CORPORATE ACCOUNTABILITY, ACCESS TO CREDIT, AND ACCESS TO MARKETS IN CHINA'S FINANCIAL SYSTEM – THE RULES AND THEIR RAMIFICATIONS FOR U.S. INVESTORS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED THIRTEENTH CONGRESS
FIRST SESSION

THURSDAY, MARCH 7, 2013

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2013

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created on October 30, 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 § 1238, Public Law No. 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. § 7002 (2001), as amended by the Treasury and General Government Appropriations Act for 2002 § 645 (regarding employment status of staff) & § 648 (regarding changing annual report due date from March to June), Public Law No. 107-67, 115 STAT. 514 (Nov. 12, 2001); as amended by Division P of the "Consolidated Appropriations Resolution, 2003," Pub L. No. 108-7 (Feb. 20, 2003) (regarding Commission name change, terms of Commissioners, and responsibilities of the Commission); as amended by Public Law No. 109-108 (H.R. 2862) (Nov. 22, 2005) (regarding responsibilities of Commission and applicability of FACA); as amended by Division J of the "Consolidated Appropriations Act, 2008," Public Law Nol. 110-161 (December 26, 2007) (regarding responsibilities of the Commission, and changing the Annual Report due date from June to December).

The Commission's full charter is available at www.uscc.gov.

March 13, 2013

The Honorable Patrick J. Leahy
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR LEAHY AND SPEAKER BOEHNER:

We are pleased to notify you of the Commission's March 7, 2013 public hearing on *"Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System – The Rules and Their Ramifications for U.S. Investors."* The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing.

At the hearing, the Commissioners received testimony from the following witnesses: Cynthia M. Fornelli, Executive Director, The Center for Audit Quality; Paul Gillis, Professor of Practice and co-director of the IMBA program at Peking University's Guanghua School of Management; Tom Quaadman, Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce; Regina Abrami, Ph.D., Director of the Global Program, Lauder Institute for Management and International Studies; Lynette Ong, Associate Professor of Political Science, University of Toronto; Carl Walter, former COO of JP Morgan China; Sheriden Prasso, Editor-at-Large, Asia Pacific Region, Bloomberg News; John Drearie, Executive Vice President for Policy, Financial Services Forum; Paul Saulski, Adjunct Professor, Georgetown University Law Center; and Steve Simchak, Director, International Affairs, American Insurance Association. This hearing examined China's financial sector in terms of its governance, transparency, and accountability; China's banking system and access to credit; and market conditions and access issues for banking, investment, insurance, and other services firms.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses will soon be available on the Commission's website at www.USCC.gov. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2013 Annual Report that will be submitted to Congress in November 2013. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Reed Eckhold, at (202) 624-1496 or via email at reckhold@uscc.gov.

Sincereley Yours,

William A. Reinsch
Chairman

Dennis C. Shea
Vice Chairman

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CORPORATE ACCOUNTABILITY, ACCESS TO CREDIT, AND ACCESS TO MARKETS IN CHINA'S FINANCIAL SYSTEM – THE RULES AND THEIR RAMIFICATIONS FOR U.S. INVESTORS

THURSDAY, MARCH 7, 2013

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room 562 Dirksen Senate Office Building, Washington, D.C. at 9:00 a.m., Commissioners Robin Cleveland and Carte Goodwin (Hearing Co-Chairs), presiding.

OPENING STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Good morning and welcome to our hearing on "Corporate Accountability, Access to Credit, and Markets in China's Financial System and the Rules and Ramifications for U.S. Investors."

In 2006, three of the four largest Chinese banks launched IPOs. Selling off a 10.5 percent stake in its business, the Bank of China issued over 25 billion shares raising $9.7 billion, ranking eighth in U.S. IPO history. This record level was invested despite corporate documents disclosing 75 cases of fraud and over $150 million in criminal conduct charges by employees.

Ranking first and second in the largest IPOs in U.S. history are the Agricultural Bank of China, yielding a whopping $19.2 billion, and the Industrial and Commercial Bank close on its heels with $19.1 billion. These numbers are staggering to me, especially when compared to other top IPOs. Visa, for example, which raised $16 billion, did so after 31 years as a proven private enterprise.

Not all offerings are on this scale, but whatever the size, Chinese expansion into U.S. capital markets presents both opportunities and risks for companies and investors alike. There is substantial opportunity in the twin pledges made by the Chinese leadership to improve the transparency, governance and functioning of capital markets and to expand access for foreign financial service firms with the knowledge, expertise and products to improve productivity and growth.

If, and it is a big if, these commitments are implemented, they not only will protect American shareholders and investments in China but will also support essential rebalancing of the Chinese economy, strengthening consumer demand and access to reliable returns.

On the other hand, if the status quo is maintained, the risks are significant. Failure to move forward on standards of governance and accountability, continued misallocation of resources to protect state-owned enterprises and banks, and secretive mishandling of non-performing loans will compromise China's economic potential sooner rather than later.

Accounting scandals and fraud already have prompted U.S. regulators to delist dozens of Chinese companies with many others losing substantial market value. 64 of 154 Chinese companies listed last year are trading well below their initial price.

Confidence in security market transitions depends on a reliable transnational audit regime--an agreement which continues to elude the Securities and Exchange Commission, the Public Company Accountability Oversight Board, and the China Securities Regulatory Commission.

While it may be understandable, I view it as unfortunate that the SEC recently chose to take legal action against U.S. auditors' inability to release working papers. A resolution is in all parties' interests, and I hope options for the path ahead are offered by our witnesses today.

While Mr. Walter has noted capital begins and ends with the big four banks which control over $16 trillion in assets, the future of growth may depend on the access China's 42 million small and medium private enterprises have to capital.

In her testimony, Ms. Prasso observes that SMEs contribute 60 percent of GDP and 80 percent of urban employment, yet rely on an unregulated, albeit legal, shadow banking system, which includes investments in trusts and wealth management products that sound an awful lot like CDOs.

I welcome our witnesses' observations on domestic lending procedures and priorities and problems. A pilot SME lending program in Wenzhou seems promising but so too would accelerating and expanding U.S. financial services firms' access and impact on the market.

By the end of the day, I hope we will have a full picture of U.S. access to Chinese financial markets, the banking, equity, and financing resources available to Chinese firms, as well as the rules and governance mechanisms which assure accountability and protect the American investor.

Commissioner Goodwin.

PREPARED STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

U.S.-China Economic and Security Review Commission

March 7, 2013 Hearing

Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System—

The Rules and Their Ramifications for U.S. Investors

Robin Cleveland, Commissioner and Hearing Co-Chair

In 2006, three of the four largest Chinese Banks launched Initial Public Offerings. Selling off a 10.5% stake in its business, the Bank of China issued over 25 billion shares raising $9.7 billion ranking in 8th in US IPO history. This record level was invested despite corporate documents disclosing 75 cases of fraud and over $150 million in criminal conduct by employees.

Ranking 1st and 2nd in the largest IPOs in US history are the Agricultural Bank of China yielding $19.2 billion and the Industrial and Commercial Bank close on its heels at $19.1 billion. These numbers are staggering, especially when compared to the other top ten IPOs. Visa, which raised $16 billion, did so after 31 years as a proven private enterprise.

Not all offerings are on this scale, but whatever the size, Chinese expansion into US capital markets presents both opportunities and risks for companies and investors alike. There is substantial opportunity in the twin pledges made by the Chinese leadership to improve the transparency, governance and functioning of capital markets and to expand access for foreign financial service firms with the knowledge, experience and products to improve productivity and growth. *If, and it is a big if,* these commitments are implemented, they not only will protect American shareholders and investments in China, but also will support essential rebalancing of the Chinese economy strengthening consumer demand and access to reliable returns.

On the other hand, if the status quo is maintained, the risks are significant. Failure to move forward on standards of governance and accountability, continued misallocation of resources to protect state-owned enterprises and Banks and secretive mishandling of non-performing loans will compromise China's economic potential sooner rather than later.

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While Mr. Walter has noted, capital begins and ends with the big four banks which control over $16 trillion in assets, the future of growth may depend on the access China's 42 million small and medium private enterprises have to capital. In her testimony Ms. Prasso observes SMEs contribute 60% of GDP and 80% of urban employment yet rely on an unregulated shadow banking system which includes investments in trusts and wealth management products that sound too much like CDOs. I welcome our witness' observations on domestic lending procedures, priorities and problems. A pilot SME lending program in Wenzhou seems promising but so too would accelerating and expanding US financial services firms access and impact on the market.

By the end of the day, I hope we have a full picture of US access to Chinese financial markets, the banking, equity and financing resources available to Chinese firms as well as the rules and governance mechanisms which assure accountability and protect American investors.

**OPENING STATEMENT OF COMMISSIONER CARTE P. GOODWIN
HEARING CO-CHAIR**

HEARING CO-CHAIR GOODWIN: Thank you. Good morning and welcome to our witnesses. Having had the benefit of living my own episode of planes, trains and automobiles to get here through the anticipated snow, and I know some of our witnesses have been through the same things, I want to thank everybody for being here today.

Welcome to our second hearing of the Commission's 2013 Annual Report cycle. As my colleague explained, this hearing will examine the state of China's markets and the impact of the Chinese government's policies on the United States, specifically, through a comparison of rules and regulations governing U.S. and Chinese financial markets, examine the restrictions to credit and access to credit faced by ordinary citizens in China, and the implications for the Chinese economy.

We will also review barriers faced by U.S. financial firms seeking to do business in China. China's 12th Five Year Plan emphasizes boosting domestic consumption and Chinese investment abroad as the country seeks to lessen its dependence on exports and chart a course for sustained economic development. Achieving these goals requires that Chinese families and private sector Chinese businesses have sufficient access to capital markets.

Unfortunately, official sources of credit in China are largely inaccessible to Chinese individuals and smaller businesses as they exist mainly to serve and service the country's large state-owned enterprises. Unofficial sources of credit are filling in some of the gaps, but China's shadow banking system remains largely underregulated and risky. As a result, U.S. financial firms see an opportunity to help shepherd China's development of a more robust financial market, yet are being faced with access barriers and other operational difficulties.

Chinese entrepreneurs face difficulty at home obtaining credit, thereby limiting the ability to diversity China's economy, one of the chief goals of the Five Year Plan. Some of these smaller companies, as a result, have sought access to capital in the United States. Other Chinese companies have entered U.S. capital markets in recent years as part of a government plan to encourage investment abroad and to create so-called "national champions" from among China's state-owned and controlled businesses.

The larger Chinese companies have mainly listed on U.S. exchanges via IPOs and have accounted for the greatest share of Chinese companies' market capitalization. But those few giant companies are greatly outnumbered by hundreds of smaller Chinese firms that have entered the markets via reverse mergers.

As our first panel will explain this morning, a reverse merger is a process by which a Chinese company merges with an already registered U.S.

entity that may have undergone bankruptcy or is otherwise greatly reduced in size. Reverse mergers have historically drawn much less regulatory scrutiny from the Securities and Exchange Commission than initial public offerings.

The SEC tightened these registration requirements for reverse merger companies in late 2011 as it became clear that they were particularly susceptible to fraud and accounting irregularities.

The Big Four accounting firms audit approximately 88 percent of all U.S.-listed Chinese companies. During recent probes, the SEC has sought audit work papers from the accounting firms, a common step during fraud investigations. Unfortunately, to date, the firms have refused to turn over these documents, citing Chinese state secret laws which prohibit the disclosure of such documents.

A similar conflict involves the ability of our Audit Oversight Board to inspect registered audit firms in China that audit U.S. listed companies, a requirement of U.S. securities law.

China, however, insists that their own regulators should perform this function internally, leading to a stalemate with the U.S., and leaving global investors stuck in the middle.

Because such disclosure and transparency and inspection, as one of our witnesses will certainly testify this morning, serves as the foundation of investor confidence in a global market, the resolution of these issues between the U.S. and China is critical going forward.

Of course, the accounting problems are not limited solely to U.S.-listed Chinese companies. Just last year, Caterpillar acquired a Cayman Islands corporation that was listed in Hong Kong but with extensive operations in China. Ultimately, after the acquisition, Caterpillar had to write off more than $650 million of which nearly $500 million was identified as an accounting discrepancy in the listed inventory.

In West Virginia parlance, that stretches the boundaries of the definition of discrepancy. But, in any event, we have a very great panel that will speak about some of these governance, transparency and accountability issues.

I'd like to begin by introducing Cynthia Fornelli, who is the Executive Director at The Center for Audit Quality, an organization that seeks to enhance investor confidence and public trust in global capital markets. She's also a member of the Financial Accounting Standards Council and formerly served as Regulatory and Conflicts Management Executive at Bank of America.

Thomas Quaadman is Vice President of the U.S. Chamber of Commerce Center for Capital Markets Competitiveness. Prior to joining the Chamber, Mr. Quaadman served for 11 years as Chief of Staff for Congressman Vito John Fossella, Jr., where he helped establish the Republican Policy Committee Task Force on Capital Markets, Economic and

Information Security.

Our third witness, unfortunately--Dr. Paul Gillis--is unable to join us today due to the blizzard. But his testimony is available outside and on our Web site.

So thanks very much. Ms. Fornelli.

PREPARED STATEMENT OF COMMISSIONER CARTE P. GOODWIN
HEARING CO-CHAIR

U.S.-China Economic and Security
Review Commission

Hearing on "Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System—
The Rules and Their Ramifications for U.S. Investors"

Opening Statement of Commissioner Carte Goodwin
March 07, 2013
Washington, DC

Welcome to the second hearing of the U.S.-China Commission's 2013 Annual Report cycle. This hearing will examine the state of China's markets and the impact of the Chinese government's policies on the United States. Today, we will compare rules and regulations governing U.S. and Chinese financial markets. We will examine the restrictions to credit faced by ordinary citizens in China and the implications for the Chinese economy. We will also review the barriers faced by U.S. financial firms seeking to do business in China. We have assembled an exceptionally knowledgeable set of witnesses to address different aspects of this topic, and I'd like to thank them for their participation in this hearing.

China's 12th Five-Year-Plan emphasizes boosting domestic consumption and Chinese investment abroad as the country seeks to lessen its dependence on exports and chart a successful course for sustained economic development. Achieving these goals requires that Chinese families and private sector Chinese businesses have sufficient access to capital markets. Official sources of credit in China are largely inaccessible to Chinese individuals and small-and-medium-sized enterprises, as they exist mainly to service the country's large state-owned enterprises. Unofficial sources of credit are filling in some of the gaps, but China's shadow banking system remains under-regulated and risky. U.S. financial services firms see an opportunity to help shepherd China's development of a more robust financial market. Yet firms seeking to participate in China's financial services sector face market access barriers and other operational difficulties.

Chinese entrepreneurs face difficulty at home obtaining credit, thereby limiting China's ability to diversify its economy, one of the chief goals in the Five Year Plan. Some of these smaller companies are seeking capital in the United States. Other Chinese companies have entered U.S. capital markets in recent years as part of a government plan to encourage investment abroad and to create "national champions" from among China's state-owned businesses. The larger Chinese companies have mainly listed on U.S. exchanges via initial public offerings and have accounted for the greatest share of Chinese companies' market capitalization. But those few giant companies are greatly outnumbered by the hundreds of smaller Chinese firms that have entered the U.S. markets via reverse mergers.

The reverse merger is a means of listing on U.S. exchanges by merging with already registered U.S. companies that have undergone bankruptcy or are greatly reduced in size. Such reverse mergers have historically drawn much less regulatory scrutiny by the Securities and Exchange Commission than initial public offerings. The SEC tightened registration requirements for reverse merger companies in late 2011, as it became clear that they were particularly susceptible to fraud and accounting irregularities. An ABC News investigation that aired in January 2013 found that since 2010, more than 70 Chinese companies have been removed from or left the NASDAQ and New York Stock Exchange after reports of alleged fraud and financial irregularities. Most of these are companies that entered U.S. capital markets via reverse mergers.

The Big Four accounting firms (PricewaterhouseCoopers; KPMG; Deloitte Touche Tohmatsu; and Ernst & Young) audit approximately 88% of all U.S.-listed Chinese companies.[1] During recent probes, the SEC has sought audit work papers from the accounting firms, a common step during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secret laws. During the SEC's investigation of Deloitte Touche Tohmatsu's auditing of China-based Longtop Financial Technologies, for instance, Deloitte said Chinese regulators had warned them that turning over working papers to the SEC could lead to life imprisonment for the partners involved and to the firm being banned from China.[2]

In China, sharing accounting information with foreign regulators and removing audit papers from the country violates Chinese state secrets laws, and Chinese authorities do not permit non-Chinese regulators to conduct investigations in China.[3] But in the U.S., withholding foreign public accounting paperwork of U.S.-traded companies violates both the Securities Exchange Act and the Sarbanes-Oxley Act, which require foreign audit firms to produce documents concerning U.S.-listed clients at the SEC's request.[4]

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress empowered the Public Company Accounting Oversight Board to negotiate agreements for reciprocal inspections with audit regulators outside the U.S., as well as the confidential exchange of information with other regulators. Such cooperation between the PCAOB and foreign auditing

[1] Paul Gillis, "Who Audits China?" China Accounting Blog, November 22, 2011.
[2] Megan Mcardle, "Accounting War," The Daily Beast, December 13, 2012.
[3] Michelle FlorCruz, *Standoff Between US, Chinese Over Audits of Chinese Firms Could Mean Delisting From US Exchanges for Many Chinese Companies*, International Business Times, December 4, 2012
[4] Kathy Chu, Michael Rapaport and Ben Dummett, *SEC Probe Puts China Listings in Doubt, The Wall Street Journal*, December 4, 2012

oversight bodies is aimed at encouraging jurisdictions to better harmonize auditing standards and requirements. That way, U.S. regulators can avoid legal conflicts such as the one that exists among the SEC and the CSRC and Ministry of Finance.[5] The PCAOB now has cooperation agreements with 16 nations. After the 2010 Strategic and Economic Dialogue, the United States and China announced their intent to negotiate such an agreement on the sharing of confidential information for regulatory purposes.[6] However, the PCAOB has yet to achieve that goal with China, despite ongoing negotiations.

The PCAOB contends that Chinese government disclosure limitations create a gap in investor protection. The lack of an information sharing agreement with China not only limits U.S. regulators' ability to ensure proper conduct at the Big Four accounting firms, it also limits their ability to ensure proper conduct at the Chinese-domiciled accounting firms that audit U.S.-listed Chinese companies and the Chinese operations of U.S. companies.

Unfortunately, these issues are not limited to U.S.-listed Chinese companies, but also extend to U.S. companies' operations in China. For example, on January 18, Caterpillar disclosed "deliberate, multi-year, coordinated accounting misconduct" at a unit of its recently acquired ERA Mining Machinery. Caterpillar said it would write off most of the $654 million it had paid to acquire ERA only months earlier. Caterpillar has disclosed $450 million in inventory "discrepancies," inflated profits and improperly recorded costs and revenue at the Siwei unit. The Caterpillar experience and the growing catalog of deception and abuse involving smaller U.S. affiliates' operations within China indicate that U.S. firms face unique accounting and governance challenges there.

[5] Cynthia Fornelli, "Financial Reporting and Confidence in Trading Markets," Center for Professional Education, Inc. 2011 SEC Conference, June 21, 2011.
[6] Cynthia Fornelli, "Financial Reporting and Confidence in Trading Markets," Center for Professional Education, Inc. 2011 SEC Conference, June 21, 2011.

OPENING STATEMENT OF CYNTHIA M. FORNELLI
EXECUTIVE DIRECTOR, THE CENTER FOR AUDIT QUALITY

MS. FORNELLI: Thank you, Commissioner Goodwin and Commissioner Cleveland, and other distinguished members of the Commission. I very much appreciate the opportunity to participate in today's hearing. As Commissioner Goodwin noted, my name is Cindy Fornelli, and I am the Executive Director of the Center for Audit Quality.

