities and created an economic bubble resulting in financial disorder. Many
trust companies went bankrupt. In 1995, China’s commercial banks stipulated for the first time that
commercial banks cannot engage in securities business. Securities firms were spun-off and separated
from banks.

In 1997 the state councils clearly stated the principle of separated financial business and
industries for the reason of financial safety and stability. A Securities law was passed which required
that securities business be separated from banking and insurance business with separate institutions
and supervision. However by 1999, with widespread cooperation and penetration between different
financial business institutions, securities firms and fund management firms were allowed to enter the
inter-bank market. Banks could also use their network to sell securities on behalf of securities firm. The relationships between various institutions became controversial as did the role of intermediation.

A. The Role of Banks

In developed economies, two rather distinct systems grew - one where capital markets are very important (mainly the English-speaking countries) and one where banks dominate. In bank-dominated systems, banks were historically protected from competition from capital markets. The issuance of short-term debt that could compete with bank deposits was often limited as was bond issuance by corporations. During the last decade, however, the sharpness of this dichotomy has been eroded by the development of capital markets worldwide.

In the past two decades capital markets worldwide have changed beyond recognition. Domestic deregulation and external liberalization resulted in major changes in competitive conditions. Advances in communications and information systems enhanced the capacity of financial market participants to use the opportunities offered by the liberalized environment, including the use of sophisticated financial and mathematical concepts for the development of new products. In all probability financial sector activities will be increasingly dominated by institutional investors who will take a sophisticated approach to investing to attain the best possible risk and return combinations. The demand of investors for a broad range of assets with different risk-return characteristics may well lead to a marked acceleration in the creation of asset backed and mortgage backed securities; this trend would also be strengthened by the desire of banks to bring under better control the size of their balance sheets. The markets in derivative products are likely to expand at least as fast as the underlying cash markets. Derivative instruments are major tools for the management of risk by market participants and an indispensable complement and substitute for cash markets. In both cash and derivative markets the traditional exchanges are likely to be challenged by alternative systems for trading, including Over The Counter markets.

Competition will intensify first due to advances in information technology and second due to aggressive policies of investors to direct orders to the cheapest trading systems. As a result the major intermediaries are likely to de-emphasize secondary brokerage market activities.

At low levels of competition from other banks or capital market financing, banks would be interested mainly in transaction lending such as credit card loans, mortgages and some types of syndicated commercial and industrial loans. At moderate levels of competition, banks would provide relationship loans such as revolving lines of credit secured by receivables and loans to small and medium-sized enterprises. At higher levels of competition from other banks and the capital market, traditional banking is likely to decline. Banks function in a much-changed shape. Banks are still key
institutions for mobilizing savings. They're essential participants in the payment system. Banks routinely perform credit analysis and are a major source of information concerning small and medium enterprises. They are also involved in providing back-up lines of credit to capital market participants. But their role will likely extend to develop new products such as origination and servicing of securitized assets and derivatives. More banking revenues will come from fee based services. Some banks are specializing in areas where they have a clear comparative advantage like investment banking, risk arbitrage. Other banks use lending relationships to sell other more profitable products e.g advisory services, cash management, foreign exchange transactions. Finally banks act as the intermediate lender of last resort, standing between a systemic financial collapse and the intervention of central banks.

For many, banks can survive only if they adapt to this trend and learn to play a major role in capital markets - a conclusion reached in several international forums in the emerging markets, notably for China. According to this view, banks will have to be fully involved in bond underwriting and in the sale of capital market products to households. In addition, they will be able to bundle bank loans into packages to be sold in the market (securitization). As this process develops, new debt instruments come into the market. In addition, such developments mean that prices derived from markets can be applied to the valuation of bank loans. This inevitably blurs the traditional distinction between intermediation through a bank (which typically acquires long-term non-marketable loans held on the balance sheet until maturity) and that through capital markets (where assets trade in secondary markets).

This evolving role of banks holds true for home mortgages and consumer credits, two areas of recent strong growth in China, because decisions about the pricing of such loans tend to depend not on any special knowledge or relationship, but rather on "objective" criteria (such as income, valuation of the collateralized asset and age). At present, the securitization of bank assets is still rather uncommon in China. This is partly because, in the current environment of weak credit demand, banks are very liquid. Nonetheless, there are also significant barriers to the securitization of bank loans in emerging markets namely; collateral rules; bankruptcy procedures etc.

After the founding of the People's Republic of China in 1949, three commercial banks merged into the central bank, which dominated all of China's banking services. Driven by the need to reform the SOEs, the banking sector started undergoing reforms in 1978. The most important re-organizations have been to separate policy banks and commercial banks from the central bank. Bank loans are still the most dominant source of financing for domestic companies in China (see figure 3). With the various deregulations in the banking industry, more shareholding and private banks have entered into the picture, offering more products and services.

**Figure 3: Composition of Private Sector Liabilities (1997)**
However China's state-run banks (see figure 4) have played the keeper to their brothers the state-owned enterprises. Inefficiencies in the state-run banking system led to the creation of a significant nonperforming loan (NPL) problem for the country.

The size of the NPL problem is in the range of half a trillion RMB (US$518B), or more than 40% of total loans outstanding -- almost half of China's GDP. To deal with the NPL problem, China established Asset Management Companies (AMCs) in an effort to deal with selling assets of debtor companies, recovering amounts owed, or writing off uncollectible debts. The four asset management companies (AMCs) set up to help reduce the NPLs will likely not solve the problem, because the governance of the AMCs is not properly structured. The AMCs are in fact set up as another type of state-owned enterprises under the regulatory oversight of the People's Bank of China with input from the Ministry of Finance. Currently, their major activity is debt-equity swaps, (i.e., AMCs acquire NPLs from the banks and then convert those assets at par into direct equity holdings in the defaulting borrower, namely large SOFs). However, the SOEs chosen for this swap are selected by the State Economic and Trade Commission (SETC) and not the AMCs themselves. The AMCs also have no power to change the management of the banks or to perform any kind of restructuring of the banks. They also do not take any control of the board. Without power as shareholders and without political independence, the hope for successful loan recovery lies in the specific methods AMCs will apply. However, evidence shows that after the debt-equity conversion of the assets are transferred to AMCs, the governance structure of the banks remains unchanged, and thus the physical restructuring of the enterprises remain unchanged. After almost two
years in operation, AMCs had only disposed RMB $90 billion in assets (7% of total transferred assets), and the recovery rates for the disposed portion did not even exceed 10%.

**Figure 4: Share of state-owned banks assets in total banking assets (%), 2001.**

![Graph showing share of state-owned banks assets in total banking assets](image)

*Source: Central bank's Annual Reports and BIS Papers No 4, The banking industry in the emerging market economies, BIS 2001.*

Relationship-based lending continues to dominate, and commercial banks are taking on infrastructure lending, the NPL issue is not likely to be resolved soon. Therefore, it still remains to be seen whether the banks have really become more efficient at capital lending.

Banks should naturally play a role in efficient fund allocation, but since banks are currently saddled with non-performing loans, the role of capital markets has become especially important by maintaining market functions such as corporate finance etc.

