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

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## Access to China's Consumer Market for Financial Services

Co-chairs, members of the Commission: thank you for the opportunity to testify today.

Since December 2016, I have been the Director for China at Eurasia Group, an advisory and consulting firm based in New York City. In this capacity, I advise our clients on the policy environment in China and how it will impact their business. Our clients include many of the country's leading financial firms, and I spend much of my time each day on issues that pertain to the focus of today's hearing.

My view on these issues is informed by my previous career in the federal government. For the prior three years (2013-2016), I served as the US Department of Treasury's financial attaché to China, based at the US Embassy in Beijing. In this capacity and in earlier roles at US Treasury based in Washington, D.C., I was deeply involved in the US government's efforts to expand market access for U.S. financial services firms in China, promote China's broader financial sector reforms, and strengthen financial regulatory cooperation between the United States and China.

## Part I. China's Financial Sector Opportunities in Context

### Ia. Overview

China's financial sector has long been attractive to U.S. firms, and there is no question that the potential opportunities are particularly significant for services marketed to Chinese households. China's middle class is by some measures already the largest in the world and is growing quickly, but has traditionally been poorly served by the financial system. Households still lack wide availability of many important financial products that are mainstays in the United States, such as reliable vehicles for long-term retirement savings. Chinese households are also increasingly looking to diversify their wealth by moving some of it overseas, a role that U.S. firms are well-placed to fill.

And yet, foreign firms have faced major challenges cracking China's financial sector, due in significant part to market access restrictions and other impediments -- formal and informal -- imposed by China's government. Foreign firms account for less than two percent of China's commercial banking assets and have less than a six percent market share in insurance, for example,

rates that are significantly below that of the United States and China's peers among middle income countries. Of course, the fact that China's financial sector assets have generally been growing at double-digit annual rates means that even with flat market share, many foreign firms are doing reasonably well in China and remain committed for the long term. But it is clear that the role of foreign firms in China today is far smaller than most expected when China joined the WTO in 2001.

My remarks will highlight some of the opportunities for US financial firms in China, and place these in the context of China's overall financial sector reforms. I will then discuss the major impediments facing foreign firms, which fall into the two main categories of ownership restrictions and broader business environment issues such as discriminatory licensing procedures. I will close with a few policy recommendations.

**Ib. China's Financial Sector Reform Agenda**

China's ongoing financial reforms provide important context for where the financial system is today and how it is likely to evolve.

Banks dominate China's financial sector, with a growing but still much smaller role for equity and bond markets; this is in contrast to the United States, where the equity and bond markets are far larger than the banking system. State-owned firms dominate the financial sector, particularly in banking. In recent years, the government has expanded pilot programs that allow domestic private investors to set up new banks, but their market share remains very small. Private firms are more prominent in sectors such as insurance, trusts, securities and asset management.

Even throughout much of the reform period that began in the late 1970s, the government has administered the financial system with the core purpose of providing low-cost funding to the corporate sector, and in particularly state-owned enterprises (SOEs). There were two main losers in this system:

(1) Households, who earned meager returns on their bank deposits as the government mandated low interest rates in order to keep funding costs cheap for banks and their corporate customers (a situation economists refer to as "financial repression"); and

(2) Private firms, particularly small and medium-sized enterprises, who have had a much harder time obtaining capital from the financial system than state-owned firms. Anecdotal evidence suggests that while access to finance for private firms has improved over the last decade, it remains significantly more difficult than for SOEs.

More broadly, the emphasis on financing state-owned enterprises, and the implicit guarantee that state-owned firms still receive from the government, has contributed to weak efficiency of capital allocation in China. State firms are less efficient than the more dynamic private sector. With credit continuing to favor state-owned firms, China's economy has become reliant on ever-greater amounts of credit to achieve a given unit of economic growth. Improving the efficiency of the

financial system is essential if China is to successfully address its growing debt problems and maintain relatively high rates of growth in the future.

While financial reforms have generally been very gradual, several important reform efforts are underway:

**Interest rate liberalization:** China's government removed the final formal limits on interest rates in 2015, though it still uses informal "window guidance" to order banks to keep deposit rates within 1.5 times the benchmark rate. Going forward, the full removal of interest rate controls will help promote the efficiency of the financial sector by allowing the most competitive banks to offer higher interest rates to depositors and thus grab market share from less efficient peers.