You all have my written testimony so I'm going to take my time this morning to emphasize a few key points, and my testimony this morning will focus on the unresolved issue between the United States and China regarding the sharing of audit working papers that is playing out in two separate contexts.

The first involves the production by China-based audit firms to the Securities and Exchange Commission of working papers relating to audits of Chinese-based companies that are traded in the United States.

The second involves the ability of the PCAOB to inspect PCAOB-registered accounting firms that are located in China. The CAQ believes that it is critically important that the U.S. and China reach agreement to settle this unresolved issue because of the potential harm to U.S.-listed companies and their investors.

The CAQ's views on this matter are grounded in our belief that the independent public company audit is both a key information and quality component of the U.S. capital market system and part of the foundation for confidence in our capital markets.

The global economic and regulatory events of the past several years have underscored the interrelationship among securities markets around the world and brought a corresponding focus on the need for coordination among regulators across borders.

The current issue between the United States and China is rooted in a conflict of law that prohibits Chinese audit firms from producing working papers directly to the SEC or any foreign regulator. This prohibition stems from a directive of the China Securities Regulatory Commission, the CSRC, instructing Chinese firms not to provide audit working papers or other materials directly to foreign regulators.

Rather, the foreign regulators are directed to seek such documents through the CSRC. If the China audit firms were to defy this directive, they would risk severe sanctions that could affect the ability of these firms to continue operating, as well as other consequences to individual partners in those firms, including potential imprisonment.

Until a satisfactory resolution can be reached between U.S. and China regulators for access to audit working papers, the China audit firms cannot comply with the laws of both countries.

Part of the PCAOB's mission is to inspect audit firms registered with it, including non-U.S. firms, and to request access to audit working papers. As has been publicly noted, the PCAOB continues to negotiate with the China authorities on the PCAOB's ability to inspect China audit firms which would include access to these working papers.

Recent public statements by PCAOB Board members, including PCAOB Chairman Jim Doty, indicate that they hope to continue to make progress with China in negotiations on the inspection front.

For example, as recently as mid-February, in an interview at the Wharton School of Business, Chairman Doty outlined a series of events over the past 12 months that indicate progress is being made on the inspections front, and he says he is encouraged that it will continue.

I should also note that the SEC and PCAOB have successfully negotiated agreements with other foreign securities and audit regulators providing for cooperation in a range of circumstances, including inspections and investigations.

The CAQ believes it is important that relevant authorities in the U.S. and China reach an agreement here as well. Let me explain why.

We are concerned about the potentially far-reaching effect on investors and the capital markets if the audit working paper issue is not resolved through a government-to-government agreement. More specifically, if the United States and China do not reach an agreement in this matter, actions taken by the United States or by China could deny China-based companies the ability to obtain the audit work needed to continue to access the U.S. capital markets, and thus negatively affect the interest of U.S. investors in such companies.

Further, our concern extends to investors in multinational companies that are listed in the United States that have operations in China. This is because auditors of multinational companies generally use the audit firms located and licensed in other countries to perform work on the company's foreign operations. This allows the signing auditors to provide opinions on the company's consolidated financial statements.

If the two countries, the United States and China, do not reach an agreement, there is the potential that the auditor of U.S. multinational companies with China operations may be precluded from using the China firm's audit work. In both cases, with U.S. listed China companies and multinational companies with China operations, the loss of access to the services of China audit firms could impair audit quality, reduce the competitiveness of U.S. capital markets, and harm the interest of investors in U.S. markets.

Finally, and let me emphasize this, it is important to understand that all China audit firms, not just those that are parties to the SEC proceedings, currently face the same conflict of laws. Thus, even if there were other China firms qualified and willing to perform audit work on China-based companies and the China operations of multinational companies, those firms would face similar obstacles in complying with SEC and PCAOB requests for working papers.

This is a government-to-government, sovereign-to-sovereign matter that can only be resolved through the agreement of relevant authorities in the U.S. and China. There is precedent where the SEC and the PCAOB, as well as the CSRC, can get past this problem. They all have successfully negotiated agreements with regulators in other jurisdictions that take into account applicable local laws and permit the sharing of relevant information.

Given the potential risks, our recommendation to you today is that we all encourage the relevant regulators and, as appropriate, other governmental authorities to continue to work to that same end here.

Thank you all very much for bringing attention to the need for the relevant U.S. and China authorities to resolve this issue and for the opportunity to address you here this morning, and I'm happy to answer any questions at the appropriate time.

HEARING CO-CHAIR GOODWIN: Mr. Quaadman.

PREPARED STATEMENT OF CYNTHIA M. FORNELLI
EXECUTIVE DIRECTOR, THE CENTER FOR AUDIT QUALITY

Thursday, March 7, 2013

Testimony before the
U.S.-China Economic and Security Review Commission on
China's Financial Conditions and Their Impacts on U.S. Interests

Cynthia M. Fornelli
Executive Director, Center for Audit Quality

Commissioners Cleveland and Goodwin, and other members of the Commission, thank you for giving me the opportunity to participate in today's hearing. My name is Cindy Fornelli, and I am Executive Director of the Center for Audit Quality (CAQ).

Based in Washington, D.C., the Center for Audit Quality is an autonomous public policy organization created to serve investors, public company auditors and the capital markets. The Center's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the audit profession's core values of integrity, objectivity, honesty and trust. Our Governing Board consists of leaders from the public company audit profession, the American Institute of Certified Public Accountants (AICPA), as well as individuals representing the issuer, investor and academic communities. Our primary members are U.S.-based accounting firms that are registered with the Public Company Accounting Oversight Board (PCAOB). My testimony represents the views of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

My testimony today will focus on an unresolved issue between the United States and China regarding the sharing of audit working papers that is playing out in two separate contexts. The first involves the production by China-based audit firms to the U.S. Securities and Exchange Commission (SEC) of working papers relating to audits of China-based companies the securities of which are traded in the United States. The second involves the ability of the PCAOB to inspect PCAOB-registered accounting firms located in China. The CAQ believes that it is critically important that the United States and China reach agreement to settle this unresolved issue because of the potential harm to U.S.-listed companies and their investors.

The CAQ's views on this matter are rooted in our belief that the independent public company audit is a key information and quality component of the U.S. capital market system. The independent audit provides "reasonable assurance," based on management's own assertions that the financial statements are fairly presented in all material respects and, accordingly, capital market participants often consider audited financial statements in connection with investment activity. As such, the audit is part of the foundation for confidence in the U.S. capital markets.

Another core piece of this foundation is the strength and maturity of the U.S. regulatory system, including the SEC and the PCAOB.

Today I will discuss a brief overview of the audit requirements for U.S.-listed companies. Then I will discuss the U.S. oversight system for audit firms, because these are critical to understanding the matters at the heart of the unresolved issue between the United States and China. I will also briefly explain how multinational audits are conducted and the role that firms affiliated with a global network may play in the audits of multinational companies.

Role of the SEC

The securities laws and SEC rules and regulations require that all companies that have securities registered with the SEC have their annual financial statements audited by an independent auditor. Without current audited financial statements, companies cannot file annual reports with the SEC and cannot bring new securities offerings to market in the United States. The requirement for audited financial statements applies equally to U.S.-based and non-U.S. companies that list their securities on an exchange in the United States.

The SEC has enforcement authority over auditors that prepare or furnish audit reports on companies registered with the SEC, including the ability to conduct investigations and to bring enforcement actions related to those audits. Broadly speaking, the SEC has the authority under U.S. law to request documents (including audit working papers) from a foreign public accounting firm that prepares or furnishes an audit report on a U.S.-listed company, and otherwise issues an audit report, conducts interim reviews or performs audit work.

Role of the PCAOB

Since its creation in the Sarbanes-Oxley Act, the PCAOB, under the oversight of the SEC, has been the regulator of the public company audit profession. The PCAOB's role includes setting auditing standards for audits of U.S. public companies, registering public company auditors, inspecting[1] audit firms registered with it, and enforcing compliance with its rules and regulations. U.S. law requires audit firms that prepare or furnish audit reports for U.S.-listed companies to register with the PCAOB. This is true regardless of where the auditor is located, and thus firms that audit non-U.S.-based companies listed in the United States generally are subject to oversight by the PCAOB, in addition to being subject to their home-country law and regulation. The PCAOB also requires that an audit firm outside the United States register with it if that firm plays a "substantial role"[2] in the audit of a U.S. issuer, even if it is not the signing firm. The

[1] The PCAOB "inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards, in connection with the firm's performance of audits, issuance of audit reports, and related matters involving U.S. companies, other issuers, brokers, and dealers." *See* http://pcaobus.org/Inspections/Pages/default.aspx.

[2] A firm performs a "substantial role" if it is: (i) Performing material services that another firm uses or relies on in issuing an audit report with respect to any issuer, or (ii) Performing the majority of the audit procedures with respect

PCAOB also has authority to request access to audit working papers of registered accounting firms.

Multinational Audits

Companies generally are audited by an audit firm in their home country. Auditors of multinational companies also need to use audit firms located and licensed in other countries to perform work on the companies' foreign operations, so that the signing auditor can provide opinions on the company's consolidated financial statements. Some larger CAQ members participate in global networks composed of legally separate, independent member firms providing audit services in the jurisdictions in which they are organized and licensed. The individual member firms in these global networks agree to adhere to common policies regarding professional standards, audit methodologies, and systems for quality control and risk management. These network firms typically practice under a common brand. For example, a U.S. multinational corporation[3] with China operations often would have as its signing auditor a PCAOB registered U.S. audit firm that would use the audit work performed by a PCAOB registered China firm that participates in the same global network.

The Critical Need to Resolve the Issue

The global economic and regulatory events of the past several years have underscored the interrelationship among securities markets around the world and brought a corresponding focus on the need for coordination among regulators across borders, including cooperation regarding audit firms that are subject to regulation and oversight in multiple jurisdictions. The current issue between the United States and China is one that is rooted in a conflict of law that prohibits the China firms from producing audit working papers directly to any foreign regulator and that requires those foreign regulators to seek such documents through the China regulator. Unless a satisfactory resolution can be reached between United States and China regulators for access to audit working papers, the China audit firms cannot comply with the laws of both countries.

As you likely know, there are two pending legal proceedings between the SEC and China-based audit firms based on those firms' inability to produce directly to the SEC audit working papers relating to their audits of China-based companies whose securities are publicly traded in the United States. One is an SEC administrative proceeding against five such firms, and the other is against one firm in Federal District Court. Although I am aware of these proceedings, the parties to these proceedings are China audit firms; neither the CAQ nor any of its U.S. audit firm members are parties to these proceedings. Accordingly, my testimony does not cover the specifics of either of these proceedings.

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to 20% or more of the consolidated assets or revenues of such issuer. PCAOB Rule 1001(p)(ii).

[3] *See*, *e.g.*, Michael Rappaport, *U.S.-China Audit Spat May Spill Over*, WSJ (Dec. 27, 2012) (noting that if the issue between the SEC is not resolved it "also could affect U.S. multi-nationals like Apple Inc., Qualcomm Inc. and Kimberly-Clark Corp. that have major Chinese operations.")

As has been publicly reported, these China audit firms are unable to produce any documents directly to the SEC, the PCAOB, or any other regulator outside of China without violating the specific directive of the China Securities Regulatory Commission (CSRC) not to produce documents directly to foreign regulators. Instead, the CSRC specified that foreign regulators must seek documents directly from the CSRC. I am not a China law expert, but I know from published reports that, if the firms were to defy this directive, they would risk severe sanctions that could affect the ability of the firms to continue operating, as well as other consequences to individual partners in those firms, including potential imprisonment.

In addition, the PCAOB has authority to inspect audit firms registered with it (including non-U.S. firms) and to request access to audit working papers in accordance with Sarbanes-Oxley. As has been publicly noted, the PCAOB continues to negotiate with the China authorities on the PCAOB's ability to inspect China-firms, which would include access to working papers. In this context, it is worth noting that at the time many China firms registered with the PCAOB, they disclosed on their respective PCAOB registration forms the conflict between China laws and U.S. laws regarding access to working papers. I do not point this out to question the PCAOB or SEC's authority to request the working papers, but to make clear that this conflict has been known for some time. And because it is a conflict of laws, it is not an issue that the firms can resolve.

The SEC's public filings in the proceedings against the China firms indicate that the SEC and the CSRC have thus far been unable to resolve the issue of working paper access for purposes of investigations. Recent public statements by PCAOB Board members including Chairman Doty indicate that they hope to continue to make progress with China in negotiations on the inspection front, although they acknowledge that significant work remains to be done.[4] Both the SEC and PCAOB have successfully negotiated agreements with other securities and audit regulators providing for cooperation in a range of circumstances, including inspections and investigations.[5]

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[4] *See, e.g.*, February 12, 2013 Wharton School interview with Chairman Doty (http://knowledgetoday.wharton.upenn.edu/2013/02/reverse-mergers-cross-border-regulation-or-cold-war-with-china/): "We have believed for a long time that our counterparts are trying to achieve a solution and are proceeding in good faith on these negotiations."; February 8, 2013 Speech by Jeanette Franzel at Baruch College (http://www.accountingtoday.com/news/PCAOB-Franzel-Sees-Progress-China-Audit-Inspections-65657-1.html): "We're currently in the process of negotiating an MoU, a memorandum of understanding, with the Chinese government. We've been doing this for quite some time, but we're hopeful that we're making progress because the alternatives are not good for the investors who are currently invested in companies over there, and if we think long term about the interaction of our markets with China, we really hope to see a breakthrough soon."; and February 26, 2013 Speech by Jeanette Franzel at Wayne State University (http://pcaobus.org/News/Speech/Pages/02262013_WayneState.aspx): "We have been somewhat encouraged by some incremental progress in our negotiations with the Chinese authorities, including an agreement last year on guidelines that enabled us to send an inspection team to observe part of an inspection carried out by the Chinese audit regulator."

[5] To date, the PCAOB has entered into 16 cooperation agreements, and 12 of these agreements were concluded over the last two years. The most recent are with the French Haut Conseil du Commissariat aux Comptes (Jan. 31, 2013) and the Auditing Board of the Central Chamber of Commerce of Finland (Feb. 1, 2013).

The CAQ believes it is important that relevant authorities in the United States and in China reach an agreement here as well.

Effect on U.S.-Listed Companies and Their Investors

Because of the roles of China-based audit firms in auditing the China operations of U.S. listed multinational companies as well as China-based companies that are listed in the United States, we are concerned about the potential broad effect on investors and the capital markets if the issue is not resolved through a government-to-government agreement. More specifically, if the United States and China do not reach an agreement on this matter, actions taken by the United States or by China could deny China-based companies the ability to obtain the audit work needed to continue to access the U.S. capital markets, and thus negatively affect the interests of U.S. investors in such companies.

Further, our concern also extends to investors in multinational companies that are listed in the United States but have operations in China. This is because, depending upon the severity of any action by the United States or China against the China-based audit firms if the two countries do not reach an agreement, the company's signing auditor may be precluded from using the China firms' work.

In both cases – U.S.-listed China companies and multinational companies with large China operations – the loss of access to the services of China audit firms could impair audit quality, reduce the competitiveness of U.S. capital markets, and harm the interests of investors in the U.S. markets.

Finally, it is important to understand that all China audit firms, not just those that are parties to the SEC proceedings, currently face the same conflict of laws. Thus, even if there were firms in China, other than those subject to the current SEC proceedings, qualified and willing to perform audit work on China-based companies and the China operations of multinational companies, those firms would face similar obstacles to complying with any future SEC or PCAOB requests for documents.

This is a government-to-government, sovereign-to-sovereign matter that can only be resolved through the agreement of relevant authorities in the United States and in China. Thus, we are hopeful—indeed we believe it is critical—that China and U.S. regulators continue their dialogue and work to resolve this issue as quickly as possible. As noted earlier, there is precedent where the SEC and the PCAOB, as well as the CSRC, have successfully negotiated agreements with regulators in other jurisdictions that take into account applicable laws and permit the sharing of relevant information. Given the potential risks, we urge relevant regulators and, as appropriate, other governmental authorities, to continue to work to that same end here.

Thank you for bringing attention to the need for the relevant U.S. and China authorities to resolve this issue and for the opportunity to be here today. I am happy to answer any questions.

**OPENING STATEMENT OF TOM QUAADMAN
VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS
U.S. CHAMBER OF COMMERCE**

MR. QUAADMAN: Thank you, Senator Goodwin, Commissioner Cleveland, Mr. Chairman, Deputy Chairman and Commissioners for the opportunity to testify before you today.

The Chamber believes that the need for the Chinese and American regulators to come to an agreement on the sharing of audit work papers is a top priority for the American business community. Simply put, capital is the gasoline that drives the engine of economic growth and job creation here and abroad. But capital will only go where it is welcome and safe.

With the rise of a global economy, we no longer have capital hemmed in by national borders. Rather we have billions, if not trillions, of dollars of capital flows going cross border on a daily and yearly basis.

With that said, national regulators are now the traffic cop on the corner. National regulators will regulate their market activities at home, yet with the 1997, 1998, and 2008 financial crises, there's also been an increasing need for those national regulators to communicate amongst each other, share information, and deal with cross-border issues.

As a result, we've seen the rise of the G-20 becoming an action body in that regard. We also have the rise of IOSCO, as well as the ability for regulators internationally to get together and try to resolve these issues.

Similarly, financial reporting is quite simply the language of investors. Investors will use that language to make decisions as to how and where to deploy capital. We're increasingly having activities in the public and private sectors to have commonality in that language, which will take some time to happen, but it is important that commonality exists so that investors are comparing apples to apples and not apples to oranges.

The Chinese-U.S. impasse on this issue has both short-term and long-term implications. With the short term, I think some of the implications are very well known. We're seeing the SEC taking unilateral action that can lead to debarment of Chinese audit firms. That, in turn, could go down so far that the SEC, if there's an agreement that can't be reached, could have to delist Chinese companies that are listed on security exchanges here in the United States.

Similarly, if this issue cannot be resolved, U.S. multinational corporations that have extensive operations in China will not be able to audit the financials there, and, in fact, will not be able to file substantive consolidated audited financial statements here in the United States that they need to in order to pass regulatory scrutiny.

Similarly, with China, there could be retaliatory action that they could take. U.S. multinational corporations currently have $70 billion in direct investments in China. So that if the SEC were to act unilaterally, I think we would have to anticipate that China would act in turn, and that would harm American companies and businesses here at home.

For the long-term issues, I think we need to look at this on a broader scale. The China-U.S. impasse is one side of the coin, but there is also another side of the coin as well. We're currently faced with pressures regarding regulatory overreach and extraterritorial application of financial regulations.

So here in the United States, we have the CFTC trying to apply proposed derivatives regulations abroad. We have the French trying to tax financial activities in the United States, and even last week, we had the EU put in place laws regarding compensation that they want to apply to American workers in the United States who work for European banks.

The Chinese-U.S. impasse is actually the other side of the coin because rather than trying to have an extraterritorial application of regulations, we're actually having regulators not talk, not share information, and not be able to resolve cross-border issues. That is a long-term problem.

Additionally, the rule of law is extremely important. Here in the United States, we have extensive laws dealing with not only how businesses have to operate but also how we protect our national security. State secrets laws, whether true or not, are perceived as being applied and interpreted in China through the eye of the beholder. That does not give businesses certainty, and it doesn't give the ability of investors to have certainty as to how they can deploy capital.

So rule of law is an important part of the equation to come to a resolution here. We agree that there needs to be an agreement that is reached, and it needs to be done in mutual terms. If we can have rule of law in China, obviously Chinese law needs to be a part of that agreement as we would certainly expect that U.S. securities laws would also be a part of the agreement here as well.