Further in disposing off NPLs banks are required to make efforts to remove such loans from their balance sheets upon setting aside appropriate provisions. Such off-balancing is realized through the secondary market for loan assets. The reference prices of NPLs to those in the secondary market make them more acceptable to lenders and borrowers alike. Corporate rehabilitation follows subsequently as market prices for loan assets can be used as an effective clue to evaluate corporate value.

In fact developing capital markets will only strengthen the management of such loans as banks begin to adjust their portfolios through measures such as securitization of existing loan assets, selling their securities holdings. Lending rates often set by the banks are appropriately corresponding to risks through a developed secondary market for loan assets by using market prices as a reference together with risk evaluation methods.
Superior bank performance is also necessary for capital market development as banks are also directly and indirectly involved in securities markets. In the primary markets, banks in some countries are permitted to underwrite securities directly or through subsidiaries. Even where this is not permitted, underwriters turn to banks for credit. In the secondary market brokers and dealers alike need term credit from banks to meet their finance their proprietary positions and facilitate buying and selling of securities, including margin requirements and daily settlement. In many countries banks act as brokers and dealers.

The relationship between banks and capital markets is more symbiotic than envisaged. Banks play an important role in developing bond markets. The view that increased bond issuance just takes away profitable business from the banks is oversimplified. First, the problem of "taking the best business" arises largely because of the regulatory framework, which can be changed. If banks are forced to hold excessive capital against loans to low-risk borrowers, this can force a migration of "good" borrowers from banks to markets that would not otherwise occur. This could represent a distortion and can be inefficient. Moreover, it could raise systemic dangers in concentrating the poorer risks on banks. Therefore a well managed banking industry is essential for managing risk in the overall financial system.

In the same vein, but a somewhat separate issue, is whether the transition to more market-dominated bond rates has meant that the exposure of banks to un-hedged interest rate risk has increased. The relative lack of interest rate hedging instruments in capital markets makes this risk more unmanaged, necessitating deeper capital markets.

B. Role of the Central Bank

Another not so new dilemma is whether the central bank should directly participate in capital market auctions. Ideally, central banks should acquire such securities passively, as a non-competitive residual buyer. The dominant view is that direct central bank participation in ways that affect the results of auction of securities should be avoided. Indirect participation is inevitable as the central bank replaces securities which are maturing in its portfolio; Central banks could intervene or acquire securities directly from the government so as to help stabilize expectations in turbulent periods.

Central banks and debt managers improve secondary market liquidity by developing a repo market in government bonds. This was seen as essential for facilitating arbitrage across the yield curve and absorbing excess liquidity in the market. The inter bank repo market tends to be very short-term, not usually beyond overnight. The lack of good collateral and the inclusion of repo transactions in eligible assets for reserve requirements is one of the main factors limiting the development of repo
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markets. A central bank which is an active player in repo markets adds liquidity to securities that would otherwise be illiquid in the hands of banks.

A pro-active view of the Central bank is one which lends securities to primary dealers and other market players to enhance liquidity. The counterview is that allowing short-selling may entail systemic risks by increasing leverage and creating an additional channel through which shocks can be transmitted in the financial system. There is also a concern that if central banks impose too restrictive conditions to limit such risks (for example, imposing a high "haircut" or a large interest rate premium), market participants may stay away.

A more balanced activism on the part of central banks is that they should just "help the market find its own depth." Central banks could be active in developing benchmarks and fostering product innovation to attract investors and encourage trading. In many cases, the fragmentation of government debt outstanding into a large number of distinct issues hinders liquidity: one symptom of this is often a very humpy yield curve. A policy of consolidation by the central bank (that is, buying back illiquid issues and selling popular issues) can make the yield curve much smoother, and thus provide a better benchmark.

C. Institutional Investors

In the household sector, the accumulation of financial assets and aging have led to an increase in assets such a pension and insurance funds, and the demands of institutional investors for long term investment vehicles have been increasing. A challenge to capital markets is thus to provide various long term financial products in response to such heightened needs. In China the products most used remain deposits (see figure 6).

Perhaps the most important dimension of domestic capital market development is the need to develop a diversified institutional investor base in the economy. Institutional investors, consisting of mutual and investment funds and other contractual savings institutions, such as pension funds and insurance companies, play a critical role in financial market development in a variety of ways. (See figure 5)

First, they provide an institutional framework for long-term capital accumulation and act as a stable source of demand for long-term debt securities and equity investments. Second, institutional investors and contractual savings institutions compete with investment banks, contribute to more efficient primary markets, and enhance financial innovation and modernization of trading systems. For example, in highly developed capital markets such as in the U.S., they supported the development of asset-backed securities, structured finance, and derivatives products, the launching of index-tracking funds, and the proliferation of synthetic products designed to protect investors against market
volatility. Similarly, institutional investors exert pressure for efficient trading, clearing and settlement facilities. In several countries, they have promoted the use of block trading, the abolition of minimum commissions, and the automation of trading facilities.

Third, institutional investors enhance market discipline and corporate governance by promoting transparency and shareholder rights. As institutional investors become dominant shareholders of non-financial corporations, they collectively have the power to help strengthen governance structures and increase the accountability of top managers. In India, for example, which has a number of large institutional investors, there is a relatively active equity market. By contrast, Russia, which does not have the same strength and variety of institutional investors, has a small capital market and is often criticized for its corporate governance standards. Fourth, the development of institutional investors and contractual savings institutions creates the need and strong incentives for the establishment of a robust regulatory and supervisory framework to minimize systemic risks.

Notwithstanding the positive externalities associated with the development of a domestic institutional investor base, several obstacles stand in their way. Pension funds still face competition from pay-as-you-go systems, while both pension funds and insurance companies are subject to strict licensing requirements and excessive portfolio investments restrictions. To the detriment of the growth and diversification of institutional investors, regulators in China follow a rules-based approach to regulating investors, placing quantitative limits on their investments, and thus limiting their investment options and creating a bias toward investing in domestic or government debt. In particular, requiring institutional investors to hold a high share of their assets in government bonds undermines the integrity of the price discovery mechanism in the market and the credibility of the government's financial soundness and issuance strategy. Public pension funds are likely to come under political pressure to invest in certain types of assets, which compromise the rate of return earned for the pension holders.

![Figure 5: Share of Institutional Assets over Total Assets of Banks and Institutional](image-url)
Figure 6: Asset allocation of insurance / pension

For institutional investors to enhance market discipline and corporate governance in the economy, however, they themselves must be well run. This, in turn, rests on the degree of reputational risks faced by institutional investors themselves, rather than any particular type of governance structure. The key sources of discipline on institutional investors include competition, disclosure, and the ability of investors to exit funds. So long as these elements are in place, institutional investors will face credibility risks and be held accountable for their investment decisions and risk management practices.

D. Role of Public Financial Institutions

The share of public finance in China's financial markets is high compared with other countries. Public financial institutions play a vital role. Due to an ever-changing economic environment the risk-return profile of corporate businesses is changing. Capital markets factor in these risks into market prices on a real time basis. A large size of public finance distorts the risk-return relationship in the economy further distorting market economy pricing. It has been seen in Japan and Germany that capital markets are as not well developed due to an over-riding involvement of public finance intermediation. It becomes necessary to consider how funds collected by private financial institutions can be effectively channeled to firms and individuals and in order to realize this, to clarify the role and functions to be exercised by public financial institutions. Areas of public financial institutions direct
lending in areas which compete with private financial institutions warrants review from a long term viewpoint.

