

Banking Watch

China

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China's financial liberalization: new challenges and opportunities

- **Financial reform has broadly maintained its momentum since 2012, when a new round of financial reforms started.**

Since then, the floor to the lending rate has been removed and the RMB daily trading band has been widened. The authorities have also started to issue bank licenses to private investors. Although high expectations have been laid on the Shanghai Free Trade Zone (FTZ), we are so far skeptical about the effectiveness of piloting financial reforms in a designated small area. However, this might change depending on the government's interest to push the project further.

- **The new leadership needs to circumvent the resistance to reform from the part of vested interest.**

Large state-owned banks (SOBs) and state-owned enterprises (SOEs) have long benefitted from financial repression, which makes them nature opponents to financial reform. The government needs to strike the right balance in terms of incentives for the reform to move forward.

- **New challenges emerged in the course of financial liberalization, including tensions in the interbank market and volatile capital flows. Surely more is to come.**

The interest rate volatility of China's interbank market has significantly increased since the middle of 2013 and gave rise to some periodic liquidity squeezes. Meanwhile, the ongoing reform of the RMB exchange rate could change the expectation of an ever-appreciating RMB and lead to capital flight in the short term. All of these are welcome developments as long as they are kept under control and should continue in the future.

- **Given the relatively weak situation of the banking system, while keeping financial liberalization as a key objective, the authorities should monitor related risks more than ever.**

A number of measures should minimize the likelihood of financial crisis while in the process of liberalizing the financial system and the capital account. In particular, a deposit insurance scheme should be established prior to the lift of the deposit rates cap by end-2015. On the external side, we would argue that full convertibility of the capital account would need to wait until financial liberalization is completed and the RMB has floated freely for quite some time. Our proposed dates are 2020 for the former and 2016-17 for the latter.

- **Financial liberalization can bring new opportunities to banks.**

Retail banking and SMEs business will continue to be the focal points in the coming years although new competition will emerge from private capital and e-commerce companies. Foreign banks can especially benefit from the further opening-up of the capital account as well as the coming bout of SOE privatization

Introduction

After years of stagnation in the aftermath of the Global Financial Crisis (GFC), China's financial reform gained traction again in 2012, marked by the widening of the RMB daily trading band (from $\pm 0.5\%$ to $\pm 1\%$) and the expansion of interest rate permissible ranges. In our December 2012 report, [Taking Stock of Financial Liberalization](#), we summarized the then-unveiled liberalizing measures and envisioned further development. In particular, we pointed out that the right sequencing is key to the success of financial liberalization. It means that domestic financial reform, in particular interest rate liberalization, should be completed prior to the opening of China's capital account.

Financial reform has broadly maintained its momentum since then, largely due to efforts of the new reform-minded leadership which took office in March 2013. In the Third Plenum last November, the authorities placed priority on financial liberalization along with a few other important areas on the blueprint of reforms (see our China Flash about [The Third Plenum Conclusions](#)).

This note is to update the recent development in financial liberalization. In addition, we highlight a few new challenges over the course of deepening financial reforms. We then provide our projected timetable for further liberalizing measures. We conclude the note with a discussion about banks' new business opportunities arising from financial reform.

A sustained momentum for financial reform

On top of the reform measures implemented in 2012, the authorities have launched a number of new initiatives to press ahead with financial liberalization. The latest liberalizing measures are aimed at financial repression in the following areas: i) formidable entry barriers for private capital in the banking sector; ii) controlled interest rates to protect banks' profit margins; iii) underdeveloped domestic bond and equity markets; and iv) the inflexible exchange rate and the largely closed capital account.

Opening the banking sector to private investors

In March 2014, the authorities announced that five bank licenses will be given to a number of private enterprise applicants, inaugurating the long-awaited pilot program of opening the state-dominated banking sector to private capital. The pilot program requires these five new banks to operate in a limited region (a bank needs to select one from Tianjin, Shanghai, Zhejiang and Guangdong) and to focus on servicing individual customers as well as small and medium-sized enterprises (SMEs). As revealed by China Banking Regulatory Commission (CBRC), the successful applicants of new bank licenses include Alibaba and Tencent, two most powerful internet companies in China. This has attracted much attention for their expertise in providing online financial services to customers.

