

## **Su Ning: Improve financial ecological environment, promote financial innovation, boost financial development**

Speech by Mr Su Ning, Deputy Governor of the People's Bank of China, at the First China Financial Forum, Shanghai, 3 November 2005.

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Honorable guests,

It is my pleasure to attend the Financial Ecological Environment Forum co-sponsored by the China Society for Finance and Banking and the Financial News. Based on their local practices, several Mayors and Governors have just elaborated on the significance of improving financial ecological environment in terms of promoting harmonious financial and social development. Improvement of financial ecological environment holds great importance not only to financial stability, but also to financial innovation and development. I would like to take this opportunity to share with you my observations on the relationship among improving financial ecological environment, promoting financial innovation and boosting financial development.

With huge increase of financial assets and more diversified financial institutions, on one hand, China's financial industry developed rapidly since opening-up and reform. On the other hand, the overall financial development is still at low level and lack of competition. We have the highest saving ratio globally, but we have not fully and rationally utilized those savings, particularly, we have rather unsatisfied financial structure that cannot meet the investment and financing needs of multi-layer economic agencies, with the banking sector taking a dominate position over other financial sectors, low proportion of direct finance and limited breadth and depth of financial market. Furthermore, due to the simplified financing structure and lack of financial instruments, financial risks were concentrated excessively and financial stability is under threat as well. The situation roots from not only China's current economic and financial development stage, but also from some fundamental conditions, especially financial ecological environment conditions. As a result, the improvement of financial ecological environment plays an important role in encouraging financial innovation and creating a favorable external environment for the financial industry.

1. An improved legal environment. An ideal legal environment can promote financial innovation. Basic legal rights, like property right and creditor's right, could provide clear definition and sufficient protection in the process of financial innovation. Take the Enterprises Insolvency Law as an example. It was stipulated mainly to deal with state-owned enterprises' insolvency more than 20 years ago. Currently, many state-owned enterprises have been transformed into companies with different ownership structures, thus we need a standard Enterprises Insolvency Law consistent with the socialist market economy. A good Enterprises Insolvency Law will define and protect the rights of shareholders and creditors when firms go into insolvency process. Corporate bonds issuance and other financial innovations will enjoy a secure environment too. The Company Law and Securities Law currently either have many constrains on or unclear definition of private placement and OTC market, affecting the establishment and development of multi-layer capital markets. Some of the shortcomings have been amended in the recent revised version of the two laws. Besides, the Guarantee Law and the Property Right Law could affect the effectiveness of guarantee, pledge, and property rights applications in financial innovation if they have unclear definition of secured interests and property rights. There are many other similar cases that show the importance of such basic laws to financial ecological environment improvement as well as to financial innovation and development.
2. An orderly institutional environment. China is still in the transitional period to establish and improve socialist market economy, during which, how to clarify the relationships among government, market and enterprises, especially the administrative scope and ways of government, exerts great impact on financial innovation and development. On one hand, compared with the developed countries, China's governmental administration covers a much wider scope and has strong influence, which could promote financial innovation and development significantly if well organized. On the other hand, if the functions of the strong government are not properly fulfilled, it could also impede the improvement of financial ecological environment. For instance, currently, excessive administrative approval, unclear

approval standards and undefined accountabilities still exist in the financial industry. Reflecting China's financial innovation process in 1980's to mid-1990's in the 20th century, China once detoured in financial products innovation, experienced some financial risks and even tried to mitigate these risks by strengthening administrative control, because of the underdevelopment of qualified personnel, technology and management skills. It was unavoidable in a certain period of time, but, with the improvement of the market economy, we need to encourage and regulate financial innovation by making more use of market tools.

3. A good credit environment. A credit environment weighs much on financial ecological environment. In terms of credit information, financial innovation is a process in which credit information is collected and managed with various financial instruments to avoid risks and get returns. Sound credit information system, true and effective information disclosure, real default accountabilities are fundamental factors to the success of financial innovation. At present, China's social credit system is still under construction and far from able to meet the needs of socialist market economy development. The development of the social credit registration system and credit reference agencies is still in its infant stage, credit information of firms and individuals are not effectively collected and accurately assessed and financial institutions cannot make accurate business decisions based on credit information provided by the clients. Effective penalty mechanism for credit slippage has not been established and all relevant parties in the society are yet to clarify and build consensus on the basic concept, function and development orientation of the social credit system. Rules and regulations concerned with credit registration are rather lagging behind, in particular, there is no clear distinction between reasonable credit information collection and protection of individual privacy and commercial secrets. In such an environment, financial innovation will be inevitably suppressed.
4. An excellent environment of intermediary services. Intermediaries will affect financial innovation in the sense whether they could timely and accurately expose the value and risks of financial products to the investors. With the socialist market economy gradually improved, markets will increasingly strengthen its basic role in resource allocation. Accordingly, financial innovation will be gradually transferred from relying on administrative approval to market discipline based on standard information disclosure and credit rating, which set higher requirements on intermediary services, such as on payment and settlement, credit rating, accounting and legal advice etc. Frankly speaking, compared with international standards, China still has a long way to go not only in improving its accounting, auditing and rating standards, but also in providing the related intermediary service and fostering code of conducts and business integrity. Strengthening infrastructure and improving intermediary services, particularly integrity of the intermediaries, become an urgent task to improve financial ecological environment.

