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The financial sector regulatory overhaul: What it means and how things will change

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On Tuesday, the State Council unveiled its government restructuring plan, in which it overhauled China's financial sector regulatory apparatus.

TL;DR: We expect the reforms will change how Beijing approaches financial regulation, concentrating prudential supervision with the central bank (PBoC) while building a new, robust agency focused on supervising the conduct of all financial institutions outside the securities sector.

ICYDK: Every five years, the Party-state reorganizes itself, resulting in new institutions being created, others being dissolved, and regulatory responsibilities being redistributed.

The big news is that the China Banking and Insurance Regulatory Commission (CBIRC) is being absorbed into a new, beefed-up regulatory agency – the National Financial Regulatory Administration (NFRA).

- The new agency will be responsible for regulating financial holding companies and protecting consumers of financial services, which were previously the PBoC's responsibilities.
- It will also take over investor protection, which used to fall to the securities regulator (CSRC).

According to the reorganization plan, the new agency will:

> *"Be responsible for the supervision of the financial sector, excluding securities"*
>
> *"Coordinate the protection of financial consumers' rights and interests"*
>
> *"Strengthen risk management and prevention"*

Also as part of the reorganization, the CSRC will take responsibility for enterprise bonds, which used to be the domain of the economic planner (NDRC).

But most importantly, the CSRC and NFRA are getting significant bumps in status.

The PBoC has traditionally been higher in the bureaucratic hierarchy than the CBIRC and CSRC, its junior partners in financial sector regulation. Under the changes, the PBoC will remain top dog, but the gap will narrow.

- The PBoC is a *constituent part* of the State Council, much like any government department, like the Ministry of Education or Ministry of Finance.
- The CSRC and NFRA will henceforth be *directly affiliated* with the State Council, much like the Bureau of Statistics or National Tourism Administration. Previously they were a notch lower on the totem pole.

The difference is that the PBoC is closer to the center of power.

- It can submit reports directly to the State Council and be represented at certain high-level meetings, while the other two can't.

The State Council said the moves are aimed at:

> *"Solving long-standing conflicts and issues in the financial sector"*

What issues might the State Council be talking about?

For one, the CSRC and NDRC have been engaged in a long-standing turf war over bond issuance that stretches back to the early days of the market's development.

- The CSRC oversees exchange-traded bonds, and the PBoC – through the National Association of Financial Institutional Investors (NAFMII) – governs the interbank market. But the NDRC still retains authority over a small corner of the market – enterprise bonds.
- Under the reorganization, the NDRC loses this toehold in the bond market.

Another long-standing issue the State Council is likely referencing is a debate that stretches back to before the Global Financial Crisis about how to structure the financial regulatory apparatus so that gaps in oversight don't form between regulators.

- This was a much bigger problem five years ago and was the rationale behind merging the insurance and banking regulators in 2018.
- This year's reforms make another, much smaller step in the same direction.

That's all well and good, but the extent to which regulatory functions are being consolidated under one roof doesn't justify the banking regulation getting a new name or a bump in status.

- The CBIRC could easily have taken over supervision of financial holding cos and investor protection without anything else having to change.

So, what's going on?

Wrapped in plastic

We believe that China is moving toward a model of financial sector regulation known as "twin peaks."

- It's an approach used in Canada, Australia, the UK, and many EU countries. (The US uses something similar, but the system is complicated by layers of regulation at local levels).

Traditionally, financial supervisory agencies throughout the world focused their activities on regulating specific types of financial institutions – like banking, insurance, and securities.

However, over the last couple of decades, the boundaries between types of institutions have blurred, with products and services overlapping between institutions.

- China initially dealt with this challenge by merging the banking and insurance regulators.

- But other countries adapted by reorganizing their regulators to focus on function rather than institution.

The "twin peaks" model divides financial regulation into two functions, split between two regulatory agencies.

- *Systemic supervision and prudential supervision* – which involves regulating financial institutions' solvency and liquidity.
- *Market conduct* – which covers regulating how firms conduct their business, design and price their products, and treat their customers.

We expect the PBoC will be responsible for prudential supervision and the NFRA to go point on regulating the conduct of financial institutions.

Broadly speaking, that division already exists between the PBoC and CBIRC.

- The reorganization is designed to better guard against systemic risk.

CBIRC has done fine work reining financial sector risk over the last five years. However, the decline in housing demand, property sector deleveraging, and local government debt problems are creating new risks that will potentially touch all corners of the financial system.

The NDRC put it like this in its report to the National People's Congress on March 5:

> ***"Risks in major fields are prone to becoming interwoven and amplifying each other. Financial risks are rising, and global financial market fluctuations are intensifying. Cross-border, cross-market, and cross-sector risks have become more interrelated."***

The new regulatory model is designed to tackle a new generation of problems.

- At the very least, it will create a more robust enforcement agency that no longer thinks of its role as a banking and insurance regulator but as a financial sector supervisor focused on the system.

It will take a while for the changes to take effect and for the regulators to work out the bugs. But if all goes according to plan, China will be better positioned to tackle the financial sector challenges likely to emerge in the near future.