

**Testimony before the
U.S.-China Economic and Security Review Commission**

*Corporate Accountability, Access to Credit, and Access to Markets in China's Financial
System – the Rules and their Ramifications for U.S. Investors*

*Panel III: Market Conditions and Access Issues for Banking, Investment, Insurance and
other Services Firms*

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I would like to thank the co-chairs and the other distinguished members of the Commission and its staff for the opportunity to speak to you today and to share my views on this very interesting and important topic. It is an honor to be invited.

First, as is indicated in my biographical information, in addition to the position of adjunct professor at the Georgetown University Law Center, I serve as senior counsel in the Securities and Exchange Commission's Office of International Affairs. Accordingly, before I begin my prepared remarks I would like to emphasize that I am appearing here in my capacity as a Georgetown Law professor and that my comments today are mine and mine alone, and do not represent the views of the SEC, any individual SEC Commissioner, or the SEC staff.

I have been asked to speak on the state of China's financial markets and access to those markets by foreign market participants. Given the complexity of each of these topics, my short remarks today by their very nature are a high-level summary. In them, however, I hope to call attention to the key factors relevant to the broader discussion.

The transformation that has been witnessed in China's financial markets over the past two decades has truly been phenomenal and is something worthy of praise. In an amazingly short

period of time by historical standards, China has built from the ground up much of the institutional architecture that is required to support well-functioning financial markets and market-based capital allocation. Examples include the establishment of the Shanghai and Shenzhen stock exchanges, the restructuring and subsequent public listing of China's largest commercial banks, the formation of a corporate bond market, and the development of insurance, brokerage, and asset management industries. At an even more fundamental level, the Chinese government has made tremendous strides in the enactment and implementation of laws and regulations that govern the financial markets and market intermediaries, and in the creation of ostensibly independent market regulators; the China Banking Regulatory Commission, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission.

Despite these impressive achievements, however, China's financial markets remain significantly repressed as a result of the virtual monopoly of capital allocation by China's state-owned commercial banks, excessively low government-controlled interest rates, strict capital controls, and poorly developed debt and equity markets.

As a consequence, all sectors of China's financial system are characterized by significant distortions and inefficiencies. This is seen on the banking side in a misallocation of capital to well-connected state-owned enterprises by the state-owned commercial banks and a resulting upsurge in non-performing loans. At the same time, private non-state owned-companies are cut off from commercial bank lending, while Chinese households place their saving in accounts providing extremely low to negative real interest rates. These distortions have led to the development of an unregulated shadow-banking system, which has the potential of generating unseen risk to the financial system. China's insurance sector is characterized by the limited variety and availability of insurance products and a resulting small percentage of insured assets. This in turn hinders diversification of China's business sector and contributes to a high-level of precautionary savings among Chinese households. As for China's securities markets, listings on China's stock markets, as well as corporate bond issuances, are dominated by those same state-owned enterprises that already receive preferential lending from the state-owned commercial banks. This being the case, China's debt and equity markets fail to serve as venues for capital raising by private entrepreneurial companies, companies that are critical for the innovation and job creation that will be necessary for China's long-term

economic health. As a consequence of the dominance of state-owned enterprises, persistent government interference in the markets, and the perception of rampant market manipulation and insider dealing, China's securities markets are not seen as viable investment alternatives for Chinese households.

Foreign Access to China's Financial Sector

Turning to the topic of access to China's financial sector by foreign market participants, despite some recent progress in this, area access to China's financial markets and financial services industries remain significantly curtailed. Studies by both the OECD and the World Bank rank China as one of the most restrictive markets for financial services among the G20. In fact, with regard to inward investment in financial services, China is by far the most restrictive of the BRIC (Brazil, Russia, India, China) nations.