Although the size of the pilot program is small, its importance for China's financial reform should not be underestimated. The pilot program is the first step to level the playing field for both state and private capital in the banking sector. It is expected to enhance the competition among banks and therefore to benefit household and SME customers greatly, which used to be underserved by the existing state owned banks (SOBs). As the CBRC pledged, the pilot program will continue to expand if the first batch of non-SOBs deliver good performance.

In addition to the above pilot program, the CBRC also relaxed the restrictions for private capital to invest in other non-banking financial institutions such as consumer finance companies and financial leasing companies. In the same vein, these liberalizing measures are expected to enhance the efficiency of capital allocation in future.

Lifting the lending rate floor

On top of expanding the permissible range of interest rates in 2012, the authorities completely lifted the floor of lending rates last June whereas they kept the cap on deposit rates (10% above official benchmark deposit rates) intact. Given that lending rates are not binding now, the removal of the lending rate floor can only benefit borrowers modestly.

Nevertheless, it is still a further step toward the goal of fully liberalized interest rates. More importantly, the authorities didn't stop their reforming efforts afterwards but continued to roll out more coordinative reforms, to name a few, allowing banks to issue CDs in the interbank market and setting up the prime rate mechanism to encourage banks to establish a market-based benchmark lending rate. In our view, these coordinative measures help to lay a solid institutional foundation for the authorities to free up deposit rates in the near future.

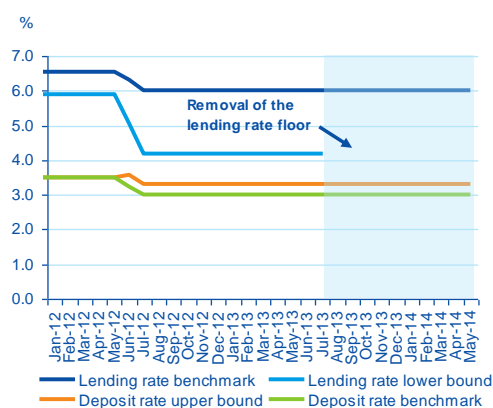
Widening the RMB daily trading band

The authorities increased the flexibility of the exchange rate by widening the RMB daily trading band to $\pm 2\%$ (from $\pm 1\%$) in March. Although we don't expect a wider trading band to change the long-term appreciation trend of the RMB, it does introduce more two-way volatility to the currency.

A more flexible RMB should help to hamper strong capital influx (particularly "hot money") and therefore strengthen the independence of China's monetary policy in the long run. In this sense, domestic liberalizing measures and exchange rate reforms are complementary to each other. Nevertheless, we reckon that China still needs to follow the conventional wisdom to prioritize the completion of interest rate liberalization over the exchange rate reform and the full opening-up of the capital account, so as to minimize risks to financial stability.

Chart 1

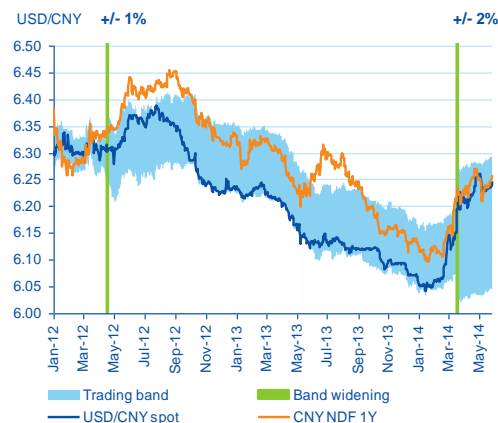
Interest rates are liberalized to enhance the efficiency of the banking sector



Source: CEIC and BBVA Research

Chart 2

The daily trading band is expanded to allow for a larger extent of exchange rate flexibility