That being said, the ball is in China's court, quite frankly. We're awaiting the successful conclusion of the transition of the Chinese leadership. It is anticipated that China will issue a proposal which we would hope would lead to good faith negotiations to resolve the issues.

But with that being said, the equation that has to be understood is that capital will go where it's welcome and safe. If an agreement is not reached here, the message that China will send is that capital may be welcomed, but it may be perceived not to be safe. That is not for the Chinese a path towards long-term economic growth, and it, quite frankly, isn't a path for American businesses to tap into the largest market in the world. That means that the failure to reach an agreement here is, in fact, a lose-lose situation.

So with that, I'm happy to take any questions you may have.

PREPARED STATEMENT OF TOM QUAADMAN
VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS
U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

ON: China's Financial Sector: Governance, Transparency and Accountability

TO: U.S.-China Economic and Security Review Commission

DATE: March 7, 2013

PANELIST: Tom Quaadman

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial
U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Reinsch, Vice Chairman Shea, and members of the U.S. China Economic and Security Review Commission ("Commission"), my name is Tom Quaadman, vice president for the Center for Capital Markets Competitiveness at the
U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector, and region. On behalf of the Chamber's membership, I appreciate the opportunity to testify on China's Financial Sector: Governance, Transparency and Accountability.

The financial crisis has taught us that we truly live in a global marketplace. Up until recently, capital markets were hemmed in by national borders. Such a system allowed national regulators to have a clear window to oversee activities within their markets and act accordingly.

That is no longer the case today. The activities and regulatory policies of one country or region can have a domino effect worldwide.

As the interconnected global economy has grown, financial regulation has evolved. While national regulators still oversee domestic activities, new organizations, such as the International Organization of Securities Commissions ("IOSCO"), have started to emerge, allowing national regulators to share information and coordinate on cross border issues. However, as the 1997, 1998, and 2008 financial crises demonstrated, the advancement of cross border data sharing and coordination mechanisms did not keep pace with ever changing global financial markets. A failure by domestic regulators to understand cross border issues and to have the information to facilitate decision making was a factor in the gravity of these crises.

That is why the Chamber has supported the efforts of the G-20 nations to facilitate information sharing and coordination amongst financial regulators. Specifically, the Chamber backed Section 981 of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which empowered the Public Company Accounting Oversight Board ("PCAOB") to enter into agreements for reciprocal inspections and information sharing. It should be noted that the confidentiality of information shared is at the heart of Section 981.

The Chamber has also supported other efforts to facilitate efficient financial reporting. We have backed a global accounting system to provide investors with a common language to evaluate financial information and make rational decisions. Similarly, the Chamber has repeatedly called for the convergence of international auditing standards to provide a global yard stick to promote confidence in financial reports. Together, these developments would create a holistic, world-wide financial reporting system, thereby promoting the ability of American businesses to efficiently raise capital and sell goods and services on an unprecedented scale. However, such a system will take years, if not decades, to create, and it will not itself provide for the requisite regulatory cooperation that is the subject of your hearing today.

Before I get to the issue at hand—the need for Chinese and American regulators to cooperate regarding financial reporting—it is important to understand that this impasse cannot be viewed in a vacuum.

The Great Depression was monumental in scale because trade protectionism seized up the international and domestic engines of growth. Today, the threat of regulatory over-reach across borders is threatening to create international barriers that may also harm long-term domestic and international growth. The proposed extra-territorial application of U.S. derivative regulations is raising alarm bells that may curtail international trade. Similarly, the French application of a financial transaction tax upon financial activities in the United States is also raising similar anxiety. A failure to reach an agreement will force the United States and China to take regulatory action that each will deem to be extra-territorial. All of these issues combined may undue the efforts of the G-20 to enhance cross-border regulatory cooperation and prevent another financial crisis.

It is for these reasons that the Chamber and the American business community have become increasingly alarmed at the continued standoff between American and Chinese regulators to resolve the impasse over the sharing of audit work papers.

Failure to resolve this issue could result in significant economic harm to China and the United States, damaging the broader bilateral relationship.

In particular, failure to reach an agreement may leave the U.S. Securities and Exchange Commission ("SEC") with little choice but to delist Chinese companies publicly traded in the United States as required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). SEC action, in turn, would likely precipitate Chinese retaliation against American businesses operating in China. With $70 billion in direct investments in China, American companies operating in China are vulnerable to Chinese retaliation which could cause serious economic harm here at home.

Regrettably, a process is now underway that would lead to a worst case scenario for both sides. On some level this has already started. The SEC has instituted unilateral disciplinary proceedings against Chinese accounting firms for their failure to produce materials to the SEC. That failure is a direct result of explicit directives from the Chinese authorities that the firms not provide the materials. At some point soon, those audit firms could face debarment from practice before the SEC. Because the Chinese companies will not be able to disclose financial statements audited by an accounting firm in good standing to practice before the SEC, the companies will effectively be prohibited from having their securities traded in the U.S.

Moreover, even if the Chinese do not retaliate, the SEC's current litigation against the Chinese accounting firms could have significant and long-lasting impact on

U.S. business interests. Large U.S. multinational corporations with significant operations in China may, just like Chinese companies whose securities are listed in the U.S., be unable to have their financial statements audited by firms in good standing to practice before the SEC. U.S. multinational parent companies must have their Chinese operations audited by Chinese licensed auditors and if their Chinese auditors have been barred by the SEC, those companies will not be able to produce consolidated audit financial statements. Let me emphasize that point—without the ability to have significant Chinese operations audited in China by Chinese licensed auditors and incorporated into the consolidated accounts of the parent company, audited financial statements suitable for filing with the SEC cannot be prepared. This would unnerve investor confidence, undermine the credibility of Chinese markets, and harm the capital formation of American businesses.

In short, both sides lose.

The Chamber believes that there are at least four incentives that should spur the two governments to reach an agreement.

First, the Chinese government has stated its commitment in the 12th Five-Year Plan to improving capital allocation through deeper, well-functioning capital markets and expanding the role of services in the economy to promote economic rebalancing and achieve sustainable long-term growth. To achieve these objectives, China needs stronger corporate governance and effective financial reporting policies that promote transparency in its capital markets. Willingness by the China Securities Regulatory Commission ("CSRC") to share information on Chinese companies listed in the United States with U.S. regulators would indicate an increased commitment by the Chinese government to ensuring that listed companies, whether in China or the United States, are well-managed with reliable financial statements. An agreement would also be an important indicator of Chinese commitment to deepen reform and increase transparency of its domestic capital markets, which has been a long-term policy objective of the U.S. government. Conversely, failure to conclude an information-sharing agreement will feed the perception within China and globally that China's capital markets are a parlor game thereby inhibiting stable access to capital for their businesses causing a misallocation of resources that may harm the Chinese economy.

Second, with two-way capital flows continuing to increase exponentially, it is essential that the SEC and the CSRC, the market regulators of the world's two largest economies, have agreements for information sharing that substantiate the credibility of market actors. In the increasingly interdependent U.S.-China economic and commercial relationship, neither regulator can have a full view of matters under its jurisdiction. A failure of the SEC, PCAOB, and CSRC to cooperate will allow bad actors to operate in the shadows, create regulatory dead-zones and provide opportunities for regulatory arbitrage.

Third, given the trend of rapidly increasing Chinese investment in the United States, Chinese companies, including large state-owned and state-supported enterprises, which are listed on U.S. exchanges, have an abiding interest in promoting increased transparency and information sharing between regulators. Action—or inaction—by the Chinese government that stymies information sharing between regulators can only serve to perpetuate questions about the corporate governance and financial statements of China's emerging multinational companies that are striving to succeed in global markets, including the United States. The Chamber is committed to increasing two-way foreign direct investment between the United States and China. However, Chinese investment in the United States will become more challenging if U.S. regulators are blocked from accessing information on Chinese companies listed on our markets.

Accordingly, the Chamber has met privately with top leaders in both countries as well as senior officials at the SEC, the PCAOB, the Treasury Department, the CSRC, and the People's Bank of China, to communicate our concerns and advocate a mutually satisfactory solution. In mid-December 2012, the Chamber's senior vice president for international affairs Myron Brilliant and Center for Capital Markets Competitiveness' CEO and president David Hirschmann sent a letter to then SEC Chairman Schapiro and CSRC Chairman Guo Shuqing, with copies to then Treasury Secretary Geithner and Chinese Vice Premier Wang Qishan, urging a bilateral agreement to avoid the significant damage that will occur if the dispute deepens (see attachment).

Fourth, a failure to reach bilateral information sharing agreements is also likely to cause other regulators, particularly in Europe, to more closely scrutinize Chinese financial reports. If they face similar roadblocks, they may be forced to take actions similar to the SEC, further undermining the credibility of China's emerging class of multinational companies. Moreover, and as noted above, an intensification of this dispute will give investors pause as they weigh investment opportunities in Chinese businesses listed abroad, thereby impairing their capital formation and credibility in global markets.

Currently, the ball is in the court of the Chinese government. The Chamber anticipates that new proposals will be exchanged later this spring following the conclusion of China's National Peoples' Congress. We are hopeful that the magnitude of what is at stake for both sides will allow the regulators to reach an expeditious solution.

An agreement between the SEC, PCAOB, and CSRC should be based upon existing structures and mutual recognition similar to other agreements that the United States has with its major trading partners. Such an agreement would also have to take into account Chinese law and the ability of the CSRC to regulate and oversee activities within its jurisdiction. The same can be said for Chinese recognition of U.S. laws and the SEC. Thereby, through its reciprocal nature, an agreement would give Chinese and U.S. regulators the ability to review information necessary to promote policies related to the safety and soundness of their financial markets. A failure to have such an information sharing agreement could touch off extra-territorial actions that are inherently protectionist in nature.

While auditing policies may not be the most exciting of topics, the Chamber and our members view resolution of this issue as a top priority in the bilateral relations. Beyond stemming the fallout from the ongoing dispute, a strong agreement between regulators to share financial information would signify important progress in China's commitment to increasing transparency and strengthening corporate governance. This would increase trust in the bilateral economic relationship, thereby benefitting investors on both sides of the Pacific and laying the foundation for a stronger, mutually beneficial commercial relationship in the coming years. Failure to reach an agreement will only fuel mistrust and lead both nations down a path that will harm both economies and undermine investor confidence on both sides of the Pacific.

The Chamber will continue to vigorously advocate for an agreement that upholds the principles of effective regulatory policies and cross border coordination needed to promote capital formation on a bilateral basis. We stand ready to support the efforts of both governments toward that end.

I am happy to take any questions that you may have at this time.

PREPARED STATEMENT OF PROFESSOR PAUL GILLIS
CO-DIRECTOR OF THE IMBA PROGRAM
PEKING UNIVERSITY'S GUANGHUA SCHOOL OF MANAGEMENT
(*WRITTEN TESTIMONY ONLY*)

March 7, 2013

Dr. Paul L. Gillis
Professor of Practice
Guanghua School of Management, Peking University, Beijing, China

Testimony before the U.S./China Security and Economic Commission
China's Financial System, Transparency and Accountability Challenges

Mr. Chairman and members of the Commission, I thank you for the opportunity to appear before you today. My name is Paul Gillis and I am a professor at Peking University in Beijing and a member of the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB). My comments today are my personal views and do not necessarily reflect the opinions of my university or the PCAOB.

American investors have lost billions of dollars because of accounting scandals in China. These scandals have ranged from accounting misstatements to outright theft of corporate assets by Chinese executives. American regulators have been unable to protect investors in U.S. traded Chinese securities in large part because China has blocked their access to people and records that are located in China.

U.S. listed Chinese companies

There are over 200 Chinese companies listed on the major U.S. stock exchanges, and hundreds more that are thinly traded on the over-the-counter bulletin board (OTCBB) and pink sheets. These companies can be put into three categories.

First are the large state-owned enterprises that rank among the world's largest companies. Most of these companies listed on the New York Stock Exchange about the time that China entered the World Trade Organization in 2001. Chinese bureaucrats encouraged these listings as a means to reform these companies by raising capital to modernize them ahead of increased global competition. U.S. listings of these companies also served to import U.S. corporate governance standards, forcing a level of transparency and accountability on these companies that helped them to reform. There have been few reported accounting problems with large SOEs. Most of these companies also have listings in China and Hong Kong and are subject to regulation in those markets.

The large SOEs are audited by a China member firm of the Big Four accounting firms. The Big

Four are the world's four largest accounting firms and include Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers. The Big Four operate through locally owned practices in most countries in the world and audit the largest corporations globally. The Big Four have been in China since 1980, and were given the right to audit in 1992. The China member firms were initially established by the global organizations of these firms, but ownership has since been transferred to local and Hong Kong partners. This past year the firms were required to restructure into limited partnerships that are 60% owned by locally qualified partners. Local ownership must increase to 80% over the next five years. The Big Four are very large in China, which each employing over 10,000 accountants.

The second type of company that listed in the U.S is privately held companies that did an initial public offering (IPO). China's stock exchanges closed with the revolution that brought the Communists to power in 1949 and reopened in 1990. Until recently, China used its own stock exchanges mainly to reform state-owned enterprises and these markets were not accessible by private enterprise. Private enterprise became legal in China early in the opening up process that began in the late 1970s, but did not become legitimate until Jiang Zemin invited businessmen to join the Communist Party in 2001. Until recently, private enterprise in China had great difficulty accessing capital and could not even obtain loans from banks. Consequently, many private enterprises looked overseas for capital. NASDAQ and the New York Stock Exchange became the preferred listing venues for private Chinese companies, although others have listed on most stock exchanges around the world. China opened an Small and Medium Sized Enterprise (SME) Board in Shenzhen in 2005 and ChiNext, China's answer to NASDAQ, in 2009. Since these boards opened more Chinese companies are seeking capital in China, and there are almost 1000 companies queued up for listing. The listing requirements in China are more rigorous than the U.S., and it is difficult for foreign investors to participate in China's markets. That has led many Chinese companies to seek listings in the U.S. Most of these U.S. listed companies are also audited by the Chinese member firms of the Big Four, although some of the smaller ones are audited by small U.S. based accounting firms.

The third category of companies includes small private Chinese companies that have gone public in the U.S. by means of a reverse merger. In a reverse merger, a Chinese company merges into a shell that is already registered as a public company in the U.S. Most reverse mergers are traded on the OTCBB although some have done secondary offerings and upgraded to the major exchanges. Companies that came to market through reverse mergers have experienced a high level of accounting irregularities, likely because these companies are not subject to the rigorous IPO process before listing. The exchanges have revised their rules for reverse mergers to require a seasoning period prior to the companies being listing on the exchanges and this appears to have effectively ended the use of reverse mergers to list Chinese companies. Small U.S. based accounting firms audit most reverse merger companies.

Accounting and auditing standards for Chinese companies

Chinese companies that list in the United States must produce financial statements following either International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP). All Chinese companies must also produce financial statements following Chinese Accounting Standards (CAS) for local tax and regulatory purposes. Companies that list on China's stock exchanges must report under CAS. CAS has converged with IFRS, which means its requirements are substantially consistent with IFRS, although details may be different. The U.S. Securities and Exchange Commission (SEC) does not accept financial statements prepared under CAS. State-owned enterprises listed in the U.S. report under IFRS, while non-State owned U.S. listed Chinese enterprises typically report under U.S. GAAP.

Accounting standards that were developed in the West based on Western business practices are often difficult to apply in China. Chinese business practices rely less on the rule of law and more on personal trust between parties. Western accounting standards, particularly in the area of revenue recognition, rely heavily on contract documentation that may be missing or delinquent in China. Similarly, internal controls designed in the West that rely primarily on the separation of duties and the need for collusion to commit a fraud commonly fail in an environment where deep personal relationships may create a perceived obligation to assist a friend, even in fraud.

Auditing standards in China are based on global auditing standards. Chinese auditing standards apply to apply to companies listed in China, while auditors of companies listed in the U.S. must follow the standards set by the PCAOB.

Regulation of the accounting profession in China falls principally under the jurisdiction of the Ministry of Finance (MOF). The China Securities and Regulatory Commission (CSRC) also regulates auditors of companies listed on China's stock exchanges.

U.S. regulation of Chinese accounting firms

All auditing firms that audit U.S. listed companies must register with the PCAOB and follow its standards when conducting audits of U.S. listed companies. 47 mainland accounting firms and 49 Hong Kong accounting firms have registered with the PCAOB, although only a small number of these firms actually issue reports on U.S. listed companies. The mainland and Hong Kong firms that are registered with the PCAOB include the local member firms of large international accounting firm networks including the Big Four.

The PCAOB sets auditing standards for audits of U.S. listed companies, and also conducts inspections of registered accounting firms to assess their compliance with these standards. These inspections are an important part of investor protection in the U.S. All registered Chinese accounting firms that audit at least one company traded in the U.S. are subject to inspection by the PCAOB at least once every three years. Accounting firms that audit more than 100 listed companies are inspected annually, but no Chinese accounting firm audits that many listings.

PCAOB inspections of accounting firms help to protect investors by assuring that audits are done in accordance with PCAOB auditing standards. There is empirical evidence that PCAOB inspections improve audit quality [1]. While I believe it is unlikely that timely PCAOB inspections would have avoided all of the accounting fraud that has occurred with U.S. listed Chinese companies, I believe that regular inspections would likely have encouraged more effective audits. More effective audits might have led to earlier detection of some frauds and have possibly prevented some fraudulent companies from listing.

Objections to PCAOB inspections

China has forbidden the PCAOB from coming to China to perform the required inspections and from having access to working papers. From the Chinese perspective, a foreign regulator enforcing foreign laws on Chinese soil against Chinese nationals violates China's national sovereignty. China has also blocked the PCAOB from conducting inspections in its Special Administrative Region of Hong Kong to the extent that the subject audit includes operations on the mainland.

National sovereignty is a particularly sensitive issue for the Chinese. The Chinese psyche is deeply etched by the humiliation brought about by the unequal treaties that concluded the Opium Wars in the 19th century and from the Japanese Occupation in the 20th century. China is particularly sensitive to any action that it perceives impinges on its national sovereignty.

A number of other countries have also raised objections to PCAOB inspections based on national sovereignty or data privacy concerns. Despite these objections, the PCAOB has successfully negotiated arrangements with many of these countries to conduct inspections jointly with their local regulators [2]. While some countries other than China, including Italy and Greece, have yet to agree to PCAOB inspections, none of these countries use U.S. capital markets as extensively as China. The PCAOB has requested permission to conduct inspections of China based firms jointly with Chinese regulators, but this request has been refused. The PCAOB had previously amended its rules to extend the deadline for foreign inspections until the end of 2012. Largely because it was unable to negotiate access to conduct inspections in China and other countries, the PCAOB failed to complete the initial round of foreign inspections that were required under its rules to be completed by the end of 2012. Because the PCAOB has been unsuccessful at obtaining access to China and certain other countries it is currently out of compliance with its own rules regarding inspections while it continues to try to negotiate bilateral agreements.

China's preference is that the PCAOB should rely on China's own robust audit regulation of accounting firms. While China regulates each of the PCAOB registered Chinese accounting firms, it does not inspect most of the audits conducted for U.S. listed Chinese companies. That is because most of these companies have incorporated outside of China, typically in the Cayman Islands, for purposes of getting themselves out from under Chinese regulation. Consequentially, these companies fall into a regulatory hole. China cannot effectively regulate them because the parent companies are not Chinese companies and the U.S. cannot effectively regulate them because China will not allow American regulators access to the people and records associated with the company. In my opinion, this regulatory hole is a significant factor in creating an environment conducive to fraud.

The SEC has faced and currently faces similar problems enforcing U.S. securities laws against those perpetrating fraud in U.S. listed Chinese companies. The SEC has attempted to obtain audit working papers on a number of alleged Chinese frauds without success. Audit working papers are useful sources for securities regulators when investigating alleged frauds. The accounting firms have refused to provide these working papers to the SEC despite the requirement to do so under U.S. laws. The firms have said that providing these working papers to the SEC would violate Chinese laws and could subject their partners to imprisonment and the firm to expulsion from China.