In the banking sector, equity ownership of Chinese banks is limited to 20 percent by any single foreign investor, with a maximum of 25 percent total collective foreign ownership. Setting aside the minority strategic investments made in China's largest state-owned commercial banks under these rules, foreign banks still have only a small presence in China's banking sector. China has taken a number of steps to implement its WTO banking service commitments, including access to the retail RMB market, however, the USTR reports that some of these efforts have generated concerns, and there are some instances in which China still does not seem to have fully implemented particular commitments, such as with regard to Chinese-foreign joint banks and bank branches. Despite these concerns, banking is the most open to foreign completion of China's financial sectors. Today most of the major foreign banks have incorporated as wholly-owned subsidiaries in China and can compete with local banks on a full range of RMB-denominated products and services for both corporate and retail customers.

The foreign share of China's insurance sector is quite low by global standards. Although China has implemented most of its WTO insurance commitments, these commitments only permit foreign insurance companies a 50 percent equity ownership in life insurance joint ventures.

Access by foreign investors and service providers to China's securities markets are also significantly restricted. Foreign portfolio investment in Chinese listed companies is, for all intents and purposes, confined to investing through designated institutional investors. Stocks listed on China's stock exchanges are classified as either A-shares or B-shares. A-shares are, by a significant factor, the largest class of listed shares. Except for certain designated institutional investors, to be discussed in a moment, foreign investors are prohibited from owning and trading in A-shares. Both individual and institutional foreign investors, on the other hand, may purchase B-shares freely. However, due to its limited size, 0.7 percent of the A-share market capitalization, the B-share market does not allow foreign investors any meaningful control of Chinese listed companies. As a consequence, foreign investors have not viewed the B-share market as a viable investment path and this market has languished since the late 1990s.

As for the foreign institutions permitted to trade in A-shares, in 2002 China allowed access to trading in the A-share and bond market to certain foreign institutional investors through the Qualified Foreign Institutional Investor (or "QFII") program. Under the QFII program, foreign institutional investors—primarily foreign banks and investment funds—may apply for permission to participate in the QFII investment quota. In April 2012, the QFII investment quota was increased from US\$30 billion to US\$80 billion. However, the total QFII quota allocation to date still represents less than one percent of the total market value of tradable Chinese A-shares.

Foreign securities firms also face significant equity ownership restrictions. This remains true despite recent progress being made in this area. In October of last year, and in accordance with its commitments made during the May 2012 US-China Security and Economic Dialogue, China increased the upper limit on foreign equity ownership in securities company joint ventures from 33 to 49 percent.

Implications and Recommendations

The picture that is painted above is one of a market that, although slowly opening up, still significantly restricts access by foreign investors and financial service providers. This is unfortunate as increased participation by foreign investors and institutions in China's financial

sector would aid in the development of China's financial markets by bringing expertise and, more significantly, providing much-needed competition to the financial sector. The current lack of significant competition in China's financial sector hinders efficiency, limits investor choice, and restricts access to capital by non-state-owned companies. Furthermore, the lack of competition in China's financial markets facilitates destructive rent-seeking behaviors by special interest groups and well-connected individuals. In its most pernicious form, this creates a perfect environment for fraud, insider dealing, and corruption. Accordingly, I believe it is in China's long-term best interest to open up its financial markets to foreign investors and financial service providers. Given the importance of a healthy and stable Chinese financial sector to the US and global economy, I believe it to be both appropriate and advisable that the US Government, through fora such as the Strategic and Economic Dialogue, continue to advocate for greater opening in China's financial markets. That being said, I would caution against viewing foreign access as a panacea to the ills in China's financial sector. Greater foreign access is only one, and not necessarily the most important, of the host of reforms that need to be implemented to address the distortions in China's financial markets and imbalances in China's economy. In addition to financial market development, of which increasing competition through foreign participation is an important part, China also needs to improve the quality and enforcement of its regulation and supervision, liberalize interest rate policy, and open its capital account. Furthermore, these reforms must be coordinated. Therefore, I would urge that along with the topic of access, the US government continue to press China on moving to a market-based interest rate regime and opening up its capital account. Also, the US should continue its outreach to China, including the provision of technical assistance, aimed at development of China's regulatory oversight and enforcement capabilities in the financial sector.