Source: Bloomberg and BBVA Research

Using the Shanghai Free Trade Zone to catalyze financial reforms

China's authorities favor pilot programs in pushing for their reform agenda even though not all of them can deliver good performances. The Qianhai pilot program in financial liberalization, which we highlighted in our previous report, has thus far significantly lagged behind the schedule. But now the Shanghai Free Trade Zone (FTZ) has become the new favorite of the central government as a test-ground for financial reforms. (Indeed, the objectives of Shanghai FTZ also encompass promoting free trade and opening more sectors to foreign investment. See our [China flash](#)). Last year the authorities unveiled the first batch of financial reforming measures in the FTZ, among which the most important ones are (i) to pioneer full interest rate liberalization; (ii) to allow cross-border borrowings from foreign countries and (iii) to permit FTZ residents to make overseas investment.

We are however sceptical about the effectiveness of piloting financial reforms within a designated small area. In practice, it is difficult to monitor and control the financial transactions across physical borders of the FTZ, which might lead to some unintended spillover effects and increase risks to the entire financial system. For one thing, residents outside the FTZ can bring money into the FTZ first and then make overseas investment, which de facto renders China's existing restrictive capital controls invalid.

Dealing with new challenges

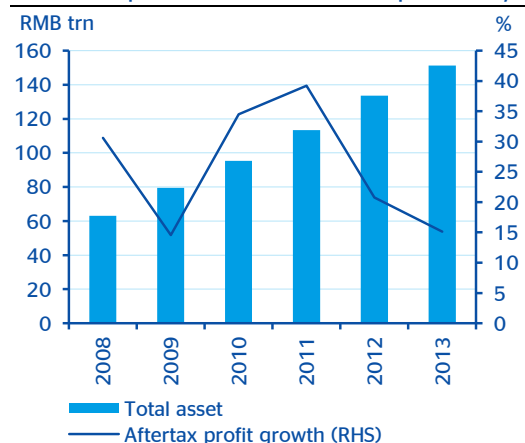
It is noted that some new challenges have recently surfaced in addition to the sequencing issue that we have stressed repeatedly. A number of them warrant the authorities' attention, including the resistance from vested interest, increasing volatility in the interbank market and large fluctuations of capital flows.

The resistance from vested interest is on the rise

State Owned Banks (SOBs) have long benefited from financial repression. The regulated interest rates enable banks to have wide and stable lending margins. The high barriers against private capital prevent existing banks from competing with new entrants and therefore protect their profitability. Due to the lack of an explicit deposit insurance scheme, the government has to provide implicit guarantees for all banks, especially the state owned ones although the government is always reluctant to admit this point publicly. As such, financial repression gives banks strong incentives to expand their balance sheets to boost profitability (Chart 3) while paying inadequate attention to risk management and the quality of financial services.

Chart 3

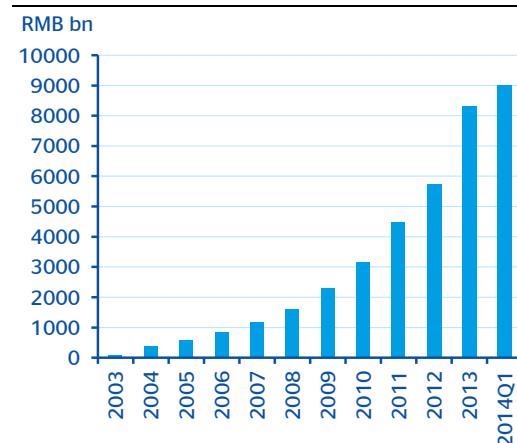
Regulated interest rates gave a strong incentive to banks to expand their assets to boost profitability



Source: CEIC and BBVA Research

Chart 4

SOEs are heavily involved in entrust loans



Source: Bloomberg and BBVA Research

Interest rate liberalization is also unpalatable for State Owned Enterprises (SOEs). Although financial repression tends to raise the financing costs of the entire corporate sector, SOEs can still receive better treatment than private enterprises. It is because SOEs also enjoy the government's implicit guarantees, which make banks consider them as low-risk borrowers. With relatively lower financing costs, SOEs could substantially increase their leverage and gain the upper hand in competition with their peers of private capital. Some SOEs even take advantage of low-cost funding and re-lend their borrowed money to private enterprises, so as to earn the differentials of financing costs. Such behavior leads to the fast increase of entrust loans (company-to-company loans), which is an important form of China's shadow banking activities (Chart 4).