China's State Secrets Law prohibits the transfer of information related to China's national security and interests outside of China's borders without the approval of relevant Chinese authorities [3]. While audit working papers would rarely contain information that would be considered a state secret in a conventional sense, China has an expansive and poorly defined view of what might constitute a state secret. While most countries have laws that protect state secrets, China's definition of a state secret often includes commercial information related to transactions with state owned enterprises. China's Archives Law also has the potential to impose broad restrictions on the transfer of information outside the country's borders.

Current status of PCAOB and SEC negotiations with China

The SEC currently has two cases pending against Chinese accounting firms. The first is in the U.S. District Court in Washington and seeks to compel the China member firm of Deloitte Touche Tohmatsu to produce audit working papers on Longtop Financial Technologies, Inc, a Chinese company that was delisted from the New York Stock Exchange under allegations of fraud[4]. The second case was filed in December 2012 against the Big Four accounting firms in China as well as the local member firm of BDO [5]. The firms were charged with administrative violations related to their refusal to provide audit working papers to the SEC as required by the U.S. Sarbanes-Oxley Act. The SEC has indicated that it is seeking to ban the firms from practice in the U.S. [6].

If the PCAOB is unable to reach agreement with Chinese regulators to conduct inspections in China and have access to working papers it may be forced to deregister the accounting firms that it cannot inspect, which may be the same result that the SEC is seeking. U.S. listed companies are required to have a PCAOB registered auditor and to submit to the SEC financial statements that are audited by a PCAOB registered auditor. Consequentially, if all of the China-based accounting firms are deregistered by the PCAOB or banned from practice by the SEC all of their clients may be unable to find an auditor and may be delisted by the stock exchanges and eventually struck off the rolls of public companies in the U.S.

PCAOB negotiations with Chinese regulators have been underway for many years. This past October, PCAOB inspectors were permitted to observe Chinese regulators as they inspected the quality control processes of a major international accounting firm in China. The PCAOB inspectors were not allowed to examine any audit working papers, which is the substantive part of a PCAOB inspection. In November 2012, the PCAOB gave Chinese regulators a draft agreement providing for cross-border audit oversight of PCAOB registered Chinese accounting firms. According to Chinese press reports, the CSRC and MOF submitted a recommendation to the State Council on how to proceed on audit cooperation. No details on the recommendations have been made public and the State Council has taken no action.

Impact on multinational corporations

The problems with PCAOB inspections in China may also affect U.S. multinational corporations (MNCs) with operations in China. Under PCAOB rules, any accounting firm that plays a substantial role in the audit of an U.S. listed company must be registered with the PCAOB. Many U.S. MNCs have significant operations in China that are typically audited by the Chinese member firm of the company's U.S. auditor. If the Chinese member firm plays a substantial role in the audit, it must be registered with the PCOAB. Should the PCAOB deregister the Chinese member firm, it could create difficulties for the U.S. auditor to sign off on the financial statements of the parent company.

The PCAOB definition of substantial role makes it unlikely that MNCs will face difficulties. An auditor is playing a substantial role if it earns more than 20% of the worldwide audit fee. It is also considered to play a substantial role if the auditor audits a subsidiary with more than 20% of worldwide assets or revenues of the company. While there are U.S. MNCs with more than 20% of worldwide assets or revenues in China, most likely operate in China with multiple subsidiaries and consequentially will likely fall under the threshold.

Recently Caterpillar announced that it would write down $580 million of the $700 million it had paid to acquire a Chinese mining equipment manufacturer [7]. The write down became necessary when Caterpillar discovered accounting irregularities at its new subsidiary. The irregularities were discovered before the annual audit was completed. The company had previously been listed in Hong Kong. The situation reminds us that accounting problems in China are not limited to Chinese companies that have listed in America, but can extend to MNCs that have operations in China.

Recommendations

The PCAOB and the SEC play critical roles in protecting the interests of all investors in U.S. markets. Full compliance with U.S. laws must be a condition of accessing capital from U.S. markets. I believe that the PCAOB and SEC have made every effort to reach agreement with Chinese regulators for access to the people and records that will allow them to fulfill their statutory responsibilities. To date, these efforts have failed to reach agreement, and U.S. investors have been harmed.

China has benefited from access to U.S. capital markets. Large state owned enterprises became globally competitive in part because of access to U.S. capital and from the reforms required to comply with U.S. corporate governance principles. U.S. markets enabled China's entrepreneurs to access capital when local funding alternatives were insufficient for their needs. If access to U.S. capital markets is cut off for China's private sector, China risks retarding indigenous innovation with potentially adverse consequences to China's long term competitiveness.

China has raised legitimate concerns that regulatory cooperation could impinge upon China's national sovereignty and risk disclosure of state secrets. However, China must recognize that protection of its national sovereignty and state secrets may be incompatible with overseas listings of its companies. If China is unwilling to cooperate with foreign regulators, its companies cannot be permitted to raise capital on foreign stock exchanges.

The decision is up to China. If it is unwilling to accept U.S. regulation of its U.S. listed companies, it must withdraw these companies from the U.S. capital markets. U.S. regulators have waited too long to act.

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PANEL I QUESTION AND ANSWER

COMMISSIONER FIEDLER: I'd like to get to the question of U.S. companies who have a majority of their operations in China and are publicly listed in the United States. From what you say, it seems to me that their audit committees of the board of directors cannot perform their fiduciary duty and therefore shouldn't be signing anything attesting to the validity of the information that U.S. shareholders are being given. Am I wrong?

MS. FORNELLI: Are you speaking of the audit firms not being able to perform their audit or the audit committee?

COMMISSIONER FIEDLER: No, I'm now getting from the firms the implication of the firm activity devolves quickly to the members of the audit committee of the board of directors of these companies.

MS. FORNELLI: Of the Chinese companies?

COMMISSIONER FIEDLER: No.

MS. FORNELLI: Of U.S. companies.

COMMISSIONER FIEDLER: I'm talking U.S. companies.

MS. FORNELLI: Okay.

COMMISSIONER FIEDLER: I really do not much care about Chinese companies at the moment. I'm talking about the broader implications to the U.S. capital markets of the validity of information being presented in any number of 10-Ks, 8-Ks, or whatever by the boards of these companies to shareholders in the United States. How do they perform their duty if they don't have access to information?

MS. FORNELLI: Well, with a large multinational corporation that has operations in China, the audit committee is going to rely on the U.S. audit firm who is performing and signing the audit. So that auditor, like it does with any company that has operations outside of the United States, will rely on the audit firms that perform that work. This is usually done with the largest audit firms under a global network where they all adhere to a common set of policies and procedures that govern audit methodology, that govern quality control, and auditing standards are administered by the PCAOB, by these firms.

COMMISSIONER FIEDLER: I actually understand the system. But then if I'm to accept your answer that they're relying all the way down the chain, when you go back to the origin in China, they cannot rely upon that information because they can't get underneath it. So if the chain is weak at that point, it weakens the whole system.

I think the implications of this are much greater than we're talking about for U.S. listed firms--forget Chinese listed firms--in the ability--I have seen recently, in the U.S. court system, U.S. companies saying that they cannot provide information to the courts because that information is either a state secret or private under the law of that other country.

This has vast implications for the rule of law in the United States and raises serious questions in my mind whether the boards of directors, the U.S. citizen members of the boards of directors of U.S. multinationals, are able, in fact, to perform their duties when their companies are invested in China.

MR. QUAADMAN: No. If I could also just add, Commissioner, I think you raise an excellent question, and I think you actually sum up some of the issues that the business community is facing. The board of directors, the audit committee, as well as the auditors, work within a legal and regulatory construct so that the papers that are filed with the SEC have to be acceptable to the SEC, which they have been up until this point.

The issue is, is that the SEC is now saying that operations in China are becoming so large that these agreements now need to be reached because there needs to be more scrutiny that's placed there. I think if we can't get to that point, what the SEC is indicating is that that will then call into question those financial statements.

COMMISSIONER FIEDLER: Yes. And what I'm saying to you is that total capitalization of Chinese companies in the U.S. capital markets is not as significant as the total capitalization of U.S. companies with operations in China. I'm less concerned about the implications of Chinese listed companies than I am about the U.S. listed companies and the vulnerability of U.S. investors.

MR. QUAADMAN: Correct. And that was what I referenced in my opening remarks, is that if you can't come to this agreement here, and if American companies can't file consolidated audited financial statements, it will actually impact their ability to raise capital here, even at home, because of the regulatory fallout.

COMMISSIONER FIEDLER: One quick technical question. How is the EU handling this?

MS. FORNELLI: Well, they, too, have had to reach agreements with the CSRC.

COMMISSIONER FIEDLER: Have they?

MS. FORNELLI: They have. Many of the EU countries have negotiated with the CSRC to be able to resolve issues.

COMMISSIONER FIEDLER: Those are acceptable to us?

MS. FORNELLI: I'm not privy to what those agreements are. I know that the PCAOB, for instance, has a model agreement that they would like to use. I would assume that the EU also does, and that there might be country-to-country variations, but other European countries also are faced with the same issue, and they've been able to reach an agreement.

One thing I would like to point out is that the audits are still continuing, so the PCAOB still has oversight over the U.S. audit firms, and they are aware of this issue and are focused on quality control and the application of the PCAOB standards by the U.S. audit firms. So there is protection there.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

VICE CHAIRMAN SHEA: Well, thank you both for being here. It's great to see Tom, a fellow exile from New York City.

MR. QUAADMAN: That's right.

VICE CHAIRMAN SHEA: Welcome, Tom, and thank you, Ms. Fornelli, for being here.

I just want to examine the issue of reciprocity. If a Chinese regulatory body that was similar to the PCAOB wanted to look at the work papers of a U.S.-based audit firm of a company registered in Shenzhen or Hong Kong or Shanghai, would there be any barriers in the United States for that to happen?

MS. FORNELLI: I would think that an agreement would need to be reached on the reciprocal side as well. I think it's a two-way flow and a two-way issue. So I would think, yes, that the need for PCAOB-CSRC agreement would need to be reached in that situation as well.

VICE CHAIRMAN SHEA: Tom?

MR. QUAADMAN: No. I was just going to say I agree with that because we view an agreement as being--it has to be a two-way street. They have to have the same ability to look at American companies as American regulators would have to be able to look at Chinese companies.

VICE CHAIRMAN SHEA: But the issue has never arisen, I guess? It's not an issue that's come to the forefront yet?

MS. FORNELLI: Not to my knowledge.

MR. QUAADMAN: Not that I'm aware of.

MS. FORNELLI: I'm not aware of any.

VICE CHAIRMAN SHEA: Okay. So the SEC--second question--the SEC sued Deloitte Touche, the Chinese member firm of Deloitte, because they can't get access to the audit papers of Longtop Financial. And Longtop Financial claims that to do so would be a violation of the state secrets law; is that correct?

MS. FORNELLI: Not exactly.

VICE CHAIRMAN SHEA: Okay.

MS. FORNELLI: The Chinese firm has been directed by the CSRC not to provide work papers directly to a foreign regulator, including the SEC. Rather the China firm would need to provide the work papers to the CSRC, and then the CSRC would determine whether or not to provide them to the SEC. And that's not limited just to the action that you've mentioned. There's also a consolidated action--

VICE CHAIRMAN SHEA: Right.

MS. FORNELLI: --with four other firms. But regardless of that, the conflict of law applies to all Chinese firms because of this directive.

VICE CHAIRMAN SHEA: So the CSRC is not divulging the information, and what is the basis for not divulging the information? What are they--I've heard the state secrets law invoked a couple of times. Where does that come in?

MS. FORNELLI: I think that they're looking to have an agreement with the SEC so that they understand how the documents will be used. I'm not familiar with the proceedings so I can't speak to those directly other than what I've read in the press, but I think you're right. I've heard the assertion of state secrets.

VICE CHAIRMAN SHEA: So I guess I'm a little confused. So I mean Longtop Financial is a private firm, and if you're telling me that they have not invoked the state--or at least their audit firm has not invoked the state secret law as an excuse for failing to divulge work papers; is that--

MS. FORNELLI: No, the audit firm has been directed by the CSRC not to provide working papers to any foreign regulator regardless of the reason why. So the conflict arises in that--

VICE CHAIRMAN SHEA: Okay.

MS. FORNELLI: --the audit firm can't provide the documents to any foreign regulator.

VICE CHAIRMAN SHEA: Okay.

MS. FORNELLI: And so, therefore, it would violate Chinese law if they did so.

MR. QUAADMAN: Yeah.

MS. FORNELLI: So it's not the audit firm making the assertion of state secrets or any other--

MR. QUAADMAN: Right.

VICE CHAIRMAN SHEA: No, but is the CSRC or the Chinese regulator making the assertion of state secrets, or is it just saying we say you can't do that, and if you do so, you'll violate the law?

MS. FORNELLI: It's certainly the latter, and I think it is more, until we have an agreement, don't provide documentation.

MR. QUAADMAN: My understanding is as well, is that I think Cindy's characterization is correct, but I believe that the Ministry of Finance also has a role in this, as well, and I believe in some form of communication between the Ministry of Finance as well as the CSRC, there is some discussion about the state secrets which is how this sort of works its way in. So at some point, I think that is a part of the discussion.

VICE CHAIRMAN SHEA: Okay. I have 42 seconds. I'll just ask this question. How long has this been going on? How long as the PCAOB been seeking work papers from these Chinese-based audit firms?

MS. FORNELLI: Well, the inspection process is a big part of the PCAOB's mandate. Since it was created in 2002, it’s been just over ten years.

They've needed to make arrangements with other jurisdictions, and so in the last ten years or so, they've reached agreements with 16 other countries but just 14 in the last two years have been--

VICE CHAIRMAN SHEA: But with the Chinese, how long has it been going on?

MS. FORNELLI: I believe it's been going on since the Chinese firms had to register with the PCAOB, and, in fact, at that time--

VICE CHAIRMAN SHEA: Which is? Five--

MS. FORNELLI: 2002.

VICE CHAIRMAN SHEA: So this has been going on for ten years.

MR. QUAADMAN: Yes.

VICE CHAIRMAN SHEA: And the PCAOB is now out of compliance with its own rules; correct? That's what Mr. Gillis says in his written testimony.

MS. FORNELLI: Yes, the PCAOB applies--

VICE CHAIRMAN SHEA: So when do you say enough is enough? I mean you've been negotiating for ten years, and it's not going to work out, so fish or cut bait, as they say.

[Laughter.]

MR. QUAADMAN: I think that's--no, that's certainly an important point. I just want to add as well, there are also difficulties with the PCAOB itself in order to engage in some of these reciprocal agreements, and, in fact, Section 981 of Dodd-Frank enhanced the powers of the PCAOB to do just that.

It's a provision in Dodd-Frank that we supported, though we have other problems with the bill itself, but I think you are right, is that it has been going on for quite a long time. I think we're getting to the point where a decision needs to be made and an agreement needs to be reached.

MS. FORNELLI: But I am heartened to see statements by Chairman Doty. I think based on public statements, the PCAOB at least thinks that progress is being made, and since the passage of that provision in Dodd-Frank, there has been an acceleration of these agreements with other jurisdictions, 12 in the last two years, two just last month with France and Finland.

VICE CHAIRMAN SHEA: Well, thank you both. Appreciate it.

HEARING CO-CHAIR CLEVELAND: So can I clarify on that point? While the PCAOB was incorporated in 2002, it wasn't--you said there were 16 agreements all together, 12 in the last two years, and two in the last few months. So I don't know that it's reasonable to say that the negotiations have been going for ten years in any kind of meaningful fashion.

MS. FORNELLI: Yes. There's certainly been acceleration, and I think to Mr. Quaadman's point, the provision in Dodd-Frank helped with that.

HEARING CO-CHAIR CLEVELAND: Expanded the extraterritoriality. Thanks.

Mr. Wessel.

COMMISSIONER WESSEL: Thank you both for being here.

This is a very interesting set of issues, and actually reading the testimony, I was not as alarmed as I am by the interaction we've had now, not with your responses, but this appears to me to be a much bigger issue, and in some ways not even really related to the PCAOB.

If you were to follow up on Commissioner Fiedler's line of questioning regarding the duties of boards of directors, CEOs, your members, Mr. Quaadman, and those you work with, Ms. Fornelli, how can they have confidence that when they sign off, whether it's under Sarbanes-Oxley or prior to, when they had to validate as part of their signing off on annual reports, that they had confidence in the accounting integrity related to their Chinese operations? I'm now just talking about a U.S. multinational.

To me, all of this calls into question the Caterpillar issue and others, that if you can't get access to the audit papers, if there's a restatement or anything else that exists with regard to a company, how do you defend yourself? How do you have the confidence that you can actually sign your 10-Ks or anything else when your General Counsel puts them in front of you? I'd like to hear from both of you on it.

MS. FORNELLI: Well, the audits are continuing to go on, and they go on under global accounting standards that apply. The issue about the work papers is just a piece of that.

COMMISSIONER WESSEL: But it's the verification of that work, whether it's GAAP or IFRS or anything.

I serve on a public board so I have some knowledge of this, but what I'm hearing here relating to the work papers of accounting entities that do the work to verify a Deloitte's Chinese operation or, et cetera, how do I as a board member have confidence that I should be putting my own liability on the line to sign these papers?

MR. QUAADMAN: You know, I think to a degree, if you think of it this way, right, if you were watching an NFL game ten years ago, what would have been a legal tackle ten years ago isn't necessarily a legal tackle today; right? And what boards have to deal with is that they are told what the rules of the game are by the SEC.

Effectively, what's going on here is that the SEC has said in the past the information you're getting is appropriate, and you can sign off on it, and that's okay. What the SEC is now saying is we're going to change the rules of the game so I think being on a public board or being on an audit committee, I think you have to be very cognizant of the fact that the activities that you engaged in before and the scrutiny you engaged in before was appropriate under Sarbanes-Oxley and all the attendant regulations, but that may now be about to change, and the SEC is effectively saying, well, either we're going to do this in a cooperative fashion, right, which if--and I think that is the desired outcome for everyone.

However, if the SEC then decides to say, well, we're either going to have to do something unilaterally, which the Chinese wouldn't agree to, which I think starts to set up that doomsday scenario, then, yes, you're correct, board and audit committees and audit firms are really going to be in a bind, and that's why I think the ramifications are going to be much more than just what happens with Chinese operations for multinational companies. It's actually going to affect their ability to raise capital elsewhere also.

COMMISSIONER WESSEL: But the conflict of laws is not a defense for a board member. So under Sarbanes-Oxley--

MR. QUAADMAN: Correct.

COMMISSIONER WESSEL: --and what a board member or CEO, has to sign right now on the annual report, what I'm hearing from you is they aren't confident that the audits have the integrity they should under Sarbanes-Oxley and PCAOB standards, and so as a U.S. citizen under the jurisdiction of U.S. laws, they're exposed; is that right?

MR. QUAADMAN: I think that is ultimately a question that the lawyers are going to have to answer, and I think there are going to be lawyers who are going to be doing very well for themselves with that. But I do think you're correct, you are both asking the questions that audit committees are going to have to ask, and effectively before even the audit committees are going to go forward, the SEC is going to have to provide those board of directors with answers as to how they can move forward.

MS. FORNELLI: The audit committee as the party responsible for overseeing the audit has to be comfortable. The auditor has to be comfortable, and if it's not, it will have to resign ultimately if it can't get itself comfortable, and then the PCAOB also has put it on its priority list. Because they're the ones who administer under the Sarbanes- Oxley and oversee the U.S. audit firms, they have put how the operations on the network scale work, and so they've got this on their radar as well.

