



China's Financial Sector Reforms and Market Openings

An Overview and Assessment

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Modernizing the financial sector is the most important of China's unfinished economic reforms. A rational, sound, and competitive financial system is the heart of a market economy, channeling capital to its most efficient and productive uses. Market-based, competitive lending and borrowing create a level playing field for companies. Consumers benefit from better savings, investment, and credit systems. In short, financial sector reforms are critical to China's sustained economic growth, which is important not only to China but also to the rest of the world.

China's leaders understand the importance of financial sector reform and have made much progress in a relatively short time. The PRC government has crafted financial laws and established regulatory institutions where, in essence, none had existed before. These efforts have affected all sectors of the financial services industry, including banking, securities, insurance, credit rating services, credit cards, leasing, and futures.

Even so, China's financial system contains remnants of the socialist planned economic system that was in place before economic reforms began. China's largest domestic financial institutions are overwhelmingly owned by the state. Many suffer from poor compliance and governance. These state-owned lenders often finance unproductive investments made on noncommercial criteria, frequently at the behest of local governments eager to boost short-term growth. High rates of household savings and enterprise reinvestment—both in large part a result of underdeveloped financial markets—fuel this inefficient investment, which many economists in and outside China

believe is unsustainable. These and other characteristics of China's partially reformed financial system limit the country's potential as an engine of sustainable economic growth.

While the benefits to China of modernizing its financial sector are obvious, China's successful construction of a modern financial sector is in America's interest, too. A modern financial system will help address three main concerns in the bilateral economic relationship: China's exchange rate policy, the US trade deficit with China, and the fostering of a competitive "level playing field" for companies competing with Chinese counterparts. Expanding the opportunities in China open to American financial service providers could greatly aid reforms affecting all three areas. By bringing their expertise to the market in China and exposing Chinese companies to international best practices, both through competition and partnership, American companies can help China as it builds the infrastructure of a modern financial sector.

First, China can only adopt a fully market-determined exchange rate—a goal of China's economic policymakers and a key concern in Washington—if it develops a robust financial system that will allow for the removal of capital controls and the creation of a fully convertible currency. Strengthening China's banks is a critical step toward the removal of capital controls. Allowing greater participation by American financial institutions would bring international standards and practices to Chinese institutions and help China build the financial instruments that facilitate a floating exchange rate.

It goes without saying that China can and should, in the meantime, allow its exchange rate with the dollar to fluctuate more freely to reflect

changes in trade flows. Movement since last July's changes to China's currency policies has been slow and limited. Many economists and observers, including those in China, expect gradual appreciation of the renminbi (RMB) to continue for the balance of 2006.

It should be noted, however, that the effect of China's exchange rate policy on bilateral trade is likely overstated. Any production that becomes unprofitable in China because of an exchange rate appreciation is likely to shift not to the United States but rather to economies in Asia or regions whose competitive strengths more closely resemble those of China.

Even so, any benefit China gains from an undervalued currency should be addressed. The best way to eliminate any such unfair trade advantage is to continue to push for greater market influences to be reflected in the exchange rate now, for broader financial reforms that will lead to the removal of capital controls at the appropriate time, and for a fully market-based currency in the future.

Second, modernizing China's financial sector could over the long run help lower the US trade deficit with China by encouraging China's transition from economic growth driven by exports and investment to more balanced growth that incorporates greater domestic consumption. Chinese households save up to 50 percent of their incomes. This high level of household savings is mainly due to the need to save for basics such as retirement, medical costs, education, and many consumer purchases. The pension, insurance, personal investment, and consumer financing products that come with a modern financial sector – products in which American financial service providers have developed a wealth of expertise – could reduce excessively high household savings in China and allow for greater consumption. As a result, some of China's exports might be diverted to domestic sales; China's imports also would increase and, with time, perhaps contribute to more export opportunities for American companies and help ease the US trade deficit.