Over the long term, public financial institutions role can be restricted to areas where there is a policy need. At an early stage of securitization e.g. Asset backed securities backed by receivables of small to medium sized firms and mortgage backed securities, public finance institutions can support the market expansion through credit enhancement measures. This is basically done by weakening the recognition of risks but should be handled in such a way so as not to distort market risk-returns.

II. INSTRUMENTS

A. Equity Market

a) SOEs, Listings and Equity Structure

The SOE privatization’s role in China’s capital market development can neither be qualified as public or private. While the SOEs were initially sold through share-issue privatizations and not through private asset sales. The program did not have the intended impact on capital market development, namely developing a robust stock and bond market, as the government could not credibly commit to policy and protection of property rights. China should ideally have chosen a private capital market privatization program for the SOEs due to this very reason. It is safe to conclude the initial listings of public companies in China were politically driven. Some SOEs were performing poorly, and the securities market became an easy venue for companies to generate funding from the public and create some independence from political influence. A system of quotas was established by the central regulators and administered in the provinces. Each province was given a number of SOEs that could be listed, and it was up to local leadership to determine which firms it would list. Certain performance requirements had to be met, but the process was full of political pitfalls, with little resemblance to market forces.

In 2000 the government undertook reform for select SOEs viz, petrochemicals, communications, rail transport and electric power sectors seeking to reorganize the entire industry and establish a regulated company system. The aim was to finally list them on domestic and overseas stock markets and establishing a regulated framework for corporate governance.

The shares traded on the markets are currently divided into four segments; A-shares, which are denominated in RMB and can only be held by Chinese; B-shares, which are denominated in USS (Shanghai) and HK$ (Shenzhen) and can only be bought by foreign investors; H-shares which are listed on the Hong Kong Stock Exchange; N-shares which are listed on the New York stock exchange. A shares, first issued in 1987, have steadily become more popular; as at December 2000, the total amount raised
through the issuing of new shares and allotment shares came to RMB 324 billion. B-shares, first issued in 1992, have been the primary means by which China secures its foreign investment. However the amount raised through B-shares has been less than the amount raised from either of the A, H or N shares. H-shares, first issued in 1993, secured RMB 225 billion by 2000.

The methods by which stocks are currently listed and shares issued in China's stock markets continue to violate the market principle. Equity in listed companies is artificially divided into different categories of shares in the same stock but with different rights - state shares held by varied ministries, bureaus and regional governments, legal person shares are kept by other SOEs, public shares are retained by individuals or private entities and internal employee shares as maintained by managers and employees. Holders of state shares can transfer their allotments and also refuse to participate in share allotments there by transferring all risks to public share holders. By contrast public shareholders can only buy and sell shares on the secondary market.

 Tradable shares are offered to -- and are freely tradable in -- the securities market. These shares are mainly held by individuals, and they provide the real liquidity in the securities market (State shares 37%, legal person shares 28%, tradable shares 35%). State shares remain the dominant proportion of total shares although the proportion of state shares in the equity structures has fallen. This is for few reasons; first China stopped capitalizing SOEs due to a shortfall in government revenues and then listed companies were constantly implementing capital increments by issuing fresh stock causing to increase the proportion of public shares. Also in the last few years there have been cases of state shares being privately transferred to legal persons increasing legal person shares.

Since the SOE reform does not involve wholesale privatization the state shares continue to be dominant. Because the majority of shares are state owned and there is too little public stock going around to be traded which would affect stocks to rise (see figure 7), on the one hand there is poor management and the other this poor management causes stock to fall and due to little trade in the markets, the stock does not rise. This is cause for concern and even if the public share owners were to respond to potential buy outs due to a fall in stock prices, they would not be able to vote with their feet.

**Figure 7: Traded shares**
$\text{EMC1} = \text{equity market capitalization of all shares,}$

$\text{EMC2} = \text{equity market capitalization of tradable shares}$

Source: based on figures given in Heilmann (2001)

State Owned Enterprise reform has shown more breadth than depth and can be turned around on its head of the Chinese government could encourage inter-regional, cross-industry mergers, acquisitions and asset reorganization between listed, listed and non-listed companies, and between companies with different ownership structures. Developing capital markets in this manner can, on the one hand, enable enterprises to increase capitalization, whilst at the same time changes in equity structures can be used to create solid foundations for dealing with the underlying causes for indebtedness of the SOEs.

In the meantime, however, the banks are trying to become more competitive by becoming corporatized - more shareholding banks as well as the Bank of China are trying to get a public listing in China's stock exchange. It is believed that going public can help support the capital expansion needed by the banks. Mergers, reorganizations and business combinations will also improve banks' economies of scale, thereby increasing banks' capabilities for resisting risk and enhancing their competitiveness as a whole. However, will corporatization work? Listing banks is a step in the right direction, but without the necessary foundation and given the still under-developed securities market, the impact of listing on banks' profitability is still unclear.

IPOs are the capital raising process for small and medium enterprises (SME). SMEs need to raise capital as it is more difficult for them to avail capital due to crowding out of investments, they are less of a choice for investors and also spell trouble for domestic exchanges due to lack of information about their performance. A well developed IPO market serves the capital market by increasing its investor base. In order to nurture IPOs besides registration information and corporate governance, underwriter function needs to be developed. Costs of going public need to be reduced. Venture Capital firms should be developed. A pricing and allocation mechanism to maintain market efficiency should be established and an equity culture should be encouraged.

h) Operational Performance of listed Companies

Whether one looks at growth, profitability and stability either individually or altogether, it can be seen that the only industries in China in which listed companies display strong performance are the
public utilities, transportation and finance. The overall performance of all other industries is clearly unsatisfactory, and poor performance is particularly widespread with respect to growth. Owing to weak demand within China, there is excessive supply, intra-industry competition has become increasingly fierce and enterprises profit margins have been squeezed. Companies have lost their ability to secure additional financing to develop their operations further. Listed companies have been willing to trade reduced profits for increasing operating revenue and market share, which has affected their ability to secure financing.

An examination of the changes of listed companies financial indicators following an IPO showed that with the exception of earnings related indicators (FPS and ROF) there is no significant change in company performance; rather it deteriorates following the listing. One of the reasons is that companies tend to submit inflated performance figures at the time of listing and the real situation reveals otherwise soon after.

The quality of listed companies is a pre-requisite and a foundation for the development of capital markets. Only when listed companies display strong fundamentals can the ongoing development of the market be maintained.

China has initiated steps to revise Chinese accounting standards according to IAS. It has strengthened regular on-site inspection on the listed companies on the issues of accounting, disclosure, related party transactions, etc. Last year about 300 firms went through regular inspection. One-third of listed companies have had changes in the controlling shareholder after IPO, most of them end up with change of management.