So I agree that it is a concern and that we need to move forward, which I think just heightens and shines a spotlight on the need to move forward. But I do think that the audits are going on now, and that audit committees and auditors are aware of this issue and focused on it.

COMMISSIONER WESSEL: Okay. If there's a second round. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Slane.

COMMISSIONER SLANE: Thank you both for taking the time to come.

I really think the overwhelming problem here is that we're dealing with two different systems of business, and you're asking the Chinese to become transparent, and that opens up a whole huge can of worms for them, and it sounds like you are saying to us we should be more conciliatory, we should continue to negotiate with them. What if we just took the position that if you want access to our security markets, you play by our rules?

As an American investor who's trying to buy stock, I assume that the Securities and Exchange Commission is doing their job, but they're really not here. So why don't we just take that position?

MS. FORNELLI: Well, I think your lead-in is exactly right, that we are looking at two contrasting systems, and probably some of the most contrasting, because the U.S. securities markets are one of the most mature, robust, transparent in the world, and the Chinese system is relatively new. While they're working toward that, that's where they ultimately have to end up and they're not there now.

And so I think that, played out to its ultimate extreme, that very well may be what happens and where we end up if there can't be a resolution to this, and the resolution isn't that the SEC or the PCAOB give up or concede their positions, but they need to continue to work with the CSRC to find a path forward. Again, I go back to Chairman Doty's statements that he's made where progress has been made. For the first time, in October, the PCAOB was allowed to go in and observe a Chinese inspection of a Chinese firm, not the PCAOB conducting an inspection, I realize, but that was a huge step forward.

They have presented an MOU to the Chinese regulators. We're not privy to what's inside of that, but I think the PCAOB has its set of requirements that they will adhere to, and so I would assume that those are in the proposed MOU, and I do think that they're working toward that. The Chinese have that now and owe the PCAOB an answer. So I think there is hope.

MR. QUAADMAN: Yeah. I actually think that the SEC's actions in court are actually the first shot across the bow, to make that exact statement, that if you want to access American capital markets, you have to play by our rules.

I do think there are some difficulties when we have 150 years of experience with public companies and the financial reporting that goes around that, and that the Chinese to some degree have been in that game for the last 25, maybe 30 years, and even then, what passes for a free enterprise system there is not really how we would see free enterprise here.

So I think there is some cultural differences that certainly need to be addressed, but I think the basic legal core argument that you're making is what the SEC is trying to get at, and it's something that we support as well.

MS. FORNELLI: And I would note that Mr. Quaadman's oral testimony, and particularly his written testimony, talks about what those consequences would be to our U.S. markets, probably more importantly, but also to Chinese companies who want to access U.S. capital.

There are consequences if that path is taken as opposed to finding a way forward for our markets as well as Chinese investing here or listing here.

COMMISSIONER SLANE: I guess I just don't share your optimism that progress is being made because they're masters at negotiating and delaying and obfuscating, and I mean that's what they do, and you are asking them to open up their kimono here, and it's not something that they're going to want to do.

I mean there's a lot of issues here with ownership and who's really benefiting in the government, and so it gets very complicated. I mean I just--either we cave or there is no resolution. That's how I see it.

MS. FORNELLI: Or they come to the table. Because I think, as Mr. Quaadman indicated, they have a huge incentive to come to the table, and they know that if they want to play in the U.S. markets, they have to abide by the U.S. rules. They have a big incentive to do that because they want access to our capital markets.

MR. QUAADMAN: I think, too, that if you take a look at Sarbanes-Oxley, you take a look at the '33 and '34 Securities Acts, you take a look at Dodd-Frank, the SEC really doesn't have the ability to cave. They have to enforce the law. There is only so far that they can go.

I think you're correct. I think the last several months, in particular, have been extremely frustrating because the leadership transition has allowed for, as I think we would see, unnecessary delay. But as Commissioner Shea pointed out, I think we're getting very close to that point where it's going to be fish or cut bait, and I think American capital markets, being the deepest and most robust in the world, if the Chinese want to continue to have a 7.5 percent economic growth yearly, they have to have access to those markets.

HEARING CO-CHAIR CLEVELAND: Commissioner Senator Talent.

COMMISSIONER TALENT: Well, thank you.

I can probably be brief because my line of inquiry has been anticipated, and the point you just made, that this isn't just a question of administrative discretion; this is what the statutes of the United States say.

And I think members of Congress would have a very negative reaction if they thought the SEC was permitting Chinese companies investing here, or American companies who invested there rather than here, to comply with lesser and less onerous standards. Whatever you think of Dodd-Frank and Sarbanes-Oxley--it's not easy to comply with--and I mean if you get a break if you invest in China, that's an incentive to invest in China so I don't know that there's much room.

Let me then take it into another area I was interested in. The EU has agreed, as I understand it, to basically allow the Chinese to supervise auditing of Chinese firms investing in the EU; is that correct? So, how did the EU square that with their concerns about financial integrity? Is it simply because they have a different set of statutes there?

MS. FORNELLI: I, for one, don't know the answer to that question. I don't think those agreements are public, so I've not been privy to the agreements between the EU and the CSRC.

MR. QUAADMAN: Just playing off of that point because I think Ms. Fornelli is right, that they're not public, but I do believe the EU is operating under a different set of standards, that they may feel comfortable doing that, but ultimately, again, we're going to have to follow what American law is.

I do also think, however, that the EU also has to think about it, as well, if there's going to be continued impasse between the United States and China. One is because of the extensive regulatory contacts and cooperation between the U.S. and EU, but even with the ongoing or start of negotiations of a free trade agreement between the United States and EU, financial services is actually slated to be a part of that, at least for right now. So these issues can even come up in that context also.

COMMISSIONER TALENT: Yes, and I'm a little concerned if an EU company has very substantial investments in China that are subject to these non-transparent auditing regulations, and American investors consider investing in that EU company, then we could have some huge issue involved, and Americans could get taken to the cleaners.

I think--and I appreciate very much, by the way, and you guys are sort of on the horns of a dilemma here because you and the people you represent want to have clear rules that your people can comply with, and you're entitled to that.

MS. FORNELLI: They do understand the importance of the U.S. securities laws and the U.S. securities markets.

COMMISSIONER TALENT: Well, and, you know, it's just that these laws were passed here, one presumes, for a reason, and there's an underlying reality to this about integrity, and, if they're not necessary, then American companies shouldn't have to comply with them. I mean it's not easy to comply with these things. If they are necessary, then everybody should have to, but you all have gotten that message, and it sounds like the SEC is starting to make it clear that China is going to have to fish or cut bait.

MR. QUAADMAN: I think one thing as well, I mean historically, the Chinese always operate in what they believe is in their best self-interests, as you would expect others, but obviously they have a very long history with that.

At some point in time, however, capital markets run on confidence, and the confidence that's engendered is based upon financial reports, and that's why I said before if investors don't feel confidence in what is being reported in financials out of China, they're not going to provide capital, and if they don't provide capital, economic growth isn't going to occur.

So I think at some point in time, the Chinese will realize, if they haven't realized already, it's in their self-interests to come to an agreement and to be more transparent.

COMMISSIONER TALENT: And I think your comments there were very appropriate, especially since this issue has now received such visibility. Even if the American authorities could and did cave in to some lesser regime of oversight, if I'm an investor, I'm going to think one, two, three, four, ten times before investing in a company that isn't being subject to the same reporting requirements that we believe necessary for other companies. I don't want to lose my money, so I think that’s a good point.

MS. FORNELLI: Well, and that's part of the reason why our capital markets are so attractive because we are known to have the most robust, transparent and accountable markets, and so that's the draw. So I think that investors and companies and ultimately the Chinese know that if they want to raise capital here --and avail themselves of the confidence in our markets--they're going to have to do the things that they need to do to be able to.

COMMISSIONER TALENT: Is this the issue that Senator Schumer--staff, was this in the briefing that Senator Schumer sent a letter to the SEC on? Well, if Senator Schumer is on the case, the SEC doesn't have much room to maneuver, I'll tell you that.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Senator Goodwin.

HEARING CO-CHAIR GOODWIN: Quick follow-up to Senator Talent's question and Vice Chairman Shea's question. It's my understanding from your testimony U.S. law does not permit our regulators to rely on or does not allow the PCAOB to rely on foreign regulators to do these audit inspections; correct?

MS. FORNELLI: That's right. The PCAOB wants to do the inspections under their rules.

HEARING CO-CHAIR GOODWIN: But they're statutorily required to do the inspection under their own rules?

MS. FORNELLI: Yes.

HEARING CO-CHAIR GOODWIN: Okay. Presumably, the regulations in the European Union provide a little bit more latitude?

MS. FORNELLI: Perhaps. Right. Perhaps they don't have that provision.

HEARING CO-CHAIR GOODWIN: Right. Well, now to Vice Chairman Shea's question about reciprocity, you all both indicated that perhaps it would still require some sort of an agreement between Chinese and U.S. regulators.

My question is what does the Chinese law--clearly, do they have a prohibition like ours in place where they are not allowed to rely on foreign regulators to do those sorts of inspections. What's the status of Chinese law on that?

MR. QUAADMAN: I'm not an expert on Chinese law, but I think, to some degree, that the state secrets laws are sort of being used as a shield. That’s why we made the point in our testimony about the rule of law because we have clearly defined rules, clearly defined laws, and actors know the parameters they have to operate in, and if you go beyond those bounds, we expect you to be hauled in and appropriate action taken.

The problem here is if there are different laws being used as shields for different points in time, actors don't know how to operate, and it does get to Commissioner Slane's point of, is this something that's being used to delay, to obfuscate, or whatever? I think that's why clarity is needed, and I think that's why ultimately I think it's in the Chinese best interests to do that.

HEARING CO-CHAIR GOODWIN: Sure. Let's talk a little bit about the state secrets laws just to provide context, and I'm not sure if you all are experts in this regard, but just, for instance, what does U.S. state secrets law provide? We certainly have provisions protecting the disclosure of certain information, national security interests, and so forth. What does ours say? How does that compare to China's? How does that compare to other nations?

MR. QUAADMAN: If you take a look at--and, again, I'm not an expert on our national security laws, but from my limited experience with them, they're more geared towards the sale or use of products and services. They’re not related to financial statements.

And so I think our concept of what those types of laws are, and obviously what the Chinese concept is, is different. I think that's where there needs to be some sort of mutual understanding that needs to be arrived at because understandably, as with any sovereign they should have the ability to protect their nation, but if those abilities are being used to further some other interests, that goes beyond the pale.

MS. FORNELLI: I'm also not an expert on China's secrecy laws, but I think part of the issue might be that they're ill-defined, and so maybe that's an area where the Chinese can have some give and tighten up their definition. Or I think it certainly allows room for them to find a path forward with the SEC and the PCAOB to be able to provide work papers and to comply with the rest of U.S. laws.

HEARING CO-CHAIR GOODWIN: So what do we do in the meantime with these conflicts, particularly the conflict that prevents the PCAOB from inspecting these audit firms? We have pending regulatory actions by the SEC against firms for refusing, invoking the state secrets laws, or having been instructed that they would be in violation of state secret laws.

MS. FORNELLI: I would make that distinction.

HEARING CO-CHAIR GOODWIN: I think, Mr. Quaadman, in your written testimony, you suggested that the ramifications if the enforcement actions proceed without resolution on a sovereign-to-sovereign basis, there might be repercussions for U.S. investors and U.S. companies in China.

I'd like for you to talk a little bit about that, and then perhaps get into a little broader discussion about what incentives exist for both countries to resolve this, and is it--I believe you alluded earlier or suggested earlier that there is a large incentive and a lot of pressures for China, and Ms. Fornelli, you said this as well, to eventually come to the table because they want access to U.S. markets.

Do we not have similar incentives and pressures on us because of desires to continue playing in the Chinese market?

MR. QUAADMAN: First off, this is such an issue of importance that last summer, our CEO, Tom Donohue, had meetings with the outgoing and incoming premiers in China where he raised this issue and the need to get a resolution. Mr. Donohue has also had phone calls with Chairman Shapiro, as well as Chairman Walter, to discuss this as well.

I think the biggest carrot that we have, quite frankly, is the access to American capital markets. They're the deepest, most robust in the world, and if the Chinese want to continue their path of economic growth, and if they want to continue the maturity of their business sector, they have to have access to those markets.

Where I think we are most vulnerable, quite frankly, is if the Chinese decide to restrict operations of American businesses in China and if they start to attack the investments that are being made there. I think there are some down sides for the Chinese with that, because others around the world will take a look at that and probably similarly retrench for fear of similar actions.

HEARING CO-CHAIR GOODWIN: I'm over my time here, but just to bring it to a head, we have these requirements in place on our regulators. We have these enforcement actions pending. If they proceed, the audit firms can no longer do the audits. If they can't do the audits, ultimately the companies could be delisted. If that happens, what happens to American interests in China today?

And, more broadly, what do we do? The SEC, the PCAOB have statutory obligations to bring these enforcement actions. Obviously, it's not the best way to conduct foreign policy, but they have to do it. So what do we continue to do in the meantime, and what does that do to our efforts to reach a resolution?

MR. QUAADMAN: If we go down that road, clearly, American interests in China will be affected. I think it is incumbent that the SEC needs to give a reasonable amount of time, which is probably shorter rather than longer, for a resolution here. However, I think they need to start to look at different actions that they can take, and, quite frankly, I think Congress needs to take a closer look at this as well.

MS. FORNELLI: Right now, this type of a hearing where it shines a light on the issue is exactly the right thing for this Commission to be doing. We should be talking about it, making sure that the discussions continue, and really push that there be a resolution, as Mr. Quaadman said, sooner rather than later.

HEARING CO-CHAIR GOODWIN: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Great. Thank you both.

I think there's agreement here that there should be a cost of entry, that is we need to have one set of rules. Anyone who has served on an audit committee would think you cannot be SOX compliant if you have a black box and can't see the numbers over there. You cannot monitor money flow accurately without understanding what the real numbers are in China..

So I'd like to go a little more into detail for the record, in terms of how it would play out if I worked at a U.S.-based company that has business in China. My internal audit department, how would they be functioning with the external audit team as it relates to transactions in China?

I'm going to ask a series of questions.

MS. FORNELLI: Sure. The internal audit function is very important in any company, particularly a large multinational company.

COMMISSIONER TOBIN: Right.

MS. FORNELLI: And so coordinating closely with the external auditor with the umbrella of the audit committee's oversight, is a linchpin to the company and to investor confidence in that company. So that would be very important.

COMMISSIONER TOBIN: I'm well aware of that, but have you heard of how they have, or have they, brought out issues related to this and has that, in turn, affectedaudit plans?

MS. FORNELLI: I'm not privy to that information. I don't know, but I would think any good internal audit function would have those conversations with their external auditor.

COMMISSIONER TOBIN: American companies have to rotate auditors on a somewhat scheduled basis. You can't have an Ernst & Young for--I think it's five years; right?

MS. FORNELLI: That's right.

COMMISSIONER TOBIN: Is that occurring with the U.S. companies doing business in China?

MS. FORNELLI: Certainly the U.S. audit partner will rotate every five years. I don't know if under the Chinese laws that they have partner rotation.

COMMISSIONER TOBIN:

MR. QUAADMAN: Right. I just want to be clear.

COMMISSIONER TOBIN: Go ahead.

MR. QUAADMAN: It's partner rotation you're talking about, not firm rotation?

COMMISSIONER TOBIN: Yes.

MR. QUAADMAN: Yeah.

COMMISSIONER TOBIN: But actually if you have an extended period of time, it can be the auditor itself, I believe. You know, if you have 20 years with the same firm, a board of directors might want to transition at some point.

MS. FORNELLI: Well, we think that the board of directors should do an annual assessment of the auditor.

COMMISSIONER TOBIN: Yes.

MS. FORNELLI: Yes.

COMMISSIONER TOBIN: Okay. Another question--did you get to answer that?

MR. QUAADMAN: Yes.

COMMISSIONER TOBIN: The audit plan, it is shaped by the auditor in conversation with the audit committee and the board. That seems to me a place where any of these companies like Caterpillar could put extra pressure on getting more open data in China. Are you hearing anything about this directlyin terms of audit plans? Can we put more pressure on through the normal oversight process?

MS. FORNELLI: I certainly think that the PCAOB's focus on the global network structure, and how the global networks operate, would cause a U.S. company or a U.S. audit firm who is the signing auditor to discuss that with the audit committee and the internal audit function to build that into the audit plan.

MR. QUAADMAN: I would just add, too, to some degree, this is a little bit of a new world as well because if you look at multinational companies that are headquartered here in the United States, the amount of business that they do overseas now is probably flipped in terms of proportions if you looked at what it was 20 years ago.

I think there is some maturity that has to happen around there. That's why we saw some of the additions to Dodd-Frank to give the PCAOB more reciprocal inspection powers. But I do think your questions are hitting on the mark.

COMMISSIONER TOBIN: I know you've both been recognizing that China, in your minds, is newer to the table. Let me offer a somewhat alternative view. When Sarbanes-Oxley compliance was required of U.S. companies, there was a deadline. Everybody was expected to meet the requirements within a given time period. Companies threw up their hands and were disturbed by it, but they had time to move forward to meet the reporting requirements,and best of all most were able to meet the requirements in three or four years.

It seems to me, particularly when you've got multinational organizations over there, that it would be, to go back to the very beginning of my remarks, a cost of entry, that we need to have one accounting system. Those are my thoughts, but do you have any comments on that? The timing seems to me like a way that we could have a carrot for them to say, okay, in three years, we're expecting this to occur.

MR. QUAADMAN: I would think that to some degree the court action that the SEC has undertaken is sort of that line in the sand. It may not necessarily have a firm date, but I think we all know from our prior experiences that judges aren't going to let actions just sit around. There's an expectation from the Chinese that something will be happening soon if they don't act.

I do want to say, however, that with Sarbanes-Oxley, even though there were firm dates with those, there were problems, particularly with smaller cap companies and with SOX 404(b). The SEC continually put off those deadlines, and finally Congress stepped in a year or so ago where they actually did away with some of those requirements.

Part of the issue here is a one-size-fits-all approach may not necessarily work in terms of a firm deadline. I also think with the line in the sand, that's an appropriate way for the SEC to go under the current construct of our laws. I do also wonder, not being a China expert, if you did set a firm date, does that then dig in their heels, and then do they not want to move and be seen as buckling under to American pressure?

COMMISSIONER TOBIN: I see Sarbanes-Oxley as a rule system but also as a cultural system. It would help the Chinese strengthen their financial systems.

Thank you so much, and I'm glad we are getting this on the record.

MR. QUAADMAN: Sure.

COMMISSIONER TOBIN: Thank you.

HEARING CO-CHAIR CLEVELAND: Can I clarify a couple of points? There is a deadline. The SEC administrative proceedings have a 300 day margin. They can make a decision before that, but that was filed December 3, 2012, so there's a presumptive 300 days ticking on that decision.

I also want to clarify something that you both may know. I'm sorry that Paul Gillis isn't here because his testimony spoke to a number of the questions that folks have been asking. He indicates that the PCAOB began conducting inspections in 2005 with a goal of completing them by 2012.

The initial inspections of foreign-registered firms were to be completed by December 2009. That deadline came and went because of objections from countries in the EU and China. It was a shorter period of time in which these negotiations were underway, and I'm not sure that it's reasonable to characterize the Chinese as the only outliers in this process.

I think a number of countries were concerned about the intrusive nature of very good standards but, nevertheless, intrusive nature.

Commissioner Reinsch.

CHAIRMAN REINSCH: Thank you, and thanks to you all for raising the issue of the extraterritorial application of law. In my day job, I do a lot of work on that in other contexts, mostly involving Iran and Cuba, but I'm very familiar with the collateral damage these things do. They put companies in the impossible position of no matter what they do, they're violating somebody's law, and we don't do a very good job of trying to reconcile those differences.