Developing China's financial sector could also help reduce the US trade deficit by removing a cause of industrial overcapacity. Chinese enterprises tend to reinvest a large portion of their retained earnings in new production facilities because of the dearth of attractive alternative investment options and because these companies generally do not pay shareholder dividends. As their productive capacity rapidly increases, largely without regard to reasonable predictions of market

growth, Chinese companies seek out export markets, including the United States, and contribute to downward pricing pressures. Banking reforms and market openings could help China increase the financial alternatives available to Chinese companies, thus helping to reverse this trend – and thereby help lower the US trade deficit with China.

Finally, the commercially based lending criteria that would be part of a fully modernized financial system in China would help American companies compete in China and globally on a more level playing field with their Chinese competitors. Although China's central government has done much to introduce commercial lending criteria to state-owned banks, these banks too often revert to their previous roles as policy-driven lenders. Provincial branches of state-owned banks, which operate with some degree of autonomy from their headquarters, reportedly often extend loans to enterprises at the behest of local governments. Some of these enterprises could not otherwise obtain access to capital, since they would not qualify under normal commercial standards. Lending and repayment are often at less-than-market terms, giving these companies an unfair advantage over American companies in China and in international markets. Expanding the participation of US financial firms in China's financial sector would help to hasten the adoption of commercial lending practices throughout China's financial sector, thereby helping to level the playing field for all American companies.

As part of its World Trade Organization (WTO) commitments, China has partially opened the door to American financial service providers. With important commitments to remove geographic and client restrictions on foreign banks operating in China due by the end of this year, China has an opportunity to open the door wider. But to gain the full benefits that the presence of foreign financial companies can bring to China's economy, China should go beyond what is required of it by the WTO and open the door fully to foreign financial service providers. Such an opening would be to China's own benefit and to that of its commercial partners.

The US government should make this a central part of its economic and commercial engagement with China. In Beijing in October 2005, then-Secretary of the Treasury John Snow called on China to undertake far-reaching financial reforms and laid a foundation for future dialogue. In that speech, Snow highlighted the benefits to China of financial sector reform and how opening up to

American companies would aid that process. Henry Paulson's recent confirmation as Treasury Secretary, and his first public comments on China, warrant optimism that Washington will make assisting in China's financial modernization and expanding the market opportunities for American financial institutions a priority.

Key to making progress on this front is ensuring that all parts of the US government—in particular, the Department of the Treasury, the Department of Commerce, and the Office of the US Trade Representative—speak with one voice on the importance of China increasing market access for American financial companies as part of China's financial sector modernization. Secretary Paulson, Secretary of Commerce Carlos Gutierrez, and US Trade Representative Susan Schwab should therefore work together to guarantee that securing greater access to China's financial sector is fully integrated with Washington's broader commercial and economic engagement with Beijing.

Engagement with China on these issues could also be the basis for a new framework for bilateral economic and commercial dialogue resembling the dialogue on strategic issues established by former Deputy Secretary of State Robert Zoellick. Current mechanisms of the commercial relationship primarily address the market access barriers that American companies confront in China. Given the financial sector's core role in the economy and the bilateral frictions created by its distortions, however, US interests in China's financial reforms go well beyond simple market access barriers. Engagement on this front requires a more extensive dialogue that, in addition to addressing market access barriers, allows each side to understand the scope of the issue and establishes a path toward a mutually beneficial outcome.

Below is a more detailed review of recent progress on reforms in the financial sector and the challenges facing American financial service providers in China.

Recent Positive Developments

Though the pace of China's financial reforms has not been as fast as many observers would like, China has taken some notable steps in a number of areas important to American financial service providers.