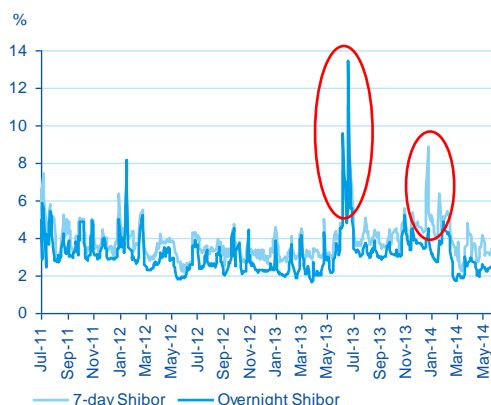
With the deepening of interest rate liberalization, both SOBs and SOEs are showing a greater resistance. As the Chinese economy slowed, SOBs and SOEs are now facing greater pressure on profitability, which might make them become more averse to interest rate liberalization. Therefore, the government needs to strike the right balance in terms of incentives for the reform to move forward.

Interbank market tension calls for the acceleration of interest rate liberalization

The interest rate volatility of China's interbank market has significantly increased since the middle of 2013, with some periodic liquidity squeezes. (Chart 5) In particular, financial tensions escalated around the end-June, making the entire financial system teeter on the edge of collapse. Even after the PBoC injected an enormous amount of short-term liquidity into the interbank market, the interest rates still stayed at levels significantly higher than before.

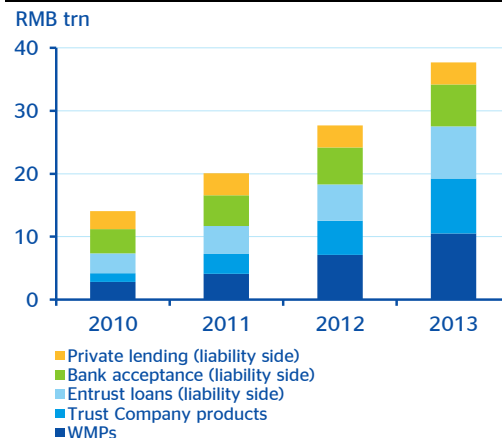
Rising and volatile interest rates of the interbank market tend to add financial costs onto both banks and borrowers and therefore pose real threats to financial stability. What complicated the situation are China's ballooning property prices as well as heavy indebtedness of public and corporate sectors, rendering the financial sector more vulnerable to interest rate fluctuations.

Chart 5
Interbank market rates have become more volatile with periodic rate spikes



Source: CEIC and BBVA Research

Chart 6
The rapidly growing of the shadow banking lies behind the intensified market tension



Source: Bloomberg and BBVA Research

In our view, it is China's fast growing shadow banking sector that caused financial tension in the interbank market. As we estimated, the size of the shadow banking sector has been expanded at a pace more rapidly than that of the formal banking sector over the past few years. (Chart 6) In particular, the majority of shadow banking activities in China are indeed banks' off-balance-sheet businesses. (See our thematic report about [China's shadow banking sector](#)). As a result, the total credit extended by banks has substantially exceeded the headline loans volume in their books. That said, banks have become more reliant on short-term liquidity provided by the interbank market to support their on- and off-balance-sheet businesses, especially around the end of quarters when banks are required to comply with a series of regulatory limits such as the Loan-to-Deposit ratio.

The gigantic shadow banking sector also makes it increasingly difficult for the central bank to accurately estimate (and then to meet) short-term liquidity demands of banks. As a consequence, even some minor external shocks could cause banks' strong reactions and trigger a full-blown liquidity squeeze in the interbank market as seen last year.