You said that the EU agreements with China are not public. I infer from your comments that you think that the Europeans might have settled for less than what the SEC is likely to settle for. Is that a fair statement?

MS. FORNELLI: I can't speak to that, but to our earlier points, the U.S. laws state what they state. And the PCAOB has obligations to conduct their inspections, and so that's what we need to be marching toward here.

MR. QUAADMAN: I think your characterization is correct, and I think Ms. Fornelli's is as well. We have a system of rules that we need to operate by, and sometimes there is at least a perception. I could talk about it a little bit differently if we were to talk about Basel III and capital standards, but I think how the Europeans may go about things and what they seek are going to be different than what our set of laws actually force us to do.

CHAIRMAN REINSCH: But isn't the first best answer here a harmonized agreement amongst all three parties or more?

MS. FORNELLI: Yes, definitely.

MR. QUAADMAN: We agree with that, and in our written statement we have continually called for convergence of accounting and auditing standards to get everybody on the same page. I think this would be something that would help in that regard as well.

CHAIRMAN REINSCH: Mr. Quaadman, you pointed out, I think quite correctly, that the EU-U.S. negotiation opens the door to a discussion of this. This is not a new issue--

MR. QUAADMAN: No.

CHAIRMAN REINSCH: --between the U.S. and the EU. Who would you regard as a larger problem, them or us?

MR. QUAADMAN: I don't know if either side is a problem. It's more or less getting on the same page, and sometimes that can take a little doing to get there. Ultimately, the U.S. and EU historically do, and it's just a matter of pressure to make that happen.

CHAIRMAN REINSCH: You're very optimistic. Let me tell you my story about chickens at some point.

[Laughter.]

CHAIRMAN REINSCH: The EU and the U.S. have a long history of failure in the regulatory area, but be that as it may--

HEARING CO-CHAIR CLEVELAND: We want to hear that story.

COMMISSIONER TALENT: Are you sure we can't have that story for the record?

[Laughter.]

MS. FORNELLI: I am intrigued, I must say.

CHAIRMAN REINSCH: I've used up all my time, and I have one more question.

[Laughter.]

COMMISSIONER WESSEL: That might be a good thing.

CHAIRMAN REINSCH: Actually it's a question you'd be interested in, Commissioner Talent, because it picks up on the conversation you had with Mr. Quaadman about the capital markets and access to capital markets.

Mr. Quaadman, why do you--and Ms. Fornelli, you can get into this too if you want--why do you think that the Chinese government has the same enthusiasm for access to American capital markets that you have or that you think they should have?

MR. QUAADMAN: I don't think they necessarily might share an enthusiasm. I don't think they necessarily have a choice because if they want to try and grow at the rates that they're trying to grow at, they need to be able to derive capital from many different sources.

I think we have all seen, and history has clearly shown, the examples of a state-run economy can only do so much for so long. If they evolve into more of a free enterprise economy, they have no choice but to be able to get into the United States and tap our capital markets, do the same in the EU, and go into other places in Asia as well.

CHAIRMAN REINSCH: I've had it suggested to me by others that that is the rational view. But their view might be very different because doing that entails certain risks in terms of their ability to control the companies, and it might require, for exactly the same reason we're discussing, a level of disclosure that they're uncomfortable with with respect to their companies.

I don't think they're exactly short of capital right now if you take a very short-term view of their situation.

MR. QUAADMAN: No.

CHAIRMAN REINSCH: I can think why they would not be particularly interested in being conciliatory on this point.

MR. QUAADMAN: No, but if you take a more cynical point of view, if they're, trying to game the system to create a more insular system that's more closed, the problem they eventually are going to run into is that capital is not going to feel safe there and that they're not going to be able to track it.

So that might be, in the short-run, the game that might be played. However, I think in the long-term, there's going to come a decision point where either they're going to have to become rational or they're facing a break-up that could cause a lot of trouble for them.

CHAIRMAN REINSCH: You put that very well. I was trying inarticulately to lay out the more cynical case that you've just done better. I'm a little less optimistic than you that at the end of the day they'll get to the point you want. They have to fundamentally decide they need our money, and I'm not sure that right now that they think they do. Now maybe in 20 years or ten years, they'll have a different attitude.

Thank you.

HEARING CO-CHAIR CLEVELAND: We keep talking about the SEC rules and Sarbanes-Oxley and what standards are required of PCAOB audits.

Is it your judgment that the rules are abundantly clear and that every deal that the PCAOB has struck with countries to engage in audits have been consistent and conform to one single standard rule or regulation, or has there been an interpretation and flexibility to allow for audits to proceed?

MS. FORNELLI: I have not looked closely at the agreements that the PCAOB has entered into with the other 16 countries recently, but generally I think that they adhere to a common template. That does make some allowances for individual country rules and regulations, local rules and regulations, but never backing away from the requirements that are imposed by Sarbanes-Oxley and other rules that apply to the PCAOB.

MR. QUAADMAN: I would agree with that. There is only so much flexibility that they have--the PCAOB. So I mean it can be tailored to some degree, but I think there's limited flexibility to do that.

HEARING CO-CHAIR CLEVELAND: And the standard that we're talking about is allowing the PCAOB to have independent access to auditors' materials so that they can conduct a review of the books, for lack of a better--

MR. QUAADMAN: Right.

HEARING CO-CHAIR CLEVELAND: --of the process that the auditor is using? They're not doing an audit or a second opinion; they are, in essence, reviewing the procedures that the auditor has in place for carrying out their audits?

MR. QUAADMAN: Correct, and they then have to view that material through the lens of the '33 and '34 Securities Acts, Sarbanes-Oxley, and Dodd-Frank. There are parameters that they have to really abide by with their inspections. So I'd agree with that.

MS. FORNELLI: Yeah, the key is the inspection. The PCAOB needs to be able to inspect the Chinese firms or get comfortable with the inspections, that's the issue for the PCAOB. They haven't been able to go in and do an inspection of the Chinese firms.

HEARING CO-CHAIR CLEVELAND: The Chinese auditing firms.

MS. FORNELLI: The Chinese auditing firms.

HEARING CO-CHAIR CLEVELAND: Okay. That's what I was trying to clarify. So in Mr. Gillis' testimony, he says that he sees final effort underway where there will be an agreement for joint inspections, and that Ferguson has commented that "the number of issues have been narrowed significantly," indicating that "Chinese regulators have likely found a way to allow for those inspections. The hang-up is going to be what to do with inspection findings."

If the PCAOB reaches an agreement on being able to conduct joint investigations consistent with their standards, and then there's evidence of fraud, what happens elsewhere? I'm trying to delineate whether or not the procedure, the process, that the PCAOB is seeking will be sufficient, and then a line drawn on what happens to the data that is uncovered?

MR. QUAADMAN: I think the PCAOB also is an adjunct of the SEC, quite frankly. The SEC is the overseer of financial reporting. They are the overseer of all the different corporate reports and securities laws here in the United States.

MS. FORNELLI: And of the PCAOB itself.

MR. QUAADMAN: And of the PCAOB itself. It's really the SEC that is going to have the final say here. I would also like to point out as well, is that eventually if Mary Jo White is confirmed as the SEC chairman, you have someone who is a very distinguished prosecutor and is respected by both Democrats and Republicans. I think that also sends a message to the Chinese because ultimately it's the SEC that is going to be the big player here for us.

HEARING CO-CHAIR CLEVELAND: Okay. It is my sense that there was the possibility of an agreement last fall when the Chinese came in November that there were a series of missteps and misunderstandings between the parties that led to the Chinese leaving without an agreement, and that has now entangled the Ministry of Finance.

We've been talking exclusively about the Chinese Securities Regulatory Commission, but the Ministry of Finance now, for lack of a better description, has its knickers in a twist because of how the Chinese were treated in November. Does that comport with information you may have?

MR. QUAADMAN: Part of the difficulty with this issue is trying to separate the wheat from the chaff. There has been some scuttlebutt along those lines, but this has been a very long and drawn out process. I think there might be excuses that try to justify some things, but the fact of the matter is that discussions of progress or possible agreements are fine, but we actually need to get something done.

To Commissioner Shea's earlier statement, we are getting to the point where we have to fish or cut bait.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of comments, first, and then a number of questions. I don't share your optimism. We've heard lots of optimism about IPR negotiations, this, that and the other negotiation with the Chinese. So optimism is something that doesn't sort of flourish in this room.

The newer to the table sort of analogy that they just started their capital markets, they--you know, they can shoot down a satellite. This is not rocket science. It took us a couple hundred years to shoot down a satellite. It didn't take them that long because they learned what we learned, and they're not stupid.

I don't think the issue of inspection is a real one, and I'll give you a little history. On the MOU on prison labor, negotiated in 1994, by the Clinton administration, they called it inspection. The Chinese said you do not inspect anything. You visit. The word "inspection" gets right to the issue of sovereignty, which is a very emotional issue with the Chinese, as with most countries.

Now I want to get back to the question of the UK or the EU. You're actually avoiding a little bit. Does the SEC have knowledge of the details, the actual agreements between the EU and the Chinese?

MR. QUAADMAN: I would have to imagine--this is just speculation on my part-- that the SEC has knowledge of that.

COMMISSIONER FIEDLER: The only way you have knowledge of it is if you have the document.

MR. QUAADMAN: Yeah. I can only speculate on that. The first part of your question, though, I think maturity, it's not an excuse. To some degree it's reality because I think you're right, they have made tremendous strides. But they don't have the institutional knowledge or basis that we do.

COMMISSIONER FIEDLER: You actually alluded to it earlier in your testimony, about it not being the same system, and I will be more specific. State secrets protect state enterprise information. The majority of the big companies in that country are state enterprises; they're not what we consider to be privately-owned companies that are publicly listed. So there are a lot of serious political issues.

But I want to get to the issue of political negotiations. We ought to know-- I cannot imagine that the British are accepting an EU securities agreement with the Chinese. The London Exchange is a major exchange. What has the London Exchange done? What have the British done in a similar situation here? Have they accepted lesser standards?

MR. QUAADMAN: I don't know, but as we've seen in recent days, the UK has shown no hesitancy to disagree with the EU and try and go its own way if they feel that the EU is going to place the UK financial markets at a competitive disadvantage. I can actually look into that, but I do believe that the UK is going to operate in a way that they believe that they have the integrity of their markets.

COMMISSIONER FIEDLER: Well, listening this morning, the multiplier effect of this so far in our discussions has been more limited than I think it is now. So there are more European countries selling ADRs on the U.S. markets than there are Chinese companies. If the EU has accepted a substandard set of agreements with the Chinese, then the European companies who have majority interests in China who are selling ADRs have got an accounting problem in the United States.

And I'm sitting here thinking how does a company self-comply in a Foreign Corrupt Practices Act investigation that has been prompted by the SEC? What you're telling me is that we cannot actually-- a company nor the U.S. government --effectively conduct a Foreign Corrupt Practices Act investigation. In a recent Foreign Corrupt Practices Act investigation of a U.S. company operating in Asia, O'Melveny and Myers sent 60 lawyers into a certain place with a bunch of auditors. Now you're telling me that they can't get the information that they need.

It's not just fundamental financial information; it's other information. Corruption is a major problem in China. They intend to hide as much of that as they can, and it involves companies, including European companies, who are more apt to bribe in a less sophisticated way than U.S. companies.

The implications of this are huge and not just to 10-Ks and board of director audit committees. I don't see, as Commissioner Shea says, any room in this negotiation for the United States. Otherwise, it undermines the integrity of our capital markets, and I don't see how anybody is willing to do that for a couple of bucks.

By the way, our own capital markets beginning in about 2007 didn't shine very brightly in terms of integrity of information. So I don't think we want to go back that far and allow the Chinese to get away with this. I don't see a way out. I think we're headed for a head-knocking very soon. I mean I may be cynical, but I don't see how we compromise on this.

MR. QUAADMAN: I agree with you. I think the implications are huge. I hope we don't get to a place where there is head-knocking. I do hope that we are able to reach an agreement, but I think to your point, too, if you look at our capital markets, have we always gotten it right? Absolutely not. Is it always a work in progress? Sure. But I think ultimately, I mean you raise a lot of the right issues that need to be resolved, but ultimately what is at the basis here is transparency. Are the Chinese going to be able to make their markets more transparent?

COMMISSIONER FIEDLER: We have no optimism on that. I'm sorry.

HEARING CO-CHAIR CLEVELAND: "We" being a "you" term.

COMMISSIONER FIEDLER: Uh?

HEARING CO-CHAIR CLEVELAND: "We" being a "you" term.

COMMISSIONER FIEDLER: Yes.

HEARING CO-CHAIR CLEVELAND: Thank you.

COMMISSIONER FIEDLER: I have zero optimism on the transparency issue. They may have gradually more, but I don't suspect a lot.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

COMMISSIONER WESSEL: Well, as one who shares Jeff's optimistic outlook--

[Laughter.]

COMMISSIONER WESSEL: --"we" is growing, and I want to thank you both for your testimony today and the interaction. It really is appreciated, and clearly this is an issue that I think has enormous repercussions. I'm reminded over the last several years that the American public has become more engaged in the U.S.-China dialogue as a result of what it means to them on a daily basis, some, of course, because of the job issues; some because of the food safety and the other issues.

Commissioner Talent raised what is a very important issue, which is the confidence of our investors--forget about the companies--forget about the PCAOB. At the end of the day, the '33, '34 Act and the other subsequent actions are meant to ensure transparency and the integrity of market information so that people can have confidence that the risk they want to accept is, in fact, the risk that they are accepting, that profits or rates of return are a function of risk.

And the question of whether an investor in Fidelity's China fund, if that exists, they're not looking at the underlying accounting issues for the companies in that portfolio. They're looking simply what's the rate of return can I get on Fidelity's investments or Putnam's or anyone else's, not picking on a particular firm.

And so the question of whether a European company and their ADR on the U.S. market that an investor is buying is, in fact, based on transparent information and the risk factors are appropriately being assessed is a huge issue and getting larger for the U.S. market as more and more people going to defined contribution plans rather than defined benefits. People are more exposed to the markets, what has been discussed here, relating to the financial problems in '08, et cetera.

How do you both from your perches look at these issues and how do you rate this issue and the risk profile that average investors and companies face. What should we be doing, if anything, more to try and highlight these problems?

I think the goal of having a harmonized system is great. We've been working on IFRS for I don't know how long, and that hasn't yielded fruit. At the end of the day, we have to ensure the integrity of the information for our own people.

MR. QUAADMAN: I think you raise a lot of good issues. To rate this issue, I think it gets inappropriately underplayed because this issue--I think we alluded to it in the written testimony-- is actually a seminal issue in terms of the economic relationship between the United States and China; right? If you can solve this issue, you have a cornerstone that you could start to build on that's based on mutual respect.

If you can't resolve this issue, that relationship is going to be long and tortured, and it's going to take an awfully long time to get it into the right place if we can get it there. Moreover, there's going to be a lot of economic damage that results along with that.

I think, to some degree, with the smorgasbord of issues that are out there, this gets overlooked, but this is an important one because, as I said, Mr. Donohue raised this with the top leadership in China. He's also raised it with the top leadership here.

I don't think you can underscore the importance that this Commission itself plays. When you read Henry Kissinger's memoirs, when he went in and negotiated, he not only had the "mad bomber" theory that he used to say, “I have to deal with Richard Nixon, and if we don't get this the right way, he may just let the B-52s go.” However, he would also say, “I have to take this agreement and take it back to the Senate to be confirmed and to get voted on.”

It's the same thing here, the more pressure points we as the United States can bring to bear on the issue, I think there's a possibility of getting to that optimistic place. And that is going to be difficult, but I also said--that's why I said it as well--the ball is in their court, and they're going to have to hit it back for return soon or else we may very well be faced with going down that doomsday scenario. I think we all have a lot to lose, but I think the principles that our system are based on are more important than that transactional relationship because, at the end of the day, we are not going to sacrifice those principles, which have built the most successful economy in the world history, to gain access to a market. They're going to have to come more our way.

COMMISSIONER WESSEL: Thank you.

Ms. Fornelli.

MS. FORNELLI: I totally agree with what Mr. Quaadman has said. Our capital markets are the best and the most attractive for a reason. I spent six years at the Securities and Exchange Commission, and so I know the importance of our securities laws and what they bring to our marketplace. There are potential severe consequences for China, which is why I do have optimism that they will come to the table and will reach an agreement with the PCAOB and SEC. This is because the access to the SEC of the audit papers, not only in the five that are involved now, but all Chinese firms, is critical. That has to happen, and the Chinese firms support that.

They're just stuck right now in the middle, and they can't resolve that. The regulators have to resolve that, and so I do join Mr. Quaadman in applauding this Commission for focusing on this issue because there are a lot of competing issues, but the fact that you're focused solely on the China relationship and focusing on these financial issues is very important. We're very supportive and pleased to be here today.

COMMISSIONER WESSEL: We appreciate your being here. Thank you.

MS. FORNELLI: Thank you.

HEARING CO-CHAIR CLEVELAND: Senator Goodwin.

HEARING CO-CHAIR GOODWIN: What do we know about the details of the negotiations on this? Presumably, it's not simply that federal law prohibits the PCAOB from relying on foreign inspectors here, but China won't let that happen, so we're simply at loggerheads.

I think Mr. Gillis in his testimony indicated that the PCAOB did seek permission to conduct joint inspections or joint visits, such as they are. What has been offered? What has been China's reaction to that, and where do we stand?

MS. FORNELLI: The latest developments occurred at the end of 2012, and it started when the Chinese came here, as Commissioner Cleveland indicated, and there was an MOU presented, which is with the Chinese right now. It's my understanding that they are reviewing that and making a determination whether or not they can accept the terms of that MOU.

And then the other companion piece was that while joint inspection is the ultimate goal, I think the PCAOB acknowledges that a way forward is incremental change and improvement. I think the PCAOB was pleased that they were invited into China to observe a Chinese inspection of a China firm, not the ultimate goal of the PCAOB, but a positive step forward.

MR. QUAADMAN: I agree with that. There has been incremental progress made. I think what's also put our side on a little bit of a holding pattern as well is that we're having a transition going on at the SEC. We had Chairman Shapiro leave in December. We have Mary Jo White coming up for a confirmation hearing I believe next week. That's also put the SEC in a little bit of a holding pattern, as well as the fact that we also had a change in Chief Accountant at the SEC last year.

HEARING CO-CHAIR GOODWIN: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

VICE CHAIRMAN SHEA: I just have a quick question. You may not know the answer, but in his written testimony, Paul Gillis says that China has blocked the PCAOB from conducting inspections in its Special Administrative Region of Hong Kong, to the extent that the subject audit includes operations on the mainland.

We as a Commission typically have a chapter every year on Hong Kong, on the special status of Hong Kong and developments in Hong Kong. I was wondering, are you aware of China blocking the PCAOB from conducting inspections in Hong Kong with respect to corporate operations in Hong Kong? You probably aren't, but--

MR. QUAADMAN: I'm not aware of it myself. I mean I've read reports of some possible goings-on along those lines. I think it would have been good to have Professor Gillis here to elaborate on that--

VICE CHAIRMAN SHEA: Right.

MR. QUAADMAN: --some more. Based on what I've just read third-hand.

VICE CHAIRMAN SHEA: Yes. Madam Chair, maybe the staff could just explore that a little bit as part of our efforts.

Thank you.

HEARING CO-CHAIR CLEVELAND: Anybody else? Commissioner Slane.

COMMISSIONER SLANE: My question is can the Chinese circumvent our security laws and still reach our market? What if Anshan Steel or Baosteel went on the Shanghai or the Hong Kong securities market and came out with a public offering, and the market makers advertised in the United States--I'm not a securities lawyer, and maybe you may know better than I do--and they place an ad in the Wall Street Journal that asks you to send your inquiry to Wuhun Securities in Hong Kong, and we'll send you a prospectus. Can't they do this?