Platform for expanded bilateral dialogues

The US-China Joint Economic Committee (JEC) is the principal forum for official dialogue on China's

financial sector and is chaired by the US Treasury Department and the PRC Ministry of Finance (MOF). The JEC last met in October 2005 in Beijing and is expected to meet again this fall. At the 2005 meeting, Secretary Snow called for an expanded dialogue on broad financial sector reforms and advocated greater market access for American financial service providers. He stressed that such market openings would aid China's financial modernization and help balance its economic growth. Furthering this theme, then-Federal Reserve Board Chair Alan Greenspan, Securities Exchange Commission (SEC) Chair Christopher Cox, and Commodity Futures Trading Commission (CFTC) Chair Rueben Jeffrey III accompanied Snow to China and all engaged in high-level, productive discussions with their counterparts.

Building on the broad focus of the 2005 JEC, MOF led a delegation of financial sector regulators to Washington, DC, for the Financial Sector Regulatory Dialogue in April 2006. The delegation of senior working level PRC officials came from MOF, the People's Bank of China, China Insurance Regulatory Commission (CIRC), China Securities Regulatory Commission (CSRC), and China Banking Regulatory Commission (CBRC). The Treasury Department chaired the US government delegation, which also included representatives from the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., National Association of Insurance Commissioners (NAIC), SEC, and CFTC. The Treasury Department hopes this dialogue will become a semiannual exchange—and the US-China Business Council (USCBC) strongly endorses this objective.

The Financial Sector Regulatory Dialogue is intended to serve as a forum for officials from both sides to exchange ideas and increase cooperation on technical matters. The Treasury Department worked with USCBC as well as other companies and organizations to ensure that the interests of US financial service providers were raised during the most recent meetings, on issues including banking, securities, insurance, credit rating agency, the bond markets, and accounting standards.

USCBC was particularly encouraged by the PRC delegation's willingness to participate in an informal meeting with interested USCBC member companies during its brief visit. USCBC plans to continue these exchanges with industry along the sidelines of future governmental meetings.

US and PRC regulators have established additional forums, both formal and informal, that

have increased mutual awareness and understanding of the challenges inherent in reforming China's financial system and the concerns of American companies. These include the Insurance Regulatory Dialogue between government officials and industry executives, as well as discussions occurring between SEC and CSRC, NAIC and CIRC, and CFTC and its Chinese counterparts that regulate the futures market. In addition to these dialogues, US industry and officials also participate in an ever-increasing number of training sessions to improve Chinese capacity for and understanding of sound financial service practices.

The increased interaction between PRC and US officials is a sign of a potentially more open and transparent financial system. It is also an indication that PRC regulators recognize the value of creating a more mature and stable system with the input of foreign regulators and companies alike. These are trends worth facilitating and encouraging.

A focus on improving corporate governance and risk management

Many obstacles impede the development, and threaten the long-term stability, of the Chinese financial sector. Chinese regulators continue to update the regulatory environment, paying particular and consistent attention to improving corporate governance and risk management. This is a significant development, because a large number of domestic financial service providers in China are untrained in the basic techniques that form the foundation for sound practices.

Furthermore, China's financial institutions have traditionally lacked the infrastructure and oversight to ensure good corporate governance.

Banks, for example, have traditionally provided easy loans to state-owned enterprises. This practice has left them burdened with a legacy of poor lending practices and a large number of bad loans. As regulators continue to construct a more modern financial infrastructure, they must also focus on teaching basic banking skills and reverse an industry-wide culture of non-rules-based lending. It is an immense task, but the initial steps have been taken. Moreover, it is evident that China's economic policymakers are intent on improving corporate governance and the technical expertise of practitioners.

China's largest state-owned banks – China Construction Bank (CCB), the Bank of China (BOC), Industrial and Commercial Bank of China, and Agricultural Bank of China (referred to as the Big Four) – account for almost 60 percent of

banking system assets and have understandably been the focus of reforms to improve corporate governance, internal organization, and risk management techniques. China's regulators are using BOC and CCB as examples for modernization. Both have been restructured into joint-stock companies and have implemented new corporate governance structures with a shareholders' meeting, board of directors, board of supervisors, and top management that operate according to newly adopted, internationally consistent rules. In addition, both banks have diversified their ownership structures by increasing the number of foreign strategic investors and listing on the Hong Kong Stock Exchange.