There is now a Joint Bureau of Investigation for Securities Crime between CSRC and Ministry of Public Security improving the quality of listed companies. Listing now aims to move towards a merit-based system, with no bias against non-state enterprises. CSRC also has instituted delisting procedures for companies which have incurred losses in three consecutive years. So far only 10 companies have been de-listed from the main board and moved to an over-the-counter share transfer system commonly known as the Third Board. It is anticipated in the future there will be orderly delisting of companies every year.

One of the things that need to be done in order to improve the quality of listed companies is to select for listing those companies which exhibit strong performance, have strong development potential and occupy a leading or advantageous position within the industry. Additionally, encouraging hi-tech enterprises and companies in other emerging industries to make use of capital markets.

The operations of listed companies need to be improved. Support can be provided for listed companies to improve their asset and liability structure through debt-for-equity swaps and refinancing.

The other task is to ensure that the capital raised through public offerings is used more
efficiently; company listing plans should be in conformity with their inventory and asset adjustment and
their technology upgrading. Listed companies need to thoroughly transform their management
mechanisms, establishing efficient corporate governance structure and corresponding stock option
incentive mechanisms. In this way it will be possible to improve the operational efficiency of listed
companies, cultivating a group of large listed companies with strong capabilities that will be
competitive in international markets, making listed companies the core element in the market and
allowing them to exercise the function of market stabilization.

B. Debt Market
a) Government Bond Market
The bond market in China is currently small (see figure 8), as is its share of the financial market. The
bond market includes government, corporate and agency bonds, and financial debentures. Local
government bonds and municipal government bonds do not exist. In addition market instruments are
still limited; the exchange market is shrinking, the inter-bank bond market is illiquid and savings bonds
outweigh marketable securities. The stock exchange market is liquid, whereas the inter-bank bond
market is not. Daily turnover in 1998 and 1999 was around RMB 10-20 billion, down sharply from
RMB300bn in 1996.

Figure 8: Total Bonds outstanding as % of GDP

Historically, bonds were mainly sold to individual investors. As the market developed, SOEs, banks, pension, insurance and investment funds were permitted to join in and actively subscribed to government securities and corporate bonds. Domestic bond markets are still developing at a rather disappointingly slow pace, notwithstanding the widespread agreement about the benefits that can be gained from them, especially after the Asian financial crisis.

On the demand side, institutional base for bonds has been fairly narrow. The situation will improve with the implementation of the Mandatory Provident Fund Scheme. Another positive factor is that bonds are yielding a real rate of return as a result of falling inflation. On the supply side, given that international credit has generally shrunk after the Asian financial crisis, there is a practical need for the corporates to diversify their sources of funds. They have thus turned to the bond markets. Moreover, many governments in the region are having real fiscal needs to borrow substantial amounts from the market to finance banking and financial restructuring.

A key question is how the government can derive enough income from the investment of the proceeds of issuance to offset the interest costs of the issuance. Given the lack of suitable fixed income securities in domestic currency, many governments have been deterred from issuing long maturity paper, thereby hindering the development of a benchmark yield curve.

In Hong Kong, China, Hong Kong dollar interest rate swaps were used to hedge the fixed rate liabilities of the longer term Exchange Fund Notes. Clearly, this hedging technique is only viable, however, when there is a suitably deep and liquid interest rate swap market in existence.

Other measures that Hong Kong, China has taken to promote bond market development include offering exemption from profits tax on income derived from Hong Kong dollar bonds issued by multilateral development banks, and other tax measures. The policy challenge of these measures is clearly how one would be willing to grant tax incentives to the bond market without creating an uneven playing field for the other sectors.

There are several general reasons for developing debt markets. The most fundamental reason is to make financial markets more complete by generating market interest rates that reflect the opportunity cost of funds at each maturity. This is essential for efficient investment and financing decisions. Moreover, the existence of tradable instruments helps risk management. If borrowers have available to them only a narrow range of instruments (e.g., in terms of maturity, currency, etc.), then they can be exposed to significant mismatches between their assets and their liabilities. If bond markets do not exist, for instance, firms may have to finance the acquisition of long-term assets by incurring short-term debt. As a result, their investment policies may be biased in favor of short-term projects and away from entrepreneurial ventures. If firms attempt to compensate for the lack of a
domestic bond market by borrowing in international bond markets, they may expose themselves to excessive foreign exchange risk. The risks entailed by such mismatches have to be managed and the ability to do so will often depend on whether certain exposures can be adequately hedged. The availability of such hedges tends to be larger the wider the range of financial instruments actively traded in markets. Liquid markets help financial market participants to hedge their exposures. As risks are spread across many participants - and not concentrated on a few - and as risks can be transferred to entities best placed to bear them, the costs of intermediation are reduced and the financial system can be made more stable.

A second general reason for developing bond markets is to avoid concentrating intermediation uniquely on banks. Since banks are highly leveraged, this may make the economy more vulnerable to crises.

Because institutional investors such as insurance companies and pension funds need to hold long-dated debt, many see such institutions as key to the development of debt markets. The development of funded pension schemes is likely to exert a particularly powerful influence; the accumulated funds of pension systems when fully mature will often approach an amount equivalent to the size of annual GDP. Moreover, the net demand for assets in a “young” pension fund is substantial during the process of maturation. If local bond markets are underdeveloped, institutional investors may be induced to hold short-term paper. Pension funds in some countries have an incentive to hold short-term paper either because of an inverted yield curve or because money market instruments can be traded more readily than long-term paper.

b) The corporate bond market

To date, the corporate bond market has been suppressed in China (see figure 9) because the law requires that all corporate bonds be sold as public instruments and because the state imposes minimum requirements to issue: minimum net assets, maximum debt/assets ratio (40%), and one-year debt service capability. The result is that almost 100% of corporate risk in China is on bank balance sheets and is mis-priced.

This problem arises from the relatively small size of the corporates. For small firms, raising funds through bond issues may be more costly than borrowing from banks or listing on the stock markets. This would mean that for many years to come bank lending would remain a major source of funds for the SMEs in the region, as the banks can understand and price the risks of these companies more efficiently than the bond market.

Other obstacles to the development of the debt market include the under-developed settlement and custody system, the continued fiscal surpluses of China, the lack of enough good quality
issuers, insufficient liquidity with associated wide trading spreads, negative real interest rates in the past, credit rating procedures, family ownership/close group control of many corporations. The business sector has relied on short-term borrowing, leading to maturity mismatches. The equity market has been overheated. The demand by Asian central banks and financial institutions (including commercial banks, insurance companies, and provident and pension funds) for investing in bonds, has lead them to invest in bonds from outside Asia, and particularly in US Treasuries.

Figure 9: Private sector bonds outstanding as % of GDP 2000.