MS. FORNELLI: Well, I don't think there is anything that prohibits a U.S. investor accessing Hong Kong, Chinese, London, or any other markets. However, they would have to go into those other markets and not our markets, and then follow the rules and the disclosures that are required by those countries.

COMMISSIONER SLANE: I share Jeff's concern. I just don't see the Chinese capitulating at all. There's too much at stake for them. And a way around it may be to develop some sophisticated marketing through Shanghai or Hong Kong.

MR. QUAADMAN: I think that if you were to issue a solicitation in the United States along the lines that you mentioned, that would trigger certain--

MS. FORNELLI: Securities.

MR. QUAADMAN: --securities laws requirements that the SEC would have jurisdiction over.

COMMISSIONER SLANE: In terms of getting an injunction, how are they going to reach Wuhan Securities in Shanghai and enforce an injunction--or some other market maker in Shanghai?

MR. QUAADMAN: It would also depend on how they're selling those securities and if they're using certain firms that have a nexus here in the United States, which is difficult not to do. That would trigger some oversight from the SEC that they would have some regulatory powers to actually deal with that issue.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Just a question. Several times, Mr. Quaadman, you mentioned that if there isn't movement forward, then one of the things that could happen is China could--you didn't use the words--but that they would close us out. Wouldn't that indeed close them out from being in the market over time? In other words, it would be more their loss than ours.

MR. QUAADMAN: No, I think the point I was trying to make is that in the short-term they could take actions along those lines that would hurt the American business community. However, I think in the longer term it's going to hurt them more by doing that because that would create different retaliatory action.

From the global investor point of view, everybody will understand pretty quickly if they can do that to the United States and to the American businesses and whatever else. They can do that to anybody that's going to have activities in the Chinese market.

Again, I think that gets to the point that capital may be welcome there, but it's not going to be safe, and if it's not safe, then you don't have the confidence to move forward and deploy it there.

COMMISSIONER TOBIN: Yes. It affects them. Let me just say, Ms. Fornelli and Mr. Quaadman, you've really done a service by giving us all this information today.

Thank you.

MS. FORNELLI: Thank you.

MR. QUAADMAN: Thank you.

HEARING CO-CHAIR CLEVELAND: I have one question on what I keep saying reverse mortgage, but I really do mean reverse merger.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Every time I read it, I see the same thing.

Ms. Fornelli, in your testimony, you talk about the fact that the SEC issued an investor bulletin expressing concern about the risk of fraud and abuse and warned investors to be extremely careful. Both of you said earlier that part of the problem with reverse mergers is that they are not subjected to the due diligence process associated with traditional IPOs.

I think it's fair to say at the end of this hearing that the traditional due diligence process associated with Chinese IPOs may not be as rigorous as we would hope. In other words, the standard--

MR. QUAADMAN: Well, yeah--

HEARING CO-CHAIR CLEVELAND: -- for reverse mergers may be fairly low if that's the--

MR. QUAADMAN: No.

MS. FORNELLI: But they have been tightened up in the United States.

MR. QUAADMAN: Yeah.

MS. FORNELLI: The exchanges and the SEC tightened up, I believe in 2011,--

MR. QUAADMAN: Correct.

MS. FORNELLI: --the listing standards for companies availing themselves of reverse mergers. It is harder to enter into a reverse merger, and when you do, there are more rules that apply to it, including a year's worth of seasoning of the securities on the exchange and compliance for a year with SEC rules.

MR. QUAADMAN: Right.

MS. FORNELLI: All required disclosures must be followed for a year prior to the listing, and then they also have to follow the exchange's rules and maintain a certain share price as established by the exchange prior to the listing going effective. So the rules have been tightened up considerably.

MR. QUAADMAN: I agree with that. I think the other thing, too, and clearly you can use that reverse merger system to try and knock out a few steps. What it also does is give the SEC capabilities and jurisdiction over that company. Even if you're trying to cut out some steps to gain access to markets, at the same time it brings a whole host of potential enforcement jurisdiction upon that country that didn't exist before.

HEARING CO-CHAIR CLEVELAND: Thank you. I think you've done a terrific job this morning. We appreciate it. We are all interested in protecting investors and promoting confidence in U.S. capital markets, and you have done a terrific job supporting that and helping us understand what we might do. So thank you very much.

MR. QUAADMAN: Thank you very much.

MS. FORNELLI: Thank you.

HEARING CO-CHAIR CLEVELAND: We'll take a 15 minute break. At 11 o'clock we will return with the second panel. Thank you.

[Whereupon, a short recess was taken.]

PANEL II INTRODUCTION BY COMMISSIONER ROBIN CLEVELAND

HEARING CO-CHAIR CLEVELAND: Welcome, today's second panel will address banking and access to credit in China. China's 12th Fifth Year Plan emphasizes boosting domestic consumption and Chinese investment abroad as the country seeks to lessen its dependence on exports and chart a successful course for sustained development.

Achieving these goals requires that Chinese families and private sector businesses have sufficient access to capital markets. Official sources of credit in China are largely inaccessible to individuals in small and medium enterprises as China's financial system is dominated by large state-owned banks that mainly serve the country's state sector. Unofficial sources of credit are growing but remain underregulated and risky, although legal.

Dr. Regina Abrami is Senior Lecturer of Political Science and Senior Fellow in the Management Department at Wharton School of Business. She serves as the Director of Wharton's Lauder Institute of Management and International Studies and is a former member of the faculty of Harvard Business School.

Dr. Abrami is widely published and a frequent commentator on the globalization of Chinese companies, Chinese industrial policy, and the relationship between political and economic context of business strategies. She also wrote a remarkable --which is in our briefing book--case study for Harvard Business School Press. that was excellent.

Dr. Carl Walter is an independent consultant and former COO of JP Morgan China. He is the co-author of several books on the Chinese economy, including Red Capitalism: The Fragile Financial Foundations of China's Extraordinary Rise, which The Economist named a best book of 2011, and I would agree. It takes a very complex issue and makes it accessible for those of us who want to understand what's going on.

So, Dr. Abrami and Dr. Walter, thank you both for your time and testimony. Dr. Abrami, let's begin with you, please.

OPENING STATEMENT OF DR. REGINA ABRAMI
DIRECTOR OF THE GLOBAL PROGRAM
LAUDER INSTITUTE FOR MANAGEMENT AND INTERNATIONAL STUDIES

DR. ABRAMI: All right. Thank you, members of the Commission, Senators and others, for this kind opportunity to present testimony on the issue of China's banking system and access to credit. In my comments, I'm going to focus mostly on the phenomenon of non-bank financial services, or shadow banking, and its implications for the financial, economic and social stability of China. In relation to this topic, I will address some of the issues about the private sector access to credit in China, and the sector's contribution to China's economic development now and in the past.

So let me start with the acknowledgement that, of course, non-bank based financing is hardly new to China. Private money houses, pawn shops, rotating credit associations not only date back centuries, but they serve today as in the past as the means to aid the economic transactions of firms and individuals who otherwise might not be able to obtain funding or resolve short-term liquidity crises.

It is also true that these and other forms of non-bank-based financing have played a critical role in the revival and growth of the private sector in China since 1978. They are an important resource as small and medium-sized private enterprises continue to face some difficulty in securing loans through the formal banking sector.

The demand side story of the non-bank-based financing sector has also changed in recent years, and I think this may be one of the reasons why we're here. Most significantly, this change came about as a result of the government's $586 billion stimulus package launched in late 2008 which loosened access to credit. Subsequent efforts to reign in its worst effects through monetary tightening increased demand for alternative financing channels.

The pool of shadow banking borrowers in China, in turn, has moved beyond small enterprises to now include larger firms, local governments, and businesses in politically disfavored sectors in China, such as mining, property development, and real estate. Collectively, they have turned to these alternative channels for existing debt financing as well as for development purposes.

Helping them along on the supply side are millions and millions of Chinese savers, profitable private firms, and state-owned enterprises looking for a better return on their earnings than might otherwise be possible through the formal banking deposit system. They're bolstered by off-balance sheet and non-bank structured investment vehicles, such that the supply and demand side of shadow banking in China has resulted in *de facto* interest rate liberalization.

Let me put this a different way. The bank share of overall financing continues to decline in China, down to 58 percent in 2012, according to Morgan Stanley. This is a four-fold increase in the size of China's non-bank sector if we go back 20 years. Such a trend seems unlikely to reverse.

Indeed, 60 percent of new loan issuance in China in the last quarter of 2012 was through non-bank channels according to official records. Given this, the government's task of regulating credit growth has now grown far more complex.

So shadow banking: what's in a name? Well, first of all, whether we can talk about this as destabilizing or not is more than a a function of its sheer size. I think we can see this once we get behind some of the practices within the sector and the actors within it.

So, first, to get a start, shadow banking, of course, refers to financial intermediation occurring outside the formal banking system. It is now a $67 trillion global industry, and estimates for China range between 2.5 to 4.1 trillion depending on sources used, and that's in comparison to the U.S. where it's 23 trillion and 22 trillion for the euro markets.

While small in comparison, the China shadow banking sector nonetheless must be understood as a significant driver of financial liberalization within China's formal sector, and one that may be aiding, curiously enough, the government's goal of shifting to a more consumer-based model of development.

Concretely, the current push to develop more secure channels to non-bank financing is also going to be the right path to getting consumers to spend whatever added earnings they may obtain through this sector.

At present, shadow banking in China is a kaleidoscope of activities. It includes entrusted loans, investment trusts, wealth management products, money markets, the community-based pooled capital system lending networks, peer-to-peer networks, and micro-lending through your good old loan shark and pawnshop.

Supporting their operation are credit guarantee companies and trust companies. When we think about this, one of the questions has to be who are the major players here.. I can tell you that it is not the informal underground banking sector that gets all the news press.

Really what we need to be thinking of is the rise the trust companies and wealth management products that are sold within formal banks but are off-book. Today, the value of assets in Chinese trust companies, of which there are 64, I think, is $1.2 trillion. This means that trust companies have surpassed the insurance industry in China as second to the formal bank sector in the financial services industry.

These alternative investment channels, and this is important to note, are not illegal. They are legal. They're also highly regulated and closely watched by government authorities. So to the extent that we think of shadow banking as the loan shark on the corner, we're missing that this is a booming industry that would not exist were it not for the government's hand in its creation. Moreover, these changes are benefiting small and medium-sized private enterprises. They're getting access to capital through these channels, and we can talk about the associated risks in your questioning. In addition, , although often less discussed, is the rise of private micro-credit companies, government-sponsored micro-credit companies, and peer-to-peer lending institutions, the bulk of which are Web-based, and all of which are geared to the financing needs of small scale enterprises and individuals. Peer-to-peer lending is now a $3.2 billion industry.

Is this a cause for alarm? In the abstract, the introduction of new financing vehicles to deal with pent-up market demand should not be a problem. In the China case, we have to ask, what are the political drivers and how might they affect things? And here, the first hazard is going to be a lack of government oversight, but that lack of oversight has to do with whether the government can play regulatory catch-up quick enough?

The second one has to do with changing market conditions, the second and third round effects of which, I would say, are going to be less easy to manage as they relate to risks associated with the composition and structure of these investment vehicles.

These risks are as follows:

First, short-term investors are being mismatched to long-term projects. So there's a higher risk of default.

The second one has to do with whether we're looking at what Bank of China Chairman Xiao Gang referred to as a Ponzi scheme, namely a trust's borrowing from Peter to pay Paul through the issuance of new products.

And, finally, there is evidence that a large share of financing in the shadow banking sector is going to the real estate sector. We can talk about the challenges of China's property sector in a moment.

I've run out of time, so let me just say that the bottom line here is simply whether or not all of this will cause China to fall into a liquidity crisis and if so, will it be able to get out of it? Thank you again for the opportunity to present.

PREPARED STATEMENT OF DR. REGINA ABRAMI
DIRECTOR OF THE GLOBAL PROGRAM
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Testimony before the U.S.-China Economic and Security Review Commission

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China's Banking System and Access to Credit

March 7, 2013

Members of the Commission, thank you for this opportunity to present testimony on the issue of China's banking system and access to credit. In my comments, I will focus mainly on the phenomenon of non-bank-based financial services or "shadow banking" and its implications for financial, economic, and social stability in China. In relation to this topic, I will address the issue of private sector access to credit in China and the sector's contributions to the country's economic development.

Non-bank-based financing in China: A New Phenomenon?

Allow me to start with the acknowledgement that non-bank-based financing is hardly new to China. Private money houses, pawnshops, and rotating credit associations date back centuries, having served much as they do today to aid the economic transactions of firms and individuals who might not otherwise be able to obtain funding or resolve short-term liquidity crises. It is also true that these and other forms of non-bank-based financing played a critical role in the revival and growth of China's private sector since 1978. They continue to be important as small-and medium-sized private enterprises in China do face some difficulty in securing loans through the formal banking sector.

The demand side story of non-bank-based financing has also changed in recent years, and most significantly, as a result of the government's $600 billion stimulus package launched in 2008. Subsequent efforts to rein in its worst effects through monetary tightening increased demand for alternative financing. The pool of borrowers, in turn, has moved beyond small enterprises to include larger firms, local governments through local government financing vehicles, and businesses within politically disfavored sectors, such as property development and mining. Collectively, these economic actors have turned to bank and non-bank channels for debt financing and development purposes. Helping them along, on the supply side, are hundreds of millions of Chinese savers, profitable private firms, and state-owned enterprises eager to see better returns on their earnings than is possible through standard deposits within the formal banking system. Bolstered by off-balance sheet and non-bank structured investment opportunities, these supply and demand side forces have resulted in de facto interest rate liberalization in China.

To put this development in further perspective, consider that bank share of overall financing continues to decline in China, down to 58% in 2012 according to Morgan Stanley. This percentage represents a four-fold increase in the size of China's non-bank financing sector since 2008, and the trend seems unlikely to reverse in the near term. Indeed, 60% of new loan issuance in the last quarter of 2012 was through non-bank channels. Given this, the government's task of regulating credit growth has now grown far more complex.

Shadow Banking: What's in a Name?

Whether expansive growth of shadow banking is destabilizing, of course, is a function of more than its sheer size. We can see this once we get behind forms of shadow banking now found within China and identify the actors and practices within this system.

To start, shadow banking refers to financial intermediation (credit flows) that occurs outside of a formal banking system, and thus does not appear on the balance sheets of depository banks. Now a $67 trillion global industry, estimates of China's shadow banking sector range between $2.5 and $4.1 trillion, and that is in comparison to the Financial Stability Board's 2012 reported shadow banking figures for the U.S. and Euro area of $23 trillion and $22 trillion, respectively.

Small in comparison, China's shadow banking sector nonetheless is a significant driver of financial liberalization within China's formal banking sector, and one that aids the government's goal of shifting toward a more consumer-based model of development. Concretely, the current push for more secure channels to higher rates of return is also the right path to getting consumers to spend added earnings.

In China, shadow banking is comprised of a kaleidoscope of activities that includes entrusted loans, investment trusts, wealth management products, money markets, community-based pooled capital lending networks, peer-to-peer lending, and other forms of micro-lending. This system is facilitated through various intermediaries including state-owned commercial banks, credit guarantee companies, trust companies, micro-credit companies, loan sharks, and over

4,000 pawnshops spread across China. Often not included in definitions of shadow banking in China, but counted elsewhere are hedge funds and private equity funds.

In China, the shadow banking system is overwhelmingly dominated by domestic economic actors, but foreign investors have taken a growing interest in Chinese trust companies. Today, for example, J. P. Morgan Chase has a 19.9% stake in the Bridge Trust and Investment Company. Foreign investors in other trusts include the Bank of Montreal, Barclays, Bank of East Asia, and the Royal Bank of Scotland, and others. Chinese law restricts their investments to no more than 20%. Most invest to the limit. As an aside, much as Chinese government officials have pushed foreign firms manufacturing in China to expand their R&D operations there, we can likewise expect that foreign financial firms may find themselves in the future being invited to invest in small guarantee companies as the price of admission to the more profitable sectors of a liberalized Chinese financial sector.

Turning back to trust companies, they were historically vehicles by which government bodies at different levels raised overseas funds to support domestic economic development projects, and infrastructure improvements especially. While these bodies continue to operate, the development of trusts as subsidiary investment arms of some of China's largest state-owned enterprises has been an important part of the story behind the explosive growth of trust loans in China today.

SOEs use trust companies not only as in-house higher-yield investment vehicles, but also as a means to provide project financing to their suppliers and other partners who might otherwise face difficulty. Two quick examples: The Baosteel Group, Chinese second largest steel company, holds a 98% stake in the Fortune Trust and Investment Company. COFCO, China's largest food processing holding company, created COFCO Trust in 2009, for the very same reasons. With $5.9 billion assets under management, COFCO Trust is by no means the largest of these companies. Nonetheless, when we take into account the potential of these trusts to serve as financing vehicles for their business group's downstream and upstream markets, no less their ability to channel credit to segments of the economy unable to access formal bank loans, the impact of these trusts on the broader economy cannot be overstated.

Today, there are 65 trust companies in China, all state-owned. The value of their assets reached $1.2 trillion as of late 2012, more or less, having doubled since 2007. The trusts now surpass insurance companies as the second largest financial services industry in China. They are second only to banks which have also entered into the shadow banking industry through their introduction of wealth management products.

Aimed to attract and retain high net worth customers, these products are short-term investment opportunities that promise higher yields than official deposit rates. Banks subsequently pool these funds to invest in different asset categories through trusts, bonds, stocks, interbank loans, and money markets. As a result, there is often limited transparency between the product offered and what assets are backing it. Even so, these products remain highly attractive to Chinese savers, with the number of wealth management products offered doubling between 2010 and 2012 according to *Caijing*, a leading Chinese financial weekly.

These alternative investment channels are not only legal in China, but are also highly regulated, and closely observed by Chinese authorities. In fact, when we speak of shadow banking today in China, it is important to keep in mind that the majority of new financing options are not illegal, or at worst originated as a means to benefit from regulatory arbitrage. Moreover, its expansion has provided small businesses and individuals with a wider range of financing opportunities than had existed in the past.

The explosive growth of online peer-to-peer lending (P2P) companies in recent years is an interesting example in this regard. Offering small, short-term loans through a service that matches borrowers and lenders from across China, these P2P companies have every interest in preventing defaults for two reasons. First, most of them offer some kind of protection in the form of compensation to lenders if that should happen. Second, their business model critically hinges on expanding their pool of lenders. As such, the two market challenges facing P2P companies are reputation and underwriting risks, both of which are made more difficult by the lack of access to the PBOC's credit bureau, the agency that maintains credit records on hundreds of million businesses and individuals.

P2P companies have been left to devise underwriting systems of their own, and yet despite this challenge, the industry continues to grow. Since 2007, more than 2,000 online peer-to-peer lending sites have sprung up online, according to China National Radio, resulting in an online lending market worth of $3.2 billion in transaction value in 2012. A number of these firms have also begun to seek out off-line clients through the introduction of wealth management services, putting them in direct competition with China's commercial banks and raising some concern that they may glide into illegal fund-raising.

By and large, however, the P2P lending platforms and the 4,000+ micro-credit companies that operate in China are filling a void in China's financial services sector, and are doing so on terms far better than what loan sharks and pawn shops will provide.

A Cause for Alarm? Shadow Banking in China

In the abstract, the introduction of new financing vehicles to meet pent up market demand should not be a problem. In the case of China, however, these market drivers cannot be set apart from the political challenges of financial system reform and the government's desire to maintain economic growth. In combination, they have given rise to the shadow banking system that we now see today. Moreover, to the extent that the formal banking system continues to fail in its role as a financial intermediary, while also facing growing pressure to retain its deposit base in the form of savers, we can expect its participation in the creation of new financing vehicles to continue to grow.

