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"U.S. Access to China's Consumer Market"

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In the 16 years since China entered the WTO, the incremental growth in its financial system has exceeded the total size of the U.S. financial system (see Chart 1). And yet the participation of U.S. financial institutions in the market has proportionately diminished. In many ways, the explosion of credit in China has been a family affair: China's government has force-fed credit to property developers and local governments for capital construction and then enabled the general securitization of debt, allowing it to move like a river among regions and institutions until it becomes impossible to distinguish sound assets from unsound or to isolate bad debt by region and type. It is not necessarily bad that U.S. institutions have largely been kept out of this market.

Market Access for Banks

When China signed on to the WTO in 2001, its government promised foreign banks "full national treatment" within five years. Instead, the foreign banks that do operate in China have been increasingly marginalized. Since the stimulus program of 2008, foreign bank assets in China have sharply diminished as a proportion of the total.[1] Foreign market share in terms of assets is about 1.5%. This compares with an average of 20% share for foreign banks in emerging markets, according to the OECD.[2] By contrast, there are 13 Chinese banks among the world's largest 100.

Rules ensure that foreign banks cannot compete: foreign banks are limited to acquiring 20% of equity in Chinese banks and 49% in brokerages and various types of financial service companies. Their regional and branch expansion is dramatically curtailed by the withholding of licenses.

[1] See "European Business in China Position Paper 2015-16": http://www.europeanchamber.com.cn/en/publications-position-paper

[2] See "Foreign Banks: Trends, Impact and Financial Stability," https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Foreign-Banks-Trends-Impact-and-Financial-Stability-25618

Without branches, they cannot collect deposits, and without deposits, they cannot extend loans, because loans are strictly limited to a proportion of deposits. Foreign banks also face restrictions on their investment activities that Chinese banks do not and consequently cannot easily expand their balance sheets by partnering with non-banking financial institutions, something that is routine fore Chinese banks. So the market is open, technically, but closed in practice via the regulator's control of partnering activities and approval process over branch expansion and other commercial processes.

The deeper and more intractable problem impeding market access for foreign banks is the unease felt by Chinese regulators with their lesser political control of foreign banks. Chinese regulators frequently issue verbal instructions to banks. Some examples are "window guidance" indicating how much foreign currency may be remitted in a given month or instructions to borrow or lend money in the interbank market at a given rate. Foreign banks, which must answer to their own regulators and to shareholders, are less inclined than Chinese banks to follow these verbal instructions, and regulators tend to be unwilling to grant them broader licenses.

As a consequence of these restrictions, foreign banks in China essentially exist to serve their foreign clientele with trade financing.

The Chinese financial system would be much healthier, and foreign financial institutions in China much larger, if China allowed the market access it promised in 2001:

- End restrictions on foreign bank branch licenses
- End minimum set-up staffing and capital requirements and simplify branch closing rules
- End caps on foreign ownership of brokerages and funds
- Allow foreign banks, brokerages, and fund managers exactly the same license scope as that available to Chinese institutions.

Securities Markets

China's securities market consciously operates as a roach motel for hard money: incoming investment is warmly welcomed. Profit repatriation and fund redemption are fought tooth and nail. The goal of Chinese financial regulators is not transparency or best practices; it is a net influx of capital. While China's currency was appreciating and its domestic rates of return high, this was acceptable to foreign institutions. That is starting to change. In the next couple of years, foreign financial investors are likely to become much more demanding.