Our diagnosis leads to clear policy prescriptions. In addition to strengthening regulations on the shadow banking sector, the authorities should accelerate to free up deposit rates and advance other related financial reforms (for example, allowing banks to issue CDs to individual investors and corporate). Hardly being lured by low deposit rates, households always try to put their savings in assets with higher yields, which eventually become fund sources of the shadow banking sector. Meanwhile, with protected interest margins and less competition from private capital, SOBs have no appetite for serving high-risk SME customers and therefore push them to the shadow banking sector.

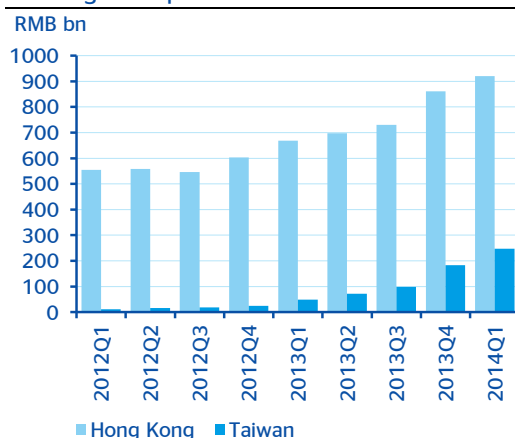
We envision that interest rate liberalization, along with the opening-up of the banking sector to private capital, can enhance financial stability in the long run by gradually including shadow banking activities into the formal banking sector. That said, with market-determined interest rates as well as a more levelled playing field for both state-owned and private banks, neither depositors nor borrowers have reasons to turn to the shadow banking sector. Admittedly, market rates might go up after the abolition of deposit rates cap as observed in some other countries. But this should be manageable since the authorities have adequate capacity to intervene.

Risks of capital flight need to be closely monitored

Another challenge is related to the ongoing reform of the RMB exchange rate. In the past several years, the RMB had successfully maintained an appreciating trend, which greatly raised overseas investors' interest in the currency (Chart 7) and facilitated its internationalization. (See our report: [RMB internationalization gains momentum from liberalization steps](#)) However, one unintended outcome of the strong RMB is large-scale inflows of "hot money" into China. Capital inflows further led to the fast rise of China's foreign reserve, via the central bank's sterilization. (Chart 8)

Chart 7

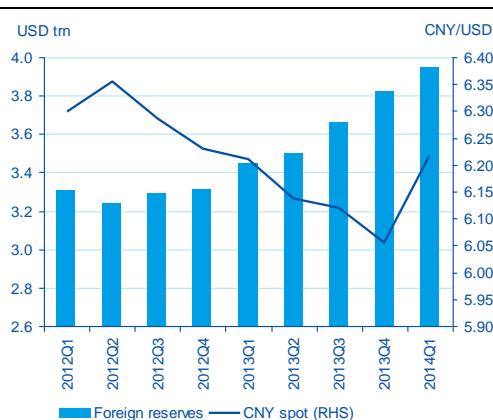
Offshore RMB deposits have increased rapidly as foreign acceptance to the RMB is on the rise



Source: CEIC and BBVA Research

Chart 8

Continuous appreciation of the RMB contributes to China's FX reserve accumulation



Source: Bloomberg and BBVA Research

In this context, the reform of the RMB exchange rate is likely to be interpreted by investors to herald the end of RMB appreciation. The increasing volatility introduced by the widening of the RMB daily trading band can also reduce investors' interest. As such, the reform of the RMB exchange rate might make speculative capital change their direction to flow out of China. If a large amount of speculative capital moves simultaneously, it could trigger a vicious circle: the initial capital outflow causes heavy RMB selling in the FX market, which in turn confirms investors' concerns over RMB depreciation and forces more speculators to move their funds out of China. In the end, capital flight can lead to a full-blown currency crisis and cripple the domestic banking sector.

Apparently, such an extreme case is what the authorities want to avoid during the course of pushing forward exchange rate reform. In this respect, the authorities should be careful about their communication with the market, so as to calm down investors' anxiety at the moment of important policy changes. Meanwhile, the authorities need to dexterously use market interventions to avoid the excessive fluctuation of the exchange rate although their interventions should diminish over time as the market forms a relatively stable outlook of the currency.