**Availability of consumer finance:** In line with China's efforts to promote consumption growth, the government has encouraged broader availability of consumer financial products such as mortgages, which have grown very quickly in recent years. Chinese "fin tech" companies, including leading e-commerce firms such as Alibaba and Tencent, have exploited new technology platforms -- and, in some cases, regulatory gray areas -- to move aggressively into consumer-focused financial services, largely at the expense of less nimble state-owned competitors. Several additional policy efforts would help improve the market for consumer finance in China, including licensing third-party credit bureaus.

**Deepening of financial markets:** China's government has sought to reduce reliance on the banking system by further developing the financial markets. China's equity and bond markets are already among the largest in the world, but require deeper reforms to serve as stable sources of long-term financing and investment. Priorities include expanding the role of long-term institutional investors (including foreign investors), broadening the array of financial products, and improving investor protection and corporate governance.

**Capital account liberalization:** China's government continues to exercise strict control over cross-border capital transactions, particularly portfolio investment. The pace of capital account liberalization intensified between 2012 and late 2015 through initiatives such as the Shanghai-Hong Kong Connect Program. Capital account reforms have slowed, and informal controls on outward flows have even tightened, since China's mishandled exchange rate reform in August 2015 set in motion a cycle of exchange rate depreciation and large capital outflows. But over the long-term, China will further liberalize both inflows and outflows; this will likely be one of the most important trends in global finance over the next ten years and a key opportunity for foreign firms.

One key take-away from the above discussion is that foreign financial firms have much at stake in China's overall financial sector reforms. This point underscores the need for the US government to continue to engage with China on the broad financial sector reform agenda, in addition to more specific market access barriers.

**Ic. Structural Opportunities for US Firms**

The broad strength of the U.S. financial services industry means that there are few areas in which China does not represent a major growth opportunity, ranging from car loans to bond and equity underwriting. With the focus of this hearing on the household sector, two structural themes in China's economy are worth highlighting as examples -- by no means exhaustive -- of how U.S. financial firms can play an important role in China:

***Funding Retirement:*** China is facing a daunting demographic challenge, the result of increased longevity and lower birth rates, with the latter exacerbated by the one-child policy. UN estimates show the number of people aged 65 and above growing from 131 million in 2015 to 371 million by 2050. As the median age of the population rises, China's dependency ratio (the population aged 65 and over relative to the working age population) will rise from 0.13 to 0.47. This will put an enormous strain on both the public social safety net and household finances to fund the retirement years, including rising health care costs.

Chinese households traditionally lack access to, or confidence in, investment vehicles that would help them meet these future needs, and frequently turn instead to property investment, or stowing money away in low-yielding banks deposits. U.S. firms stand to benefit by creating solutions in areas including mutual fund management, life insurance and insurance-linked investment products, private pensions, and private health insurance. U.S. firms are already active in many of these areas in China, most of which are still at a relatively early stage of development.

The lack of tax benefits for retirement savings is a key limit holding back growth of this sector. The United States should encourage progress in this area as part of China's ongoing tax reform efforts, as it will spur development of what could be an important part of households' financial safety net.

***Outward Investment:*** Lack of capital convertibility has meant that Chinese households and firms have their wealth overwhelmingly invested within China. Particularly as China's economy continues to slow from peak rates, and with the currency no longer a safe one-way bet to appreciate, both households and firms have already sought to diversify their wealth by moving it more of it overseas. This trend has very far to run: by one estimate, non-government outward securities investment and direct investment accounts for only 13% of China's GDP, compared to an average of 90% of GDP for the United States, EU and Japan[1].

China has introduced several programs in recent years to gradually allow households to access foreign markets in a controlled manner, such as through the Qualified Domestic Institutional Investor (QDII) program and the Mutual Fund Recognition program with Hong Kong. The further expansion of such programs will be very gradual for at least the next 1-2 years, given China's concerns that outward capital flows could jeopardize the stability of the exchange rate and broader financial system. Over the long-term, however, China's government will almost certainly create more windows for households to access external financial markets, aware that blocking such

[1] Source: DBS Group Research, "China: Outbound Investments Intact", May 5, 2016

efforts would be difficult and counter-productive. Chinese households will need investment services from firms that can serve as bridge to U.S. and global financial markets.