I listed the above basic conditions for financial innovation from the perspective of financial ecological environment. To cultivate those conditions, we need to further push changes in mindset, institutions and operating mechanisms. Therefore, we should further improve financial ecological environment associated with institution building, law enforcement, credit system and intermediary services so as to create a favorable platform for financial innovation.

First, establishing a market-driven financial innovation system. Basically speaking, financial innovation originates from the intrinsic needs of economic and financial market development. Governments at different levels and financial regulatory authorities could only play positive roles by improving legal system and relevant mechanisms and maintaining market orders. Take the corporate bond as an example. Corporate bond is a matured financial product in market economies and a direct financing tool that market players bear relevant risks themselves; therefore, we can adopt more market-oriented strategy and measures to foster its development. In line with the principle of openness, fairness and equality, we should gradually create conditions for market-oriented corporate bond issuance by regulating information disclosure, cultivating qualified institutional investors and strengthening market infrastructure building-up. Once institutional investors are developed, information disclosure and intermediary services are improved and the trading platform as well as payment & settlement system are enhanced, investors could more efficiently manage financial risks by making use of the market, more corporations could have opportunities to issue bonds and market innovation could be developed further. In the future, we should improve market infrastructure and create a good and market-friendly institutional environment to develop internationally matured financial products, particularly those products targeted institutional investors.

Second, improving legal system protecting financial innovation. Improving financial legal system lays the foundation for the establishment of financial ecological environment and the encouragement of financial innovation. We should improve the Enterprises Insolvency Law and the Guarantee Law that are relevant to financial credit protection. With regard to improving the Enterprises Insolvency Law, it should become the last resort for lenders to protect their rights. The legal status of creditors in the process of enterprises bankruptcy and restructuring should be strengthened, particularly creditors should be endowed with the right to apply for entering into liquidation of the debtors. With regard to improving the Guarantee Law, secured creditors' priority in debt repayment should be strengthened so that the securities could become the effective protection to avoid relevant risks. Movables, especially enterprises' account receivables and inventories, should be incuted in guaranty and mortgage and the role of guarantee and security should be adequately fulfilled in financial innovation, in particular, supporting the small & medium-sized enterprises' financing. As to improving the Company Law and the Securities Law, market entry threshold for stock companies should be lowered to lay a good foundation for the development of private placement and OTC market and to make enough room for the establishment of multi-layer capital markets. As to improving the Patent Law, the intellectual property right of financial products innovation should be protected in the form of registered patents. At the same time, law enforcement environment should be improved to remove administrative interference.

Third, improving credit environment to promote financial innovation. Credit environment is the key factor to financial innovation and stability. For example, informal financing exists in various parts of China, but with great regional differences in terms of the business size. Coastal areas, like Zhejiang province, are homes to not only very active informal financing, but also to many financial innovations in supporting small & medium-sized enterprises' credit needs and the risks are generally under good control. But in other parts of China, informal financing is very risky, and it even falls into disguise for intentions cheating. The reason behind such phenomena is the different credit environment in different regions. Economic development in Zhejiang is based on private enterprises, full market competition and completed transformation of governmental function, which hold great significance to the cultivation of credit culture. With regard to improving social credit system, the focus should be placed on the establishment of enterprise and individual credit registration system by accelerating legislation of credit registration laws and regulations so as to set up a regulated credit registration market. The establishment of credit registration system and market cultivation should be accelerated via unified planning and staged implementation; collection of basic credit information should be properly centralized to avoid duplicated system construction and information segregation; value-added credit reference services, such as credit rating and appraisal, should be fostered in principle of diversity and fair play. The core technics and business standards in credit registration should be unified to promote information sharing. Credit registration market supervision system should be established which combines regulation by the respective authorities and self-discipline by the industry.

Fourth, improving fundamental services for financial innovation. In order to establish the market-oriented financial innovation system, intermediaries, like these engaging in payment & settlement, accounting, auditing and legal services should be allowed to play adequate role. First, the establishment of payment & settlement system should be strengthened, and the basic services, including registration, custody, trading and settlement should be improved to facilitate financial transactions and promote enterprises' financial management and information transparency. Second, international accounting and law standards should be studied and learned so as to create a foundation for learning from international practice in financial innovation and improving risk prevention of the financial institutions. Third, building of the intermediary services system should be promoted by taking legal, institutional and market-based measures to enhance service quality.

In November 2006, the transitional period of China's WTO accession will come to an end. More and more foreign financial institutions' joining will not only bring advanced financial products and management skills, but also promote China's financial innovation.

The just concluded 5th Plenum of the 16th CPC Central Committee has adopted the 11th Five-Year Program which focuses on the next five-year development by taking a scientific approach to economic development. I believe, with further transformation of China's economic growth model and the gradual improvement of the socialist market economy, a financial ecological environment that facilitates financial innovation, development and stability will be built up. As the central bank, we are ready to make efforts with other social sectors to transform function, improve rule by law, maintain credit order and improve services to create a favorable financial ecological environment for financial innovation and development.