A projected timetable of further reforms

In the third Plenum last November, China's new leadership announced that they will seek to make "important breakthroughs" by 2020 in the areas included in their reform agenda, which, we believe, revealed the authorities' unannounced target of completing financial liberalization

by then. In view of the right sequencing, we envisage that the targets in the financial sector are to be completed in the below order:

- Abolition of the cap on deposit rates by 2015.
- Free float of the RMB by 2016-2017.
- Full convertibility of the RMB under the capital account by 2020.

The pace of currently projected progress is broadly in line with our forecasts two year ago, except for the exchange rate reform which we last projected to be completed by end-2015. It is partially due to the financial turmoil in other emerging markets triggered by the Fed's tapering of its unconventional monetary easing. Nevertheless, we still have reasons to be sanguine about the outlook of China's financial liberalization. In particular, the new leadership has sufficient incentives to press ahead with reforms and reap the benefits of financial liberalization given that they will stay in power for a relatively longer time.

The primary task of financial liberalization is to lift the cap on deposit rates. In this respect, Governor Zhou Xiaochuan of the PBOC recently indicated that he had the confidence to have it done within the next couple of years. However, some important works need to be rolled out in coordination. First, a nationwide deposit insurance scheme (including a bank resolution mechanism) should be established to alleviate the moral hazard problem in the banking sector. As we described in the previous section, banks, in particular SOBs, now have implicit government guarantees, which boosted their risk appetite and led to excessive lending. Without a deposit insurance scheme in place, full liberalization of deposit rates might aggravate this moral hazard problem and incentivize banks to lend more for the sake of offsetting profit decline. In view of its vital importance, we expect a deposit insurance scheme to be established in 2014 or 2015 prior to the lift of the cap on deposit rates. Second, the authorities need to gradually shift their intermediate target of monetary policy away from money quantity (M2). After freeing up interest rates, the existing policy regime of targeting M2 could lead to excessive volatility of interest rates in capital markets. To avoid such a case, the central bank can choose a market-based interest rate as the new anchor of monetary policy. In this respect, we believe that the 7-day SHIBOR rate has the potential to become the new intermediate target given that it is widely used as a benchmark interest rate for derivatives pricing. Last, the authorities should effectively lower the entry barriers of the banking sector so as to increase competition among banks. Without real threats from new entrants, existing banks might continue to maintain low deposit rates via some form of collusion, undermining the authorities' efforts to liberalize interest rates.

Opportunities for financial institutions

As we stressed before, the ongoing financial liberalization, along with the economic rebalancing and household wealth growth, will continue to provide enormous business for retail banking. In particular, banks will need to shift their focus to provide diverse wealth management and pension services to their retail customers. The trend can also benefit some non-banking financial institutions which have expertise in certain niche markets, for example the consumer finance companies and auto finance agencies. Moreover, rising deposit rates will force banks to shift their focus further to SMEs customers for obtaining higher profit margins. Banks with greater experience in this segment of the market are likely to benefit.

However, banks are set to face fierce competition from E-commerce firms focusing on online trading platforms, such as Alibaba and Tencent. In particular, both of them have obtained bank licenses in the pilot program, enabling them to initiate competition against banks in more areas.

For foreign financial institutions, ongoing capital account liberalization and RMB internationalization will bring about new business opportunities, including: investment in

China's domestic capital market, financing China's outward FDI projects and financial advice. The best example in this respect is the prospective program of direct share-trading between Hong Kong and Shanghai ("Through Train" program), which is expected to substantially increase the brokerage businesses for security firms and banks in Hong Kong and China. On top of the program, financial institutions across-borders can even develop more derivative products and markets to meet customers' demand. Another noteworthy trend for foreign financial institutions is the incoming SOEs privatization, which is also in the conclusions of the Third Plenum. It is foreseeable that the privatization of SOE will give rise to a lot of businesses of Leverage Buyout and Merger& Acquisition. Foreign banks with strong expertise in these fields would not only directly benefit from being involved in the deals but also leverage these opportunities to establish long-term relationships with Chinese enterprises.