Some of the market rules that tend to trap money invested by foreign securities firms include:

- Periodic "window guidance" that limits Chinese banks' willingness or ability to approve foreign remittances

- Low quotas for Qualified Domestic Institutional Investors and Qualified Foreign Institutional Investors (QDII and QFII). The former are domestic institutions that may invest in overseas securities markets, and the latter are foreign institutions that receive a RMB quota for investing in Chinese securities.
- A limit on capital repatriation of 20% per month
- Lack of clarity on the tax treatment of trading gains realized by foreign funds in China
- Internal guidelines that direct underwriting deals to domestic institutions.
- Quotas on foreign debt permitted to domestic investors that limit shareholder loans
- Pre-approval requirements for funds investing in Chinese securities

Insurance

Foreign insurers are hampered by the limitations on regional expansion that beset foreign banks. After 25 years' operating in China, for example, American insurer AIA, the first foreign insurer in the Chinese market, is permitted to operate only in three cities and one province in China, while its domestic competitors operate nationally.

Foreign insurers are also restricted from investing in the assets that have enabled Chinese insurers to sell high-return universal policies and bancassurance products. While a typical Chinese insurer sells universal products that yield 4-6%, American companies can generally offer only about 2%, making them uncompetitive. These rules may, ironically, have kept the foreign insurers' balance sheets clean, but that is an issue for management to decide.

More insidiously, Chinese government authorities frequently intervene in the settlement of claims without permitting adequate investigation and discovery. Some major accidents are classified by the government, ad hoc, as state secrets, and the settlement of insurance claims is then directed by authorities without adequate disclosure.

These practices have undermined not only the profitability and scope of American insurers but the health of the Chinese market.

Fintech

Fintech is among the more promising areas of financial services for U.S. companies but also one of the most closed to foreign participation.

The two major categories of fintech are payments and virtual currencies, with payments being much larger and more economically significant.

The first problem for foreign investors is that a "third party payment provider" license is required in order to operate a payment system like Stripe or PayPal and no such licenses have been issued

to foreign companies. Current regulations do not prohibit foreign investment in this segment, but they anticipate specific foreign investment rules, which have not been issued.

The second problem is that Chinese regulations make payments fundamentally unprofitable. Regulators in September 2016 limited interchange fees to 65 basis points for most types of transactions. This compares with total fees in the U.S. market of between 1.4-3.5% and often higher. These interchange fees are split among an issuing bank, which issues the customer's credit or debit card, an acquiring bank, which holds the merchant's account, a card scheme like Visa or Mastercard, and the interbank payments system. Often these parties use technology providers as subcontractors

Chinese third party payments companies are often willing to lose money on payments to achieve other objectives. It is also an open secret that many of them invest the float they carry before remitting cash to all parties, even though this is not technically permitted. Foreign companies would be unlikely to do that, i.e. operate in compliance gray areas, which is the modus operandi of most Chinese firms across many sectors, and a soft access barrier in effect for foreign companies.

These two sets of regulations mean that foreign payments providers and card schemes face highly circumscribed and generally money-losing markets, if they can play in the China market at all. The payments restrictions are also a key impediment to U.S. e-commerce, since a proprietary payments system is a key competitive advantage.

Virtual currencies were the predecessor or third-party payments systems; it is no coincidence that Tencent, which has the second most popular payments system after Alipay, was the issuer of the biggest virtual currency in China, the QQ coin. Because of their role in money laundering, virtual currencies and newer cryptocurrencies are now being closely monitored by Chinese regulators whether managed by foreign or Chinese companies, but Chinese companies have so far enjoyed some advantages:

- Direct government subsidies and access to below-market prices for the electric power needed to mine Bitcoin, Ethereum, and other virtual currencies
- Right to operate exchanges within certain limits
- The right to retain mined Bitcoin and Ethereum for investment

Data Protection, Data Privacy, Encryption Regulatory Structure Evolving

China has always maintained a complex and opaque information regime whose hallmark is the ability to sanction virtually any use of information that is ex post facto determined to be politically threatening. The definitional scope of "national security" provides the bulwark, technically within the confines of WTO rules.