CIRC, China's insurance regulator, has been equally focused on improving corporate governance and risk management techniques in its sector. A few recent regulations issued by CIRC that highlight the PRC government's attempt to correct deficiencies in the oversight and risk management capability within the insurance sector include the

- Regulation on the Management of Insurance Salespersons;
- Directive Opinion on the Administrative Structure of Insurance Companies;
- Measures on the Administrative Investigation of the Leadership of State-Owned Insurance Companies in Serious Cases; and
- Interim Rules Governing Off-Site Supervision of Domestic Insurance Companies.

In addition, CIRC launched a three-year campaign in the first quarter of 2006 to inspect investment activities by insurers as part of an effort to encourage adequate internal control systems and risk-prevention techniques. CIRC also recently established a means to compensate policyholders if an insurer fails. This represents another important step in building confidence in the market.

American financial service providers frequently cite the Chinese public's limited familiarity with and trust of financial products as a hindrance to growth. As confidence grows and more Chinese citizens become familiar with the concept of personal insurance, US companies that have invested in China will gain more customers.

Fulfillment of WTO commitments in the banking sector

Thus far, China has fulfilled its WTO banking obligations. In addition to allowing foreign banks

to expand their local currency business with Chinese companies into seven more cities in 2005—five of which were opened ahead of schedule—CBRC, China’s bank regulator, has also reduced the minimum operating capital requirement for a foreign bank branch conducting RMB services by \$12.4 million, to just over \$50 million.

Still, foreign banks are not currently permitted to provide RMB banking services to Chinese individuals, though China has committed to allow this by December 11, 2006. Moreover, prudential restrictions, although lowered, still limit foreign banks’ ability to develop extensive branch networks. Many foreign banks have turned to buying stakes in state-owned banks in an attempt to gain greater access to China’s market. As China continues to reform its troubled banking system, Beijing has welcomed the capital injections and shared expertise that comes with foreign investment. According to the chair of CBRC, there were 173 foreign banks doing business in China by the end of 2005, and their total assets amounted to \$84.5 billion.

By December 11, 2006, China’s WTO commitments require it to lift all geographic and customer restrictions on foreign banks and eliminate any nonprudential measures that restrict ownership, operation, and operational form of foreign-invested banks. As such, American banks should be able to establish wholly foreign-owned branches in any city and provide local and foreign currency services to Chinese individuals in 2007. Note, however, that foreign ownership in Chinese banks will still be capped, as is discussed below (p. 6).

Insurance sector openings

China implemented its WTO commitments on schedule to allow foreign-invested enterprises to provide health, group, and pension/annuities insurance to both foreign and Chinese clients. The expanded market access and removal of geographic restrictions that followed China’s implementation of these WTO commitments have benefited foreign insurers, as Chinese consumers, exposed to more insurance products, have become more sophisticated. As a result, USCBC members report increasing demand from Chinese customers for insurance services. In addition, CIRC has recently made steps toward more transparency and accessibility by engaging US government and industry representatives on two occasions in 2005 during the second and third sessions of the Insurance Regulatory Dialogue. The next

installment of the dialogue is expected to be held this fall. USCBC looks forward to more opportunities for such bilateral exchanges.

In 2005, PRC regulators released regulations on reinsurance, insurance company investments in debt, and a clarification of the provision of group insurance. Previously, foreign and domestic insurers were only permitted to provide group life insurance for clients headquartered in the geographic area where the insurance provider is licensed to sell its product. The clarification broadens that scope to allow them to serve a client that has a human resources or settlement department in the region.