## Part II. Market Access Barriers for U.S. Firms in China

### IIa. Ownership Restrictions

Even more than 15 years after its WTO accession, China maintains major restrictions on foreign participation in the financial sector. According to the OECD[2], China has the second-most restrictive regime for foreign investment in the service sector (behind Indonesia) of any economy in the G-20, and the most restrictive regime in the G-20 for financial services [Table I].

The most significant of these restrictions are ceilings on the share of equity that U.S. and other foreign firms can hold in their China operations. China has been gradually lifting these "equity caps" across different parts of the financial sector, due in significant part to sustained engagement by the U.S. government through bilateral dialogues. Nonetheless, within the main areas of the financial sector, foreign firms are still not permitted to control a majority share of a joint venture. In commercial banking, a single foreign firm can hold no more than 20% of a joint venture, although it also has the option of operating as wholly foreign-owned bank. In securities and in asset management, foreign investment is limited to a 49% share, and in life insurance the limit is 50%.

The restrictions on foreign firms' ability to exercise control over their China business is a major barrier. This is particularly the case for foreign firms that are seeking to invest and grow their China operations; they are often contributing most of the financial and human capital in the business, while the joint venture partner receives the majority of the profits and exercises management control.

Lifting and eventually removing equity caps in financial services and other sectors has been a key rationale for the United States to negotiate a Bilateral Investment Treaty (BIT) with China. While talks have been underway for many years, they intensified in 2013 after China agreed to negotiate under the principle of national treatment and through a so-called "negative list" approach. The two sides made substantial -- though still insufficient -- headway on key issues in the final year of the Obama Administration. Public comments by US officials suggest that the Trump Administration is still formulating a position on whether it wants to take the BIT forward.

My view is that as long as the United States can secure a suitably ambitious offer from China, the BIT remains the most effective vehicle to make progress in lifting equity caps. For one, the comprehensiveness of the agreement is more likely to lead to broad opening than a series of one-off commitments on market opening under annual bilateral dialogues. Just as importantly, China's leadership has made clear that signing the BIT is one of its major priorities, giving the United

[2] OECD FDI Regulatory Restrictiveness Index (http://www.oecd.org/investment/fdiindex.htm)

States important leverage in pushing for significant liberalization in financial services and other areas.

However, the U.S. should not allow BIT talks to stymie progress on market opening altogether, particularly if prospects for reaching final agreement seem several years away. The United States should continue to push China to lift equity caps in financial services through bilateral dialogues such as the upcoming Comprehensive Economic Dialogue. Chinese officials and even Chinese firms increasingly recognize that further liberalization will benefit China by attracting additional capital and know-how to China's financial sector.

Outside of the bilateral context, China's State Council announced in January 2017 its intention to further liberalize foreign investment in a variety of sectors, including financial services. Such commitments are welcome, but there are few details and similar announcements by China in the past have failed to produce significant market opening without an external push from the United States or China's other major trade partners.

It is worth noting that in mid-May, China announced several market access measures in the financial sector as part of the 100-day action plan now under negotiation with the Trump Administration. These include a commitment to allow wholly foreign-owned financial services firms in China to provide credit rating services, and a commitment to issue remaining guidelines for U.S.-owned suppliers of electronic payment services (EPS) to begin the process to receive licenses in China. These commitments are not breakthroughs -- the commitment on EPS comes a full five years after China lost a WTO dispute brought by the United States in this sector -- but they are at least positive signals towards potential further opening in financial services.

**IIb. Licensing and Regulatory Barriers to Market Access**

In addition to ownership restrictions, foreign financial firms face a host of limits imposed by the specific regulators in their sectors. The key challenge in this area is distinguishing between requirements that arise from legitimate regulatory concerns and those that are arbitrarily directed at foreign firms and are intended at least in part to give domestic competitors an advantage.

This distinction is often difficult to make in practice. China's financial regulators lack political independence, and have at least an informal mandate to promote growth of the domestic market and domestic firms in addition to traditional regulatory objectives like financial sector soundness. China will frequently use the granting of licenses to specific foreign firms as a bargaining chip in bilateral negotiations. China's self-regulatory organizations (SROs) in the financial sector also present a challenge when it comes to the awarding of specific licenses under their remit: the SROs are comprised of Chinese firms, who are essentially deciding whether they want to allow market access for foreign competitors -- and the answer is often that they do not.

This blurring of regulatory and market access discussions is exceptionally challenging for foreign firms since the guidelines and criteria are often opaque. It also a challenge for the US government in acting on behalf of firms, since US agencies -- particularly independent regulators --

appropriately seek to avoid pushing foreign counterparts to lower or regulatory standards for foreign firms.