Elements of this regime include regulations prohibiting encryption that is not transparent to Chinese authorities, restrictions on access to certain types of financial data, and much more. With the official entry into effect of the Cybersecurity Law on June 1 this year, authorities have finally developed a national legal structure for implementing rules and regulations governing personal data, corporate data, and data deemed important to the state ("important data"). Chinese officials claim that these new regulations will not place restrictions on corporate operational data transfers across China's borders, but have defined "important data" broadly, and it is unclear how specific cross border data flow measures will be implemented and enforced. Beijing has postponed compliance with the measures until the end of 2018 to provide time for companies to understand how compliance will work. Chinese officials claim that the measures are "convergent" with international practices, such as the EU General Data Protection Regulation (GDPR), but there are many areas that will require further clarification.

Financial sector data have long been a sensitive issue in China, and the potential inclusion of e-commerce companies under the critical information infrastructure provisions of the new cybersecurity law is likely to further complicate financial data flows. Ways in which the regulatory system already inhibits foreign activity in the financial services industry include:

- Classification of audit records as secret. This makes it impossible for U.S. regulatory bodies to review the audits conducted on firms that are publicly traded in the United States.
- Internet information services licensing rules: These make it practically impossible for U.S. financial news services to operate in China.
- Personal information protection standards: A revision of these standards is expected in the near future. Currently, the standards make it difficult for U.S. data-analysis companies to access consumer databases and provide intelligence. The play space is gray, creating in effect a compliance barrier to entry – and foreign companies are prohibited from housing data, much less owning it. Foreign companies are prohibited from engaging in the aggregation and management of credit records. Among other things, this forces banks into unhealthy collateral-based lending.
- Alleged national security issues justifying Chinese government constraints on sharing and examination of working papers, Mainland tax filings and registration information, and other information sources relevant to regulatory assessment of the accuracy and integrity of financial reports.

- Rules on surveys: Current rules, observed in the breach, require that all surveys be conducted in conjunction with the National Bureau of Statistics, which has the right of review and must receive payment. This is a key impediment to market research to support a range of financial services.
- Arbitrary designation of information as secret: Every foreign organization that deals with data in China must be concerned that collecting newspaper reports, conducting phone interviews, and maintaining databases may at some future time be designated a violation of state secrets. Penalties for violating state secrets are draconian.

U.S. Regulatory Tools

While the U.S. government concerns itself with baby steps toward market access in China, it ignores the risks being imposed on U.S. investors by wide access to our own equities markets.

Organizations in the U.S. responsible for assuring the integrity of our capital markets were unprepared and understaffed to deal with the scale and unique characteristics of the Chinese inrush to U.S. capital markets, and many marginal or outright fraudulent Chinese entities have extracted substantial resources from investors, while those investors have been left with limited or immaterial remedies.

Among the unique characteristics that have challenged the regulators, unique in scale if not basic nature:

- The wide use of reverse mergers to achieve backdoor listings involving totally unrelated industries, primarily to avoid the normal listing disclosure and reporting requirements.
- Where basic data like domestic tax filings has been accessible, major discrepancies between those declarations and formal filings with the SEC are commonplace.
- There is a dense curtain obscuring ultimate ownership, making it difficult to map related-party activities in both pre and post IPO investment flows and the resultant impact on calculated market capitalization, use of proceeds, material M&A activities, and the like.
- Undisclosed insider buying and selling campaigns in the open markets themselves, fueling substantial price moves by entities domiciled in China but of indeterminate ownership and hence relationship to the listcos themselves, resulting in insider profiteering and manipulation that is extremely difficult for the regulators to identify and control.

While these issues do not affect U.S. market access to the Chinese market, they suggest that the U.S. government has powerful regulatory tools with which to impel Chinese entities that want to continue to access U.S. investment to improve disclosure, lobby for market participation by respected international auditors, brokers, lenders, research companies, credit bureaus, and the like, and playing according to international rules.

Chart 1: Bank Assets, U.S., Japan, and China

Source: People's Bank of China, Federal Reserve, Bank of Japan. Exchange rates: YTCI.com, Chinamoney