More recently, China’s cabinet, the State Council, released a broad-spectrum directive that aims to direct the reform and work efforts of insurance regulators. Importantly, the directive recognizes that insurance can play an important role in stimulating domestic consumption, lowering savings rates, and accelerating investment by providing long-term and stable sources of funds. It also notes the role that foreign insurers can play, stating that they should be relied upon as a source of innovation and high standards. In fact, the State Council used the directive to urge China’s insurance industry to adopt international norms.

...More Work Remains

Despite these improvements, much work remains to be done to modernize China’s financial sector.

Banking

A reformed commercial banking sector is widely recognized as critical to sustaining China’s economic growth levels for all of the reasons mentioned above. Foreign banks have already contributed to the modernization of China’s banks with much-needed capital, technology, and know-how. Still, foreign banks find themselves stymied when trying to compete in the marketplace. Despite the fact that they have invested \$84.5 billion in total assets, they account for less than 2 percent of the market.

As in most other sectors of the Chinese economy, foreign investors in China’s banking industry have two options when entering the market. They can either enter directly, by setting up wholly foreign-owned branches or subsidiaries, or invest in an existing domestic player. Foreign banks that are not partnered with Chinese banks are currently allowed to conduct foreign currency

services with Chinese individuals and businesses and RMB services with local businesses. They will not be permitted to conduct RMB services with Chinese nationals until China fulfills its year-five WTO commitment by December of this year. Still, foreign banks have proven eager to position themselves to gain access to China's \$1.65 trillion of local currency household deposits. By mid-2005, they had established 244 representative offices and 214 operational branches or subsidiaries. By the end of April 2005, total assets of foreign banks had reached \$76.22 billion, including \$28.5 billion in foreign currency loans and \$10 billion in local currency loans.

- **Branching requirements** In order to be truly competitive in the industry, banks must have the ability to establish large branch networks and reach as many customers as possible. The obvious benefits to establishing wholly foreign-owned bank branches and subsidiaries in China include full control of corporate governance and avoidance of the problems plaguing many Chinese banks, such as large portfolios of nonperforming loans, chronic overstaffing, and poor management. The downside to establishing a wholly foreign-owned presence is that Chinese regulators have relied heavily on prudential measures to protect local institutions from foreign competition and have made it extremely difficult for these banks to establish a wide presence in China.

Each new branch requires an additional \$50 million of operating capital. These expenses associated with opening a branch in China have discouraged all but a few US banks from even attempting to enter the market.

In addition to the cost of establishing a truly competitive presence in China, the application processes are cumbersome and far from transparent. Current regulations stipulate that foreign banks can only open one branch and two sub-branches per year. In addition, the WTO accession agreement requires a new investor to operate a representative office for two years before it can upgrade to a branch office. Furthermore, a foreign bank branch must have profitable operations for two years before it can qualify for a license to conduct RMB transactions.

Though nonprudential restrictions such as these may not violate China's WTO commitments, they prevent US banks from increasing their participation in China's banking sector, and thereby inhibit US banks' ability to contribute more to China's own modernization goals.

- **Ownership caps on domestic investments**

Because of the cost and limitations associated with a wholly foreign-owned banking operation, many foreign investors have turned to buying stakes in state-owned banks in an attempt to gain greater access to China's market. As China reforms its troubled banking system, Beijing has welcomed the capital injections and shared industry expertise that comes with foreign investment. Among the deals that have taken place include Citigroup Inc.'s \$653 million purchase of 20 percent of Shanghai Pudong Development Bank, Bank of America Corp.'s acquisition of a 9 percent stake in CCB for \$3 billion, and Merrill Lynch & Co., Inc.'s share of a \$3.1 billion investment for a 10 percent stake in BOC.

Still, foreign investors that choose to invest in Chinese banks face significant restrictions. Banking regulators have imposed caps on foreign investment in Chinese banks. A single foreign investor's share in a Chinese bank must be less than 20 percent, and total foreign ownership of a bank may not exceed 25 percent. This ownership restriction effectively prohibits foreign banks from having a greater management role in the institutions they invest in, again denying Chinese institutions the full benefits of the expertise foreign investors have to offer.