Consistent engagement by the US government has been effective at addressing many problematic areas. Through the Strategic and Economic Dialogue, for example, the US won agreements by China to shorten a needlessly long three-year waiting period by which foreign banks were required to wait before engaging in RMB-denominated business. And in the last twelve months, China has agreed to issue several important licenses for the bond market to qualified US firms.

Nonetheless, arbitrary and discriminatory regulatory restrictions will remain a challenge for the foreseeable future. There are few easy solutions to addressing these issues other than persistent pressure from the United States for China not to treat regulatory matters as intentional barriers to foreign firms.

I do not believe it is inappropriate for the United States to warn China that such behavior will ultimately lead to a less welcoming attitude towards similar Chinese investment in our markets. However, the United States should avoid reciprocal treatment, in the sense of a similar blurring of regulatory and market access issues, as that would undermine the effectiveness and transparency of both U.S. financial regulation and our investment regime.

## IIc. Restrictive Technology Policies

*Cybersecurity Law*

China's Cybersecurity Law, which became effective on June 1, is a significant source of concern for foreign financial firms and other information technology companies. Much will depend on how China implements the law and accompanying regulations. At least on paper, the law raises two key issues for foreign financial firms:

*Provision on cross-border data flows.* As drafted, the law and accompanying draft measures require companies to conduct a review of data protection processes before transiting customer data across borders. Beijing has postponed compliance with these measures until the end of 2018, giving financial firms time to understand how to implement processes to comply with requirements. Since foreign firms operate much of their underlying IT infrastructure outside China, elements of the new regulation could hamper their ability to serve customers within China. Chinese officials have indicated that data transfers involved in normal business operations may not be subject to the reviews, and regulators in different sectors may interpret the measures differently. Adding to the confusion are questions about data definitions used in the measures and what the final language will look like.

*"Secure and controllable" procurement.* The law requires "critical information infrastructure" operators, which includes the financial services sector, to use products that meet China's standards of "secure and controllable" technology. To qualify as secure and controllable, products must undergo a cybersecurity review process whose full parameters are still unclear. A number of factors suggest that some foreign IT firms will find it challenging to pass this new review process,

which early indications suggest may require access to source code and details about supply chains. While China claims the review process does not discriminate against foreign products—and some foreign network products have passed informal reviews—implementation of the reviews could favor Chinese technology firms and put Western firms at a disadvantage. For foreign financial services firms, the danger is that firms will be unable to use significant parts of their global IT infrastructure in China, and forced to use domestic substitutes. Depending on how China implements its regulations in practice, this could result in anything from an irritation to a major business impediment.

China has focused on commercial banks and insurance firms as the two focal points to date for cybersecurity in the financial sector, but the broad sweep of China's cybersecurity efforts indicate it will reach across financial services (draft cybersecurity regulations for the securities industry came out earlier this year). Fin tech firms will face particularly steep challenges navigating not only the Cybersecurity Law, but China's increasingly restrictive policies in the technology sector more broadly.

## Part III. Key Recommendations for Congress and the Administration

Below are recommendations for the Congress and the Administration with respect to engaging China on market access issues and broader reforms in the financial sector. Over the next nine months, China will undergo a significant reshuffling of the leadership of the Communist Party and the government. This transition may somewhat complicate the process of engagement on these issues in the short term, though it also provides an opportunity to start fresh with a new round of senior officials as they take up their posts.

**(1) Deepen high-level engagement on China's broader financial sector reforms.** The conversation shouldn't just be about market access. China's continued financial reforms are critical to the ability of U.S. financial services firms to capture opportunities in China. U.S. firms will do best in a financial system that rewards well-run firms that are the most efficient in deploying capital and managing risks. U.S. firms will struggle in an environment where regulations are opaque and capital is allocated based on political criteria.

There are two other enormously important reasons for the United States to maintain a robust dialogue on financial regulatory issues: (1) to help China deal effectively with mounting financial risks, which pose a threat to China's economic stability and hence to U.S. and global growth; and (2) to strengthen cooperation between U.S. and Chinese agencies on cross-border regulatory issues, which are already important and will become even more so as China's financial sector continues to open up and integrate with global financial markets.