C. Credit Rating Agencies

While Korea had a large bond market because of the size of the large chaebol mainly due to massive issuance of three-year corporate bonds during the crisis years of 1997-98, (bonds outstanding rose above 25% of GDP); initial public interest in earning the higher yields available through the bond-type beneficiary certificates issued by the investment trust companies (ITCs); the evaporation of public confidence following the collapse of the Daewoo group in mid-1999; and then a prolonged period when various government measures to shore up demand failed to prevent massive withdrawal of funds. This experience contrasts with that of Thailand. Corporate bond issuance also rose strongly after the Asian
crisis but from a much lower initial level. Moreover, liquidity has tended to improve over the years. What are the reasons for this very different performance? One possible element of an answer is that, early in the post-crisis period, the outstanding volume of corporate bonds may have been artificially driven above a sustainable level. The mechanisms of channelling household savings through ITCs may have misled households about the real risks involved. This meant that credit risks were not properly assessed. A second element is the poor accounting practices of investment institutions. The maintenance of historical cost accounting contributed to the early massive flow of funds into the bond-type beneficiary certificates issued by the ITCs. The absence of mechanisms designed to protect bond investors' interests in the event of liquidation was another factor. One implication often drawn from US experience is that a key prerequisite for the development of a corporate bond market is the existence of some form of independent credit risk assessment. For this reason - and because of the greater reliance on external assessment envisaged in the proposed new Basel Accord - most countries have reinforced efforts to develop credit ratings in their country. How successful have these efforts been? In most countries, this is very difficult to judge because the practice of the independent credit rating of corporations is still rather new but it is possible to reconcile the overriding need to promote objective ratings with more activist official policies (e.g. to promote credit rating agencies or subject their performance to official audits).

In China a credit market has yet to be formulated since there are no internationally recognized rating agencies in the country.

The other problem arises from the generally low credit ratings of sovereigns and corporates in Asia, apart from in Japan and in Singapore. A low credit rating is a negative factor in bond market development. Mr. Chan noted that there is not much that individual economies can do on their own to better their low credit ratings.

The establishment of a national rating agency may solve only part of this problem, as it is not easy to build up credibility and confidence overseas. While acknowledging that low credit ratings are a reality that most Asian issuers will have to live with for some time, it seems sensible to consider the idea of setting up a regional credit enhancement and guarantee agency to address investor concern on credit exposure.

D. New Instruments

In the meantime many firms have actively been making efforts to innovate their management style under a rapidly changing industrial structure. In the process, firms have come to face increasingly complicated and diversified risks. Capital markets provide a variety of risk hedge methods against such
diversified risks as price volatility pertaining to interest rates, foreign exchange rates, stock prices, and property prices. Newer instruments are available to manage the same

a) Asset Backed Securities Market

As the housing market develops, asset-backed securities will be introduced and the assets of state-owned enterprises (SOE) will be securitized. China's big four state-owned commercial banks will continue to focus on limiting risk in 2000 but they are also encouraged to increase their investment in business sector. The shifting of bad loans from their balance sheet to Asset Management Companies (AMC) will reduce the bank burden and restore their confidence.

Previously the receivables of small to medium sized firms against big firms and other counter parties were not used as funding collateral because they were not in the form of securities or bills and the amount was relatively small. These days banks have successfully extended loans using receivables as collateral and subsequently converting these loan assets to securitized products and sell them to investors.

These schemes are well received as they support funding of small and medium sized firms. For them to be successful however aggressive disclosure of financial data is necessary.

In parallel with such moves syndicated loans for major firms have been gradually increasing in addition to the expansion of the secondary market for loan assets. A syndicated loan is a loan extended to a firm by multiple banks based on a single contract under the arrangement of a managing bank. Syndicated loans have been increasing because major banks, in their effort to strengthen themselves, have started to earn profits by playing the role of a managing bank while reducing loan concentration risk. While for regional banks and institutional investors they consider syndicated loans as an opportunity to extend loans to major firms and broaden their chance of profitability and risk management. If transactions in the syndicated loan market and secondary market for loan assets become active such markets will contribute to maintaining smooth corporate financing even when banks try to reduce their assets.

The Mortgage market is one of the largest and fastest growing markets worldwide. In the US it exceeds the Treasury securities market. Mortgage loan is a small amount and thus difficult to securitize directly. One can make a securitized product which satisfies the demand of the investors by bundling similar loan assets. Pension funds and life insurance companies have strong demand for long term assets. Such loans can be provided by government housing loan corporations and commercial banks alike. This market has gained significance with commercial banks as it provides them with a place to manage their interest rate and prepayment risks. Increasing the participants in this market including banks, securities market and public agencies, will nurture this market.
Banks to select eligible collateral based mainly on creditworthiness and marketability. Bearing in mind that such eligibility contributes indirectly to expansion of market banks should make active efforts to adopt new financial products as collateral, e.g. ABS and ABCP.

b) Derivatives Market

The development of derivatives markets is more difficult to discuss in broad terms and does not fit precisely into a hierarchy of market development. Derivatives markets range from interbank financial derivatives traded over the counter to commodity and financial derivatives traded on exchanges. Derivatives and their underlying markets are interdependent—derivatives require the existence of a liquid market in underlying products but they also enhance the liquidity and price discovery in those underlying markets. Certain derivatives markets, including interest rate swaps, foreign exchange swaps, and forward contracts, are critical to facilitate risk management for financial institutions, and hence foster liquidity and price discovery in markets for the underlying securities. At the same time, derivatives themselves raise other forms of risk. Managing the risks associated with derivatives requires additional infrastructure (for example, in the case of settlement systems for derivatives exchanges) and additional ability to understand more complex risks (for example, in the case of accounting for derivatives on bank balance sheets). We do not propose to address these issues in detail but we raise derivatives as a dimension of market development that must be considered in conjunction with the development of fixed income and equity markets.

E. Risk Management

To reap the benefits of financial market development and maintain financial sector stability, the risks introduced by each market need to be effectively managed as the markets are developed and more risks are injected into the financial system. Financial market development policies thus must accord high priority to mitigating the risks introduced by increasingly more sophisticated markets and the risks to macroeconomic control from institutional reforms. For example, central banking and money market reforms, including interest rate liberalization, can lead to the release of excess reserves and strong capital inflows, which in turn, can stimulate credit expansion, undermine monetary control, and lower banks' asset quality. Similarly, increased price volatility in equity and real estate markets, particularly in the context of capital account opening, can complicate monetary policymaking as well as the soundness of institutions. Thus, in the absence of regulatory and institutional capacities to measure, monitor, contain, and manage the range of financial risks, the risks can accumulate over time and undermine the policy consensus and commitment to liberalize further.
The process of financial market development and capital account opening also entails additional risks to financial institutions and markets arising from the common exposures of institutions to macroeconomic risk factors such as increased volatility of asset prices, capital flows, and macroeconomic conditions, both locally and in global markets. The resulting impact on financial soundness could by itself have feedback effects on macroeconomic outcomes. Macro prudential surveillance monitors these linkages through an analysis of aggregate information on financial soundness of banks and nonbanks, and through stress testing of individual institutions' resilience to certain plausible, but exceptional, common shocks. Such top down surveillance is increasingly being recognized as a critical complement to prudential supervision of individual institutions, particularly in a globalized environment.

a) Debt Market Risks

Given their longer maturities, government bonds involve a particular type of credit risk, namely sovereign risk and the risk of higher inflation and macroeconomic instability that can erode the value of the bonds, even if they are repaid in full and on time. Finally, more sophisticated derivatives markets combine a variety of risks already present in the financial system, but their inherent complexity heightens operational risks in institutions as the widely known cases of Barings and Allied Irish Bank illustrate.