Appendix

Table 1

Selected important steps in financial liberalization

Reform	Date	Regulator	Key Points
Wenzhou Financial Liberalization	March 2012	State Council	Allow private lenders in the city to operate as investment companies with the goal of increasing small and medium enterprise (SME) finance. Wenzhou residents are allowed to invest in nonfinancial companies overseas.
Exchange Rate Band Widening	April 2012	PBoC	The daily band for the renminbi /US dollar exchange rate increased from $\pm 0.5\%$ to $\pm 1\%$ around the fix daily rate set by the PBoC.
Enlargement of QFII Quota	April 2012	CSRC	Increased the quotas for qualified foreign institutional investors to \$80 billion from \$30 billion.
Over-the-Counter (OTC) Market	April 2012	CSRC	Creation of a new OTC market primarily consisted of SMEs, which is aimed to broaden the finance channels for SMEs, especially high-tech companies.
Qianhai Pilot Program	June 2012	State Council	Companies in Qianhai will be encouraged to sell renminbi bonds in Hong Kong and to experiment with cross-border loans in the Chinese currency.
SME Bond Market	June 2012	CSRC	Creation of a high-yield (aka junk bond) market for SMEs through private placement.
Interest Rate Benchmark Band Widening	June/July 2012	PBoC	Allow 10% of premium for deposit rates and 30% discount for lending rates.
Enlargement of RMB-QFII Quota	November 2012	PBoC, CSRC and SAFE	Increased the quotas for RMB qualified foreign institutional investors to RMB 270 billion from RMB 70 billion.
More access to the QFII investors	March 2013	PBoC	Qualified QFII institutions are allowed to investment in the inter-bank bond market. Previously, QFII investors were only allowed to invest in the A-share market and bonds listed in the Shanghai and Shenzhen exchanges.
Guidelines for the program of RMB Qualified Foreign Institutional Investors (RQFII)	May 2013	PBoC	Designated foreign institutional investors (mainly including banks, insurances companies, pension, and other financial institutions) are allowed to repatriate offshore RMB to the Mainland for investment use.

Source: Regulators' websites and BBVA Research

Table 2

Selected important steps in financial liberalization (Cont.)

Reform	Date	Regulator	Key Points
Removal of lending rate floor	July 2013	PBoC	Removed: (i) the lending rate floor on bank loans (before set at 70% of the benchmark lending rate); (ii) controls on the price setting of banks' bill discounting; and (iii) lending rate caps (previously set at 2.3x the benchmark lending rate) on rural credit unions
Expansion of a pilot program of consumer finance companies	September 2013	CBRC	The pilot program will be expanded from previous 4 cities to 16 cities. Before, the CBRC will only approve one consumer finance company for every eligible city and strictly prohibit their cross-city operation.
Launch of Shanghai Free Trade Zone	September 2013	State Council	The government officially launched the Shanghai Free Trade Zone. In addition to the promised implementation of trade and investment liberalizing measures, the Zone has attracted market attention for its plans to become a test ground for the liberalization of interest rates and capital account opening.
Creation of New Prime Lending Rate	October 2013	PBoC	The new prime lending rate will be calculated daily as a weighted average of nine banks' actual lending rates, and is meant to assist banks in pricing their loans.
Issuance of the CDs in the interbank market	December 2013	PBoC	Issuance of the new CDs (ranging from one-month to three years) is open to commercial and policy banks, while purchase is open to both banks and non-bank financial institutions. Interest rates on the CDs are to be market-determined, with the Shibor to serve as a benchmark.
Greater private entry into the banking sector	March 2014	CBRC	China Banking Regulatory Commission issued bank licenses to five banks owned by private capital in a pilot program, marking the opening the country's banking sector to private investors.
Widening the RMB's daily trading band	March 2014	PBoC	The daily band for the renminbi /US dollar exchange rate increased from +1 % to +2 % around the fix daily rate set by the PBoC.
Cross-border stock investment between Shanghai and Hong Kong	April 2014	CSRC	The China Securities Regulatory Commission (CSRC) announced a pilot program to allow cross-border stock investment between Shanghai and Hong Kong stock exchanges.

Source: Regulators' websites and BBVA Research

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