Insurance

An overarching problem facing the insurance industry in China is the lack of transparency at various levels of government. In many cases, US insurance companies are denied the right to comment meaningfully on new regulations because the comment periods are too short. Instead, CIRC, China's insurance regulator, should recognize the experience of foreign insurance providers as an asset and allow all interested parties to consistently participate in the rulemaking process.

- **Branching restrictions** Much like the banking sector, insurance companies rely on the expansion of their branch networks to connect with more clients. While insurance regulators allow domestic insurance companies to license new branches concurrently, foreign companies' new licenses are approved only consecutively. Because it generally takes about eight months for regulators to process a license application, foreign insurance providers are, in effect, limited to establishing about one branch per year. The opaque and confusing regulatory framework in which insurance companies are forced to operate has left foreign

companies vulnerable to discriminatory treatment of their applications for new branches. Limiting foreign insurance companies to consecutive, rather than concurrent, branching is a major impediment to the ability of US insurers to expand their offerings within China.

- **Wholly-owned nonlife insurance subsidiaries** Under the terms of its WTO accession, China agreed to permit foreign nonlife insurers to establish wholly owned subsidiaries within two years. US and other foreign nonlife insurers, however, continue to face substantial difficulties in securing approval for their conversion to wholly owned subsidiaries. These companies face a nontransparent approval process, as CIRC has not offered clear guidance as to what additional information it needs from applicants to make a decision. In addition, CIRC has not provided a concrete timeframe for final consideration of applications.

Securities

Foreign firms operating in the securities sector recognize that China's WTO accession commitments were an important first step toward the liberalization of its capital markets, but they continue to face significant restrictions on their ability to conduct business in China. Foreign securities firms are limited to minority joint ventures with ownership levels capped at 33 percent; foreign participation in China's asset management sector is limited to no more than 49 percent ownership of domestic fund management firms. In addition to ownership restrictions, these firms' operations are also restricted. For instance, they are not permitted to trade and sell in the most liquid domestic market: RMB-denominated A shares. Foreign entities are also restricted in many cases from trading RMB and RMB-linked products with other enterprises in China.

Further openings in this sector should be implemented. Foreign firms, whether securities firms or commercial banks, should have the right to participate fully in the securities sector, either through a wholly owned entity or through other ownership forms of their choice, without geographic limitation—including the fundamental right to sell and trade A shares. In addition, foreign entities should be permitted full rights to offer

RMB and RMB-linked products to foreign and domestic enterprises in China. Finally, deeper and broader domestic bond and equity markets must be developed as a complement to bank intermediation for savings and investments.

The efficient allocation of capital is a precondition for robust economic growth and job creation in China. By adopting these measures, China would enable foreign securities firms to contribute to the development of Chinese financial markets through shared expertise on the infrastructure and techniques needed to serve clients effectively. Foreign players can also assist in the creation of new products and services while demonstrating the benefits of high corporate governance standards.

Other Issues

- **Restrictions on credit rating companies** Regulations proposed by CSRC, China's securities regulator, would significantly restrict the ability of international rating agencies to participate in China's domestic credit ratings market. Most troublesome, the regulations would limit foreign ratings firms operating in China to joint venture investments with a licensed local Chinese rating agency and would inhibit credit rating agencies from convening diverse rating committees comprised of staff best suited to make decisions without the prior approval of CSRC. Such a requirement could severely threaten the integrity of the rating process.
- **Access to the futures market** China's futures markets currently suffer from limited trade participation and insufficient liquidity. Regulators should permit more foreign participation to create a more stable market and counteract the current emphasis on speculative interests. One way to do this would be to grant foreign brokers access to the market. The current regulatory structure requires foreign investors to trade using underdeveloped domestic brokers that are limited in terms of size (capital) and scope (volume of trades). If foreign brokers are granted greater access to the markets, they could make significant improvements in the overall health and virility of China's futures markets.