Perhaps the single most important market risk involving debt securities in normal times is interest rate risk. Banks in particular are exposed to re-pricing risk—arising from timing differences in the maturity and re-pricing of banks' assets and liabilities—and yield curve risk, which arise from changes in the slope and shape of the yield curve. This highlights the importance for the supervisory authorities to enhance monitoring and reporting requirements on the maturity structure of Interest-sensitive assets and liabilities by asset class and currency and for financial institutions to actively manage maturity mismatches and conduct sensitivity analyses of balance sheets to changes in interest rates.

Governments are the largest issuers in the market in most countries and as the most important and most creditworthy issuers in the market, governments must manage their debt prudently to minimize their exposure to market volatility and potential shocks and to build investor confidence in the market. Market risks stem from potential changes in interest rates, which affect the cost of debt-servicing and new issuance.

b) Equity Market Risks and Counter-Measures and Instruments
Equity markets introduce additional dimensions of market risk and liquidity risk to the system that are strongly responsive to perceived macroeconomic and sectoral prospects. Market risk is the risk that the book value of the instrument is suddenly unattainable in the market, causing loss to the holder. A sudden drop in asset value can be destabilizing to both financial institutions and non-financial corporations. Such market risk is exacerbated where there is concentrated exposure to the particular market.

Market risk is ameliorated through transparency in markets that improve price discovery and from active prevention of market abuse including insider trade reporting, related party transaction rules, and anti-market manipulation rules, as well as through adequate disclosure requirements (particularly financial disclosure and material event disclosure rules) and enforcement of those requirements.

Equity holdings can also present a liquidity risk—insitutions must be able to liquidate equities in order to meet liabilities. This will raise concerns during times of distress with downward price pressure in the markets, when institutions are forced to liquidate at low prices. Liquidity risks are managed through appropriate valuation standards (for example, requiring a mutual fund to mark its asset book value daily), and greater transparency in the market. In many emerging markets, equity markets are relatively illiquid and consequently financial institutions are prohibited from investing in them or have their investments restricted. This can present difficulties in many emerging and transition economies when such institutions are also restricted to domestic investment for capital account and other reasons. A pension fund, for example, that is restricted to the domestic market may have difficulty finding suitable investments and may hold much of its assets in cash and deposits.

Equity markets also introduce more complex counterparty and settlement risks—there is wider participation in the market and participation is often financed by third parties. Counterparty risks are present in the clearing and settlement system and these become settlement risks. Settlement risks are dealt with in a number of ways. Ideally, clearing and settlement systems are directly connected to payment systems and large value transfer systems, enabling a quick transfer of funds for the cash leg of transactions. Similarly, for the securities leg, the system must be connected to a depository of securities. Ideally, this depository would be centralized and connected directly to clearing and settlement.

In some systems, a central counterparty is used so that the risk of failure is absorbed by a central system. Central counterparties are particularly popular for derivatives clearing and settlement. Settlement risk is further mitigated with the appropriate capital standards for intermediaries. In systems where capital requirements are not adequately enforced, the system may require up-front payment for trades, which is more expensive and less efficient and which will reduce liquidity since it
ties up the intermediaries capital. Counterparty risks also exist between market intermediaries and their clients. These are normally reflected in capital requirements and in margin requirements which restrict the amount of financing an intermediary can extend to a client. This counterparty risk can also be addressed through restrictions on activities between market intermediaries and related entities and conflict of interest rules governing relationships between the intermediary and customers (for example, mutual funds or banks). Operational risks are also present in equity markets—these pervade all levels of the system including market intermediaries, trading systems, and clearing and settlement systems. Operational risks are met by entry/licensing requirements governing management and technological capacity, ongoing internal control requirements, inspections, and other means of ongoing supervision of institutions.

Finally, equity markets introduce market risks for the equity issuer. The issuer faces the risk that access to financing will be negatively impacted by market prices. Quality of disclosure and transparency to the market will, of course, help to ensure the issue is accurately priced in the market, but a single equity can still feel the effects of a general shock to the equity market.

F. Credit Culture and Liquidity

The term credit culture suggests the essence of capital markets where investors accurately evaluate risks and returns and pursue investment and financing based on calculations derived from such evaluation. What is necessary is the expertise and technique which supports such decisions and justify the raison-detre of financial intermediaries. Credit markets are markets where investors invest in the credit risks of firms and banks and expect returns, and hence in this sense it is quite natural to say they thoroughly evaluate the risks and invest appropriately.

The tradability of stocks is one of the frequently-discussed areas of the Chinese securities market. As mentioned in the previous section, tradable shares only account for about one-third of all shares, and the inferred liquidity of the Chinese capital market is only about 40% of the total market capitalization. Although the turnover ratio is 550% for tradable shares the highly volatile market suggests that the high turnover ratio is a product of the speculative nature of the market, rather than a well-developed liquid market. Moreover, because of the lack of depth in the market, the stock market is also prone to manipulations.

Chinese investors are for the most part unsophisticated. They operate on a hearsay basis and are usually in the market for short-term gains. In China, large-cap stocks account for a very small fraction of total market turnover. In more developed and less speculative markets, large-cap stocks usually account for a larger percentage of turnover, and investors maintain a longer investment horizon.
Retail investors, individually, have no means or intention to exercise any influence over the companies in which they hold shares. Historically, having strong returns in the market makes people less interested in fundamentals and governance than in speculative stock returns. This is not surprising, since many of the investors that have the time to gamble in the stock market are retirees.

Another example of investors’ lack of concern for company fundamentals and corporate governance is the case of ST-labeled companies. When listed companies have accounting losses for 3 years in a row, exchange regulations require “ST” to be placed in front of the company name. Retail investors flock to ST shares despite their poor financial results, because investors know that a form of bailout will be in the works. Parent companies have been skilled at creating success stories through financial engineering and restructuring to prevent further losses also referred to as re-engineered through debt restructuring and selling assets.

By the end of 2001, proprietary trading and investment in the funds by securities companies accounted for less than 10 percent of the capitalization of the negotiable shares in China’s stock market, indicating that institutional investors are still a weak group in China. The presence of institutional investors has a stabilizing effect on the securities market because institutional investors make long-term investments in specific stocks, with less portfolio turnover. Moreover, institutional investors with a large stake in a particular company could exercise powerful influence over corporate governance in those companies. Although there is evidence that institutional investors in emerging markets tend to adopt a shorter-term investment perspective, a stronger presence of institutional investors will benefit the Chinese securities market.

IV. INFRASTRUCTURE

A. Securities Exchanges

In 1990 and 1991, the government set up the Shenzhen and Shanghai securities exchanges, respectively, as an experiment in installing a capital market apparatus in China. While the exchanges enjoyed relatively high levels of autonomy in the first few years of operation, the combination of the extended coverage and the Asian financial crisis led the central government to tighten its control.

The China Securities Regulatory Commission (CSRC) was created to contain the fallout of the Asian financial crises and became a governing body that answered only to the State Council. Regulatory enforcement thus became more centralized and local governments played a much less active role in formulating regulations and policy about the further development of the capital market.