**(2) Use the BIT to push for broad lifting of equity caps and other investment impediments, but push for incremental progress in the meantime.** I believe the BIT is very important to putting the U.S.-China investment relationship -- which is increasingly a political and economic flashpoint -- on a fair and sustainable footing. The BIT is also the United States' best source of leverage for pushing for broad opening in finance and other services. However, the United States

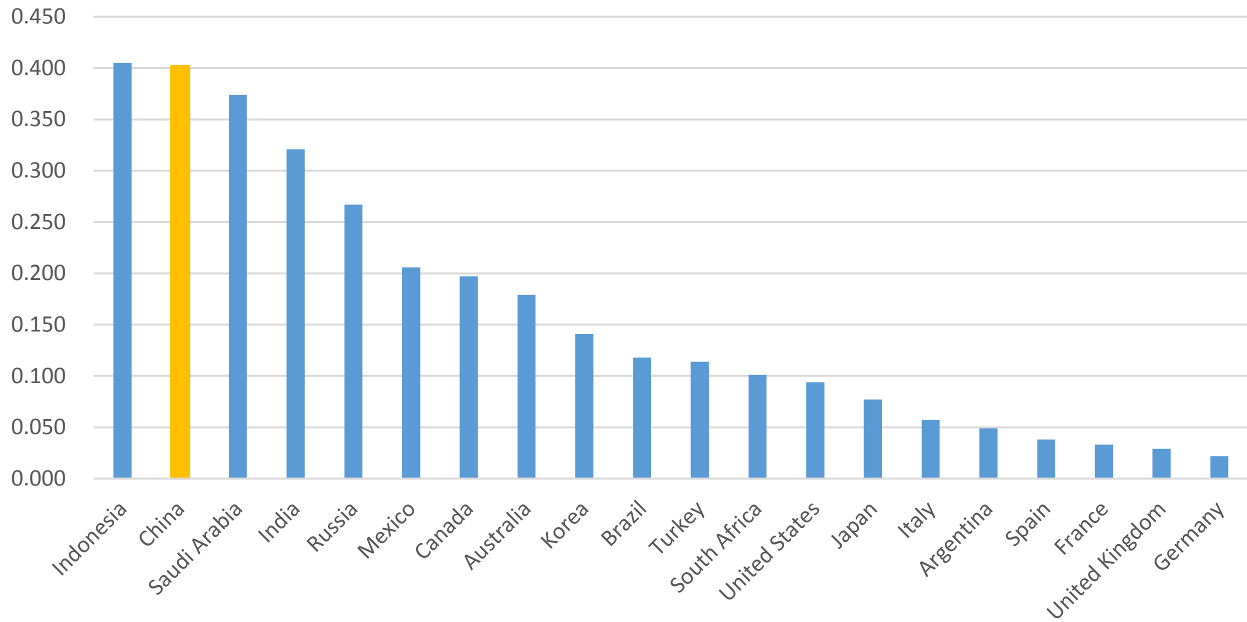
must continue to make it clear to China that all progress on financial services opening cannot wait on the conclusion of BIT negotiations, which may still be years away. The United States should use the Comprehensive Economic Dialogue and other bilateral tools to encourage China to announce at least incremental market opening in the meantime.

**(3) Engage China at the highest levels to ensure that the Cybersecurity Law and other technology policies are implemented without discrimination towards foreign firms.** The challenges posed to U.S. financial firms show that China's increasingly restrictive technology policies are not only a detriment to U.S. technology firms, but have a much broader impact. China's technology policies are a core aspect of President Xi Jinping's policy agenda. The United States will only be effective engaging on these issues if concerns come are conveyed to China by the very highest levels of the Administration. Congress should also continue to make its concerns known, noting to senior Chinese leaders that China's discriminatory technology policies are detrimental to the broader bilateral relationship.

**(4) Urge China to cease the use of regulatory measures as market access restrictions.** The United States should monitor China's broad use of regulatory measures as market access restrictions, keeping in mind that such distinctions are often difficult to make with respect to individual measures. The goal should be to convey to China that the United States is on the watch for discriminatory practices, and for evidence that China may use informal market access restrictions to impede foreign firms even as it seeks to liberalize formal investment measures such as equity caps.

**Appendix:**

## Table I. Restrictiveness toward FDI in services among G-20 economies (2016)




Source: OECD FDI Regulatory Restrictiveness Index
(http://www.oecd.org/investment/fdiindex.htm)