An important step forward to the installation of efficient financial markets was the adoption of the Hong Kong stock exchange (SEHK). The PRC now has a "harbor" which offers the opportunity to increase
the flow of funds from foreign investors again. The stock exchange in Hong Kong is a highly liberalized and in the whole world accepted financial centre and the third-largest in Asia in terms of market capitalization (after Tokyo and Osaka). Another important factor is the well developed banking system divided into three tiers. Together with the external stability resulting from the 'Currency board' arrangement foreign investors can be sure of the system's stability.

In several years of the Chinese transition the SEHK already acted as the main financing centre for China itself which was one main factor for SEHK today's importance. At the SEHK Chinese companies can issue H-shares which are denominated in HK$ and can be sold world-wide. This offers a big chance for Chinese companies channelling foreign funds to their portfolio. As the Chinese government did not show too many interests in changing the economic system of Hong Kong at all the SEHK will continue serving as China's "leading financial system".

The rising trend is towards demutualization in stock exchanges i.e. make them self-sustaining, profit organizations not supported by members. However there are 3 key factors affecting the development of securities exchanges in developing countries; the small number of liquid shares, the viability of international listings for blue chip companies and alternate trading systems. However hybrid models may work well for countries where leading industries can go the international way while smaller domestic companies can avail low cost technology options of well distributed small stock exchanges.

Stock exchanges are also hard pressed for revenues to sustain them. Traditional sources of revenue are under threat due to competitive businesses. But stock exchanges can still provide services like Clearing and Settlement. Stock exchanges have also been a source of price discovery and can garner revenue by providing the most reliable trade data. New instruments like derivatives and mutual funds are also a source of revenue while at the same time help in deepening capital markets.

For better operational efficiency in the short to medium term, linking the stock exchanges is a very viable option. The three stock exchanges can be linked by way of services which can reduce costs and on the other hand, increase liquidity by offering a range of specialized services with a wider reach. Some functions can be shared like marketing, listing, order routing and execution etc. Contractual procedures would also become easier to implement while lending the exchanges to more efficiency and information sharing. The combined exchange would also be large enough to sustain international investors.

There are however two disadvantages to this approach. First, in event of defaults it is very difficult to hold either of the exchanges responsible under common contracts, besides renegotiating contracts becomes fraught with procedures. The second overriding concern is the influence of exchange governance structures. Unless commonality exists they may be difficult to integrate. The issue of state political leverage in exchanges also makes it difficult to sustain linkages.
Mergers and Acquisitions in stock exchanges are rife with political problems but shows three advantages; combined gains and can be shared, credibility of agreements entered into at either of the exchanges. Contracts can be reworked between the exchanges without being specified in advance. EURONEXT is one such example where listing is decentralized which increased the investor base but trading is on a single platform which led to the transfer of know how. However regulatory convergence is a must.

Against this backdrop a very appropriate approach would be to create linkages within the 3 exchanges. The 3 exchanges are diverse in the services provided. While the SEHK would lend its international credibility, due to political reasons and to establish a convergent corporate governance regime it may be appropriate to lend more import to the Shanghai securities exchange. Although it remains a very under-developed exchange. China can leverage the market coverage extended by the Shenzhen securities exchange. It would be a very long drawn out exercise to develop all the exchanges independently yet bring about a convergence in corporate governance standards, NOREX is a proven example in this instance. In addition to this China can increase its investor base by establishing electronic stock exchanges, learning from the successful models in other developed and developing economies like India.

B. Corporate Governance

Corporate governance is a broad subject, intertwined with many areas of financial reform. The main mechanisms to look for include an independent board of directors, treatment of minority shareholders, and coordinating the interests of capital owners and business managers. The existing model of corporate governance in China speaks of the legal system in a Continental Law tradition which highlights dual boards; a supervisory board (consisting of employees and representatives of shareholders) and board of directors. There is a high level of ownership concentration. The largest shareholder, which is usually the state, holds about 53% total shares in average in a listed company. The state also owns about 59% all the shares in the stock market. 75% of listed companies are whose controlling shareholders are with the state or state controlled companies. Management or the parent company have acquired considerable discretion over the use of state assets. China poses some major issues on Corporate Governance in Chinese Listed Companies. There is an evident inability or reluctance to have separation of personnel, finance and assets between the listed companies and their controlling shareholders. Fiduciary obligations of the controlling shareholders, which are usually the parent companies, are found lacking. There is conflict of interests between controlling shareholders and listed companies often leading to unfair related party transactions between parent company and the listed company, which is detrimental to minority shareholders. The chairman of the board of directors and
top executives of state-controlled listed companies are still mostly chosen by the local and central governments. Only 5% of listed companies have established some sort of stock-based compensation scheme for the management.

In its development of corporate governance, China tried to avoid financial crises and plundering of state assets. Retaining capital, fostering domestic investments, and raising badly needed cash to fund social obligations were recurring policy themes. In a sweeping attempt last year, China laid down laws to open the stock market for insurance funds and social security funds, allowing insurance companies to now allowed to invest up to 15% of their total investment in the stock market. It opened stock market for foreign institutional investors. Qualified foreign institutional investors with good record and certain size, including fund management firms, insurance companies, securities houses, and commercial banks are allowed to enter into Chinese stock market and buy and sell A shares. A Take-Over Code for Chinese listed companies was promulgated and became effective on December 1, 2002. Stock market listed SOEs are open for foreign M&A, and take-over by private sector.

However the actualization of Corporate Governance in the short to medium term remains far-fetched with certain glaring deficiencies.

Certain factors are inherent in the system e.g set of incentive mechanisms need to be developed to reduce agency costs and ensure that the investors receive a return on their investments. The SOEs have run into two major problems in their attempts to imitate the incentive mechanisms of private enterprises. First it is very difficult to find suitable indicators for implementing incentives as both the starting point and policy objectives are different. Second, there is lack of faith in incentives made. As a result enterprise management for such pivotal industries remains divorced from owner’s interest and prevents their listing to develop capital markets.

In August 2001, the CSRC issued detailed guidelines regarding independent directors, mandating that companies have 3 independent board members by 2003 and including strict board meeting attendance requirements. With 1,000 listed companies, this means there will be a need for at least 3,000 independent board members next year. The short supply of qualified directors will continue to be a challenge for companies needing to meet the CSRC’s requirements.

The significant hurdles China is yet to overcome include the legacy of a quota-based, politically-driven listing process, the role of the CSRC, the development of a liquid market with institutional investors and the ability of companies to bypass domestic markets by seeking financing abroad.

Different countries are at different states of development and the choice of corporate lever used is highly dependent on the country of domicile. In Asian countries corporate board reform are most highly valued. Although Emerging Markets should adopt all major elements of the market model
For corporate governance, alternate institutional and government arrangements are possible. Emerging market firms have lower leverage, less working capital, volatile returns and use more external equity. For this very reason a strong corporate governance culture is of utmost import. The WTO accession has provided a time frame for when SOEs have to be dressed up for the ball adding additional urgency to corporate governance Reform in China. The WTO code of Corporate Governance covers OECD principles which cover 5 sections; rights of shareholders, equitable treatment of shareholders, role of stakeholders in Corporate Governance, Disclosure and Transparency and the responsibility of the board. IOSCO principles cover registration of financial markets, self regulatory organizations, co-operation in regulation, enforcement, collective investment schemes, market intermediaries, secondary securities market and issuance.

![Diagram](image)

**Figure 10: McKinsey's market model for Corporate Governance**

C. China Securities Regulatory Commission (CSRC)

In 1997, with the Asian financial crisis as the backdrop, CSRC was appointed as the sole overseer of the two exchanges in Shanghai and Shenzhen. This was a drastic departure from previous practices, because the local and municipal governments were in effect removed from the decision-
making path. Further, with the passage of the Securities Law, CSRC seemed to possess the dual power of overseeing and managing the securities market and of standardizing existing laws and regulations within a unified legal framework. In terms of the listing process, the CSRC reformed numerous aspects of the system. For example, the administrative approval system was revamped so that the right for local government to recommend stock listings was abolished. Instead, a set of listing criteria was set up and a central committee was created to review and evaluate the legitimacy of the potential listing companies. As compared to the CSRC's record of rejections under the local recommendation scheme, the record following the passage of the Securities Law (40% of applications have been rejected) was much more impressive. Furthermore, CSRC is currently promoting the usage of internationally-accredited law and accounting firms for the due diligence process of potential listing firms. This, coupled with the demands of the WTO entry, seem to be promising in setting up a credible monitoring and enforcement system in the securities market.

In delivering new regulations, the CSRC has made an effort to improve compliance by reducing the discretion that companies have in interpreting laws. Templates have been provided for dealing with profit warnings, connected party transactions, ownership changes and other important events. The Shanghai Stock Exchange now requires that companies issue warnings by January 30 if their profits will drop by more than 50% from the previous year or will report losses in the year. According to statistics, the CSRC unveiled 51 laws and regulations from early 2001. So far, the CSRC has established a basic framework of regulatory rules. During that period of time, more than 80 listed companies and 10 brokerages were publicly criticized, penalized according to administrative rules, and even put under judicial investigation. The CSRC has also de-listed three companies and revoked the securities licenses of five local accounting firms that had been involved in the improper preparation of listed-company financial reports.

However, academics are at times skeptical of the long-term effectiveness of the CSRC. In terms of enforcement, new cases of delisting and other crackdowns seem to have subsided. While the establishment of a coherent regulatory framework and the continued dis-incentivization of corruption in the listing process is commendable, the real power that the CSRC holds - in enforcing the regulations and acting as a governing body independent of the central government - is in serious question.

D. Information Technology

Derivative transactions isolate risks intrinsic to underlying assets and enable trading in those trades separately. These derivative transactions have enabled and facilitated the unbundling and rebundling of risks to generate combinations of risks and returns different from those of the underlying assets. Such transactions are made possible by computer calculation technology.
Asset Backed Securities are backed by the receivables of small to medium sized firms and mortgage-backed securities, aimed at diversifying risks by bundling numerous small lot assets into one security. It is impossible to have these products in the absence of massive data collection and expeditious calculations.

E. Payment and Settlement Systems

Another vital policy goal is the development of an efficient, reliable and low cost clearing and settlement system. In Hong Kong, the HKMA developed the Central Moneymarkets Unit in 1990, which cleared initially the Exchange Fund Bills and Notes and later, to meet market demand, private sector bonds as well. The system was subsequently enhanced to link up with the Hong Kong dollar Interbank payments system so as to provide DVP capability on a real-time basis.

It is very easy to think that the biggest challenge is the technology required to develop the clearing and settlement systems. However, he maintained that another equally important policy challenge relates to how the authorities perceive their roles vis-à-vis the private sector in the development of such systems. It can be argued that private sector bonds should be cleared by a clearing system developed by the private sector. To leave it entirely to initiatives from the private sector would run the risk of slowing down market development.

China has responded to these issues with a range of policies. It has sought to enhance its financial infrastructure. It established a central clearing and custodian system for debt securities: the Central Moneymarkets Units (CMU), which has formed links with Euroclear, Cedel, and other central securities depositories. It has implemented a Real Time Gross Settlement (RTGS) inter-bank payment system to reduce settlement and clearing risks, which could also be extended to be a regional system. It is developing a US dollar clearing system for real time settlement of US dollar transactions. This is linked with the Hong Kong dollar payment system to provide real time PVP settlement for US dollar-Hong Kong dollar transactions, and also with the stock and debt securities clearing houses to provide DVP settlement. A range of government initiatives have also been undertaken. These include: the introduction of the Exchange Fund Bills and Notes Program (EFN) (a market-making system); the creation of a yield curve; granting of permission to use Exchange Fund paper as collateral for trading in futures, index options and stock options; the listing of EFNs on the exchange; building a platform for retail investors to access the debt market; the elimination of stamp duty, the reduction of profits taxes, and the lowering of brokerage charges; the establishment of the Hong Kong Mortgage Corporation, which will purchase mortgage loans with the issuance of unsecured debt securities, and securitize the mortgages into mortgage backed securities; and finally, the implementation of the Mandatory Provident Fund Scheme will stimulate the demand for high quality debt securities.
CONCLUSION

China bites the bullet?

On the one hand a court case in Beijing over the country's biggest stock manipulation laid bare the underhand dealings of scores of securities outlets. In a deliberate decision by the authorities, the embarrassing detail about the involvement of Chinese securities firms was laid bare. China's securities firms are all state owned and do not have to publicly report their earnings except to the CSRC. Coupled with a year long flat market the message to securities firms is that the days of easy money and market manipulation are over and the need to rationalize their businesses, supreme. The CSRC can claim a measure of success in reducing blatant market manipulation, enduring much of the blame for a depressed market. In a potent reflection of sentiment, individuals would rather leave their money in the bank than use it to buy stocks, in spite of the Government's efforts to induce them to buy stocks by keeping interest rates low and imposing taxes on incomes from bank deposits.

On the other hand Bank of China's IPO's initial pricing was on the high side, the US$ 2.8 billion offering making it the second largest. However shares fell 4.7% lower the very first day of trading undermined by a concern that the issue price was too high. The IPO was subscribed to by major tycoons in Hong Kong for the reason of patriotism. The practice has worked in getting IPOs off the starting block but it does little to transform China into a truly market economy. It's a cultural thing where you can't let a listing of Bank of China go out and be a flop. China's much awaited Telecom road-show elicited a similar response. As one senior managing director of an investment bank put it, "This clubby system is not helpful in the bigger scheme of things", he said. "China has got to sort out which model they want to adopt" - economic or political?

Foreign banks in China have joined forces to protest against the People's Bank of China, the central bank, which told them limits would be set on their borrowings of local currency from Chinese institutions. These banks rely heavily on local institutions for funds because they are not allowed to take deposits from the Chinese and have a narrow base of multinationals to go to for deposits. They use these funds to extend loans to their multinational clients at a nominal charge. Bankers view this as a pure protectionist measure which is contrary to the spirit of the WTO.

Fraught with such concerns, pseudo financial market reforms will only undermine the political will that backs reforms in SOEs, Banks, Corporate Governance upon which hinges capital market development.
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