Given this, we have to ask three things: (a) what are the hazards of rapid credit growth outside formal bank channels; (b) will the Chinese government be able to address them, and (c) how it might do so.

The first hazard is a lack of government capacity and oversight. At the broadest level, there is little evidence of this, given that the government had a role to play in the creation of the trust companies, the new forms of micro-finance discussed earlier, and is hardly unaware of the long-standing role of private lending networks in support of the private sector's development. The work, as such, is whether it can play regulatory catch up in due time.

The second, more significant hazard is the impact of changing market conditions, the second and third round effects of which are less easy to manage as they relate to risks associated with the composition and structure of investment vehicles in the shadow banking sector.

The first of these risks is the duration mismatch between short-term investors and the long-term projects of borrowers, thus increasing the likelihood of default. This state of affairs led the Bank of China's Chairman Xiao Gang to liken wealth management products to ponzi schemes, where capital raised from one product is used to pay off another newly matured product. The second is lending portfolio composition and particularly evidence of loans to property developers where the risk of default is greater, and where the ability to exercise sale of collateral to recover losses is unlikely to yield much under current conditions. Most analyses of the shadow banking sector report that real estate's share of these loans is growing. The third risk is investor expectations in the face of default, and specifically the presumption of guarantee even with regard to investment products.

In sum, changing market conditions can be the basis of a liquidity crunch in China. With rising defaults, demand for these new investment products is sure to decline, which will worsen the liquidity crisis and leaving the government in something of a binding spiral. They will have to weigh the costs and benefits of allowing for failure of these instruments, something which will bring the raise the ire of investors, if the recent Huaxia bank default is any indication, and its likely impact on saver confidence, in general.

In this context, the government must do what it can to ensure – at the start - that defaults do not happen, and that necessarily includes, as already underway, three things: (1) continued tolerance of shadow banking as means of sustaining economic growth; (2) a regulatory strategy to increase transparency regarding bank guarantees (if any) and asset composition of wealth management and trust products, including potentially a cap on the number of wealth management products as a share of total deposits that any bank may offer; and finally, and (3) continued willingness to bring China's underground banking system into the light through reforms that permit informal lending enterprises to register as private lending companies. This approach is currently being piloted in Wenzhou city (Zhejiang province), and ultimately may introduce a greater degree of transparency and accountability in a segment of the economy that is so important to the private sector.

The Private Sector in China: The Invisible Engine

Regarding the latter, its contribution to China's post-1978 economic development has been profound. Since 2008, the standard figure for small and medium-sized private enterprise share of GDP has been 60%. They also account for over 90% of all firms in China, and thus unsurprisingly are China's largest employer. They are also its major exporter, and as such, the social, economic, and political well-being of China is integrally linked to the well-being of its private entrepreneurs. Even so, its successes cannot be attributed to a supportive policy environment, a factor that has only begun to change rather recently.

OPENING STATEMENT OF DR. CARL WALTER
FORMER COO OF JP MORGAN CHINA
CO-AUTHOR OF *RED CAPITALISM: THE FRAGILE FINANCIAL FOUNDAITON OF CHINA'S EXTRAORDINARY RISE*

DR. WALTER: Thanks very much. It's really a pleasure to be here today, and it's nice to see the great weather outside.

I want to talk about the Chinese banking system and address the following kinds of questions: what role do the banks play, particularly the five largest banks, in the nation's economic development; what is the basis for their lending practices and to whom do they lend; how are interest rates determined; what's the quality of bank assets; and how stable are China's financial institutions in the end?

In the case of the role of banks in the financial system, in China, capital begins and ends with the big banks. The banking system has thousands of entities of its 12 second-tier banks, the urban and rural banks, the Postal Savings Bank, and rural credit cooperatives are included.

But the heart of the system is just four. In 2011, the state-controlled banks held $16 trillion in financial assets, or 75 percent of China's total financial assets, with the Big Four alone counting for almost 60 percent. These banks are too big to fail.

In terms of incremental capital raising, in spite of all the fanfare and discussion this morning, it's obvious, to me anyway, the stock markets in Hong Kong, Shenzhen and Shanghai, and even New York, are an afterthought. For example, in 2007, it was a record year for Chinese equity financing with more than $123 billion raised in all markets, both domestic and overseas.

In the same year, however, banks extended new loans totaling $530 billion and total debt issues in the bond market accounted for another $581 billion. Over the past decade, equity as a percentage of total capital raised has been measured in the single digits as compared with loans and bonds.

And who underwrites and holds all that fixed-income debt? Banks hold over 70 percent of all bonds including those issued by the Ministry of Finance.

As for foreign bank participation, despite of the WTO, they are an afterthought. They hold less than two percent of Chinese financial assets. China's foreign debt also is very minuscule, limited almost entirely to short-term credit debt.

So beyond the pressures of competition and overseas debt holders, the Party treats its banks as basic utilities to provide unlimited capital to the cherished state-owned enterprises. With all the banking under the Party's control, risk is thought to be manageable. In China, the banks are everything.

But I think that to really understand the banking system in China, you have to understand that it is part of China's fiscal system. As is well known, investment in infrastructure and fixed assets has been the major force driving China's economic growth to near double-digit levels over the past 20 years. In the past three to four years, investment contribution to GDP has exceeded 50 percent. It's at a level unseen in the history of economic development.

China's banks have provided the loans and underwritten the bonds that have financed these investments. Such lending was directed and approved by the central government based on projects by local governments. To this extent, China's banks have to be seen as part of the fiscal system. In fact, they've never been properly transformed into commercial institutions.

Who do they lend money to? This is easy. China's banks lend overwhelmingly to the state sector. Data provided by the central bank illustrate this fact: over the decade ending in 2005, loans to private sector, including foreign-invested companies, never exceeded ten percent of total outstanding loans and, in fact, declined from eight percent in 1996 to 4.2 percent in 2005 when the series ended.

A close review of the bond market issuers last year--I looked at every one of them--shows a similar picture. Of the total value raised in the bond markets, non-state issuers accounted for only 3.7 percent.

So why have the banks focused on the state sector when it's clear both to the government and the banks that the non-state sector is a vital part of the economy? Commissioner Cleveland quoted from this this morning so I'll skip it, but I think there's two parts to this answer:

The first is the banks try to lend, but they really don't know how to lend. This is a really risk-based lending decision. So how do you lend to smaller companies that really have questionable ownership of the assets that they're sitting on? So it's a really small part of their business.

And the second, a corollary to this, is lending to the state sector is easy. You don't have to think about it. You can lend in bulk. There is no political or economic risk.

How are interest rates determined? China's interest rates are set not by the market, as you all know, but are set by the central bank based, in turn, by the approval of the State Council and ultimately the Party's Leading Group on Finance and Banking. People's Bank provides a schedule of mandated minimum interest rates for borrowers with maturities out to five years. Banks have the discretion to lend to their best customers at 90 percent of the minimum rates. But there is no limit on how high banks can set borrowing rates.

Of all these rates, the one-year lending rate is the most influential, and it is paired with the one-year deposit rate. The central bank sets these two rates so that there is a three percent, or 300 basis point, spread between them. This, in effect, guarantees the banks will make a profit on their renminbi lending business.

The one-year rate is also a critical reference point for the huge primary bond market. At the end of 2012, China had issued new bonds worth $902 billion and had the equivalent of $3.7 trillion in bonds outstanding.

As in international markets, corporate and bank bonds in China are priced based on the underlying riskless yield curve, which is the Ministry of Finance. But this yield curve is a false one. It does not trade. Nonetheless, this results in bonds being priced under loan rates so that you have similar kinds of bonds and loans outstanding to the same issuer or borrower. So it makes it very difficult to have a secondary market in the country, and so there is no real yield curve that comes out.

Bank asset quality. You can look at the H-share statements of all the banks, and you'll see that non-performing loan ratios are less than one percent. How can this be possible when over the last four years, lending and total credit has approached 30 percent of GDP each year? Bankers everywhere make mistakes, but the performance of China's largest banks strain credibility.

What might the size of this be? I've done a very simple calculation here. Compared to the loan problems of ten years ago, the size could be anywhere from one trillion to $2.3 trillion against bank capital of $400 billion.

So are the banks stable? I'll finish up with this. Yes, the banks are stable. The answer is that taken alone, the government has the resources and will to make the banks stable. But the point is you got to step back and look. The banks are part of a larger system. It's almost like you have three shells here. You have the government itself, you have the banks, and you have the SOEs. You can move these bad loans anywhere you want.

Any kind of financial reform is going to be very destabilizing and at a minimum will require a second restructuring of bank balance sheets and a large recapitalization.

The question is the impact of these massive levels of debt are going to have on government borrowing or investment capacity and ultimately the country's economic growth.

I may not have been as fast as you, Regina, but I made it.

PREPARED STATEMENT OF DR. CARL WALTER
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Testimony before the US-China Economic and Security Review Commission
China's banking system and access to credit

March 7, 2013

Carl E. Walter

It is a pleasure to provide testimony to the Commission on China's banking system.
My comments seek to address the following kinds of questions. What role do China's banks, particularly its five largest state banks, play in the nation's economic development? What is the basis for their lending practices and to whom do they lend? How are interest rates determined? What is the quality of bank assets and just how stable are China's financial institutions? Finally, I will briefly touch on the role of rural credit cooperatives.

The role of banks in China's financial system

In China, capital begins and ends with the Big 4 banks[1] and Bank of Communications (the "Big 4+"). The banking system has thousands of entities if the 12 second-tier banks, the urban and rural banks, Postal Savings Bank, and rural credit cooperatives, are included. But the heart of the system includes just four. In 2011 state-controlled banks held $16 trillion in financial assets or 75 percent of China's total financial assets with the Big 4+ banks alone accounting for almost 60 percent (see Table1).

Table 1: Relative holdings of financial assets in China, FY2011 (RMB trillion)

RMB trillion	**2007**	**2008**	**2009**	**2010**	**2011**	**2011 US$ Trn**
PBOC	16.91	20.70	22.75	25.93	28.10	4.10
Banks	52.60	62.39	79.51	95.30	1,13.29	16.54
Securities companies*	4.98	1.19	2.03	1.97	1.57	.23
Insurance companies	2.90	3.34	4.06	5.05	6.01	.88
	77.39	87.62	108.35	128.25	148.97	21.75

Note: *includes brokerages and fund management companies.
Source: PBOC *Financial Stability Report*, various.

In terms of incremental capital raising, in spite of all the fanfare, it is obvious the stock markets

[1] The Big 4 are China Construction Bank, Bank of China, Industrial and Commercial Bank of China and Agricultural Bank of China.

in Hong Kong, Shenzhen, and Shanghai are an afterthought. For example, 2007 was a record year for Chinese equity financing: more than $123 billion was raised in all markets both domestic and overseas. In the same year, however, banks extended new loans totaling $530 billion, while total debt issues in the bond market accounted for another $581 billion. Over the past decade, equity as a percentage of total capital raised has been measured in the single digits as compared with loans and bonds. Who underwrites and holds all that fixed-income debt? Banks hold over 70 percent of all bonds, including those issued by the MOF (see Figure 1). Taking this a bit further, in the stock markets as well, the huge deposits placed by institutional investors seeking share allocations in the primary market are also funded by loans from banks.

China's heroic savers underwrite this risk; they are the only significant source of capital inside the system of the Communist Party-controlled domestic economy. This is the weakest point in China's economic and political arrangement, and the country's leaders understand this. This is why over the past 30 years of economic experimentation they have done everything possible to protect the banks from serious competition and from even the whiff of failure. As for foreign bank participation, in spite of the WTO, they consistently constitute less than two percent of total domestic financial assets: foreign banks are simply not important providers of capital in China. Nor does China, its banks or corporations issue foreign currency denominated debt overseas. China's foreign debt is miniscule, limited almost entirely to short term trade-related borrowings.

Beyond the pressures of competition and overseas debt holders, the Party treats its banks as basic utilities that provide unlimited capital to the cherished state-owned enterprises. With all of banking under the Party's control, risk is thought to be manageable. In China, the banks are everything.

The banks and the fiscal system

The banking system cannot be analyzed independently of China's fiscal system. In theory, a transition from a centrally planned to a market economy requires a fundamental change in the role of the government in economic management, in particular as it affects investment. As is well known, investment in infrastructure and fixed assets has been the major force driving China's economic growth to near double-digit levels over the past 20 years (see Table 2). In the past three years investment's contribution to GDP growth has exceeded 50 percent, a level unseen in the history of economic development. It is no wonder that high-speed rails now

Table 2: Drivers of GDP Growth, 2000 - June 30, 2011

	2000	2007	2008	2009	2010	1H 2011
Investment	35%	38%	38%	92%	55%	53%
Consumption	62	39	47	53	37	48
Net Exports	2	24	16	-45	8	-1
Nominal GDP Growth	8.4	14.2	9.6	9.2	10.3	9.6

Source: Wind Information

crisscross a China that is also dotted with entirely new cities, airports and endless real estate projects. China's banks have provided the loans and underwritten the bonds that financed these investments. Such lending was directed and approved by the central government based on projects submitted by local governments. To this extent China's banks should be seen as a part of the fiscal system; in fact, they have never been transformed into truly commercial institutions.

At its start the People's Republic adopted a Soviet-style planned economy. This presupposed a financial system in which banks played a very minor role as deposit taking institutions, while the national budget provided investment funds to state enterprises as grants. After 1979 this arrangement gradually changed as a weakened fiscal capacity pushed capital investment out of the budget (see Figure 2). Local governments and state enterprises were then compelled to take responsibility for investment and funds came from the banks in an arrangement that still had a strong aspect of state planning. This continued in place until the Asia Financial Crisis in 1997. The collapse of China's second largest non-bank that year brought home to the government the need to strengthen its financial institutions.

The government acted with a sense of urgency. Within a decade the Big 4+ banks had been stripped of problem assets, adopted international accounting standards, incorporated as companies limited by shares and been recapitalized using foreign strategic investors and public listings in Hong Kong. From an institutional viewpoint, the banks were no longer under the leadership of the Ministry of Finance, having been placed under the central bank during the course of their restructuring. It seemed as if the banks were indeed emerging from their dominance by the fiscal system with the explicit objective of becoming far more commercial in their operations.

This effort, however, hardly outlasted the changeover in political leadership in 2003. By 2007 the banks had been changed over to the management of the Ministry of Finance. In 2008 the global financial crisis and the collapse of China's exports compelled the government to use the banks as the channels for a massive economic stimulus. The floodgates opened and China nearly drowned in liquidity. By 2010 total outstanding bank loans alone were 131 percent of GDP and by some measures new credit in 2010 reached 40 percent of GDP. It is not surprising that M2 climbed to 2.5 times the size of the country's GDP. In short, China's big banks may appear to be commercial entities, but in reality they, and the Big 4+ state banks in particular, remain simply an arm of the Ministry of Finance and the national budget.

To whom do the banks lend money?

China's banks lend overwhelmingly to the state sector. Data provided by the central bank illustrate this fact: over the decade encompassing the bank reforms mentioned previously, loans to the private sector including foreign-invested companies never exceeded 10 percent of total outstanding loans and, in fact, declined from 8 percent in 1996 to 4.2 percent in 2005 when the data series ends. A close review of bond market issuers in 2012 shows a similar picture. Of the total value amount raised in the bond markets in 2012, non-state issuers accounted for only 3.7 percent.

Why have the banks focused on the state sector when it is clear both to the government and the banks that the non-state sector[2] is a vital part of the economy? For example, in FY2010 the private sector provided 80 percent of new job opportunities, accounting for 75 percent of urban employment. That same year total employment in China was 150 million with the private sector accounting for 110 million or 73 percent. The small and medium-size enterprises constituting this sector contributed 60 percent of China's GDP, but obtaining finance is typically their biggest challenge. Why don't China's banks lend to this incredibly important sector?

There are two parts to an answer. The first is that the banks try to lend, but have an extremely difficult time. One reason is that the majority of these companies are extremely small scale. For the larger private companies Chinese banks typically lend against collateral or a guarantee. In the case of collateral, even if it is available, banks will discount its value to offset risk and, in the end, any company has only a limited amount. Such asset-backed lending limits an enterprise's ability to grow. As for guarantees, perhaps not so amazingly there were some 6,000 guarantee companies in China in 2011. Local governments back a few of these companies and banks treat their guarantees as of value. The rest are privately established, thinly capitalized and unprofessionally managed. In short, banks have a difficult time lending to this sector. Such loans as are made are inevitably constitute only a small percentage of overall bank lending.

The second part of the answer is a corollary of the first: lending to the state sector is easy. The basis of the lending decision is straightforward: the banks are state-owned, the state enterprises are also state-owned: where is the risk? As for the now famous local government borrowing platforms, these are simply government bodies in the guise of corporations and often carry an implicit government guarantee. Bankers will never be criticized for such lending. In addition, the 116 large centrally-owned state groups can borrow in bulk due to their huge, national operations.

When the 2008 financial crisis broke out and the central government launched its massive economic stimulus, local governments were asked to provide for approval all outstanding

[2] The non-state or private sector here refers to small and medium sized enterprises not directly owned by the state. It excludes foreign-invested enterprises and joint ventures.

projects that required funding. Based on such central government approvals the banks simply provided the funds. As for the larger state enterprises, the banks had no problem making loans; the enterprisess, in effect, became a part of the fiscal mechanism to stimulate the economy. The ease of lending huge amounts without concern for risk helps explain why a planned US$750 billion equivalent stimulus package turned out to be more than twice as much (see Figure 3).

How are interest rates determined?

China's interest rates are not set by the market, they are set by the central bank based, in turn, by the approval of the State Council and ultimately the Party's Leading Group on Finance and Banking. The People's Bank provides a schedule of mandated minimum interest rates for borrowers with maturities out to five years. Banks have the discretion to lend to their best customers at 90 percent of the respective rate; there is no limit to how high banks can set borrowing rates.

The one-year lending rate is the most influential lending rate and it is paired with the one-year deposit rate. The central bank sets the two rates so that there is a 300 basis point (or three percent) spread between them (see Figure 4). This, in effect, guarantees that banks will make a profit on their lending business.

The one-year rate is also a critical reference point for China's huge primary bond market. As of FY2012, China issued new bonds with a value of US$902 billion and had the equivalent of US$3.7 trillion in bonds outstanding. As in international markets, corporate and bank bonds in China are priced at a spread to the underlying MOF yield curve. For example, the minimum 15-year AAA-to-MOF spread is circled on Figure 5.[3] The trouble in China, however, is that the MOF yield curve is largely disregarded in favor of the central bank's loan rates. It is disregarded because the yield curve does not truly exist, as is explained further on. When a bank underwrites a bond, therefore, it will compare its potential return with that of a loan of a similar maturity to a similar borrower. The issuing company will, of course, consider the same thing. To the extent that this comparison to loan rates influences the underwriting decision, bond

[3] The Ministry of Finance is rated by China's five rating agencies as an AAAA.

Table 3: Yields on loans, investment and restructuring bonds, *2008-2009*

	2008			2009		
	Loans	**Bonds**	**Bonds from restructuring**	**Loan s**	**Bond s**	**Bonds from restructuring**
CCB	7.16	3.64*	2.01	5.35	3.11*	2.13
BOC	6.12	3.63*	2.10	4.44	2.73*	2.25
ICBC	7.07	3.88	2.23	5.21	3.38	2.19

Source: Bank FY2008 financial statements
Note: * CCB and BOC bond rates are calculated on portfolios that include the restructuring securities, hence returns are pulled down; ICBC rates have been separately calculated. Restructuring securities were issued by the asset management companies to each bank to finance the purchase of bad loan portfolios from the banks when each bank was recapitalized.

pricing does not reliably reference the MOF yield curve. In actual practice, the MOF curve is frequently disregarded and corporate and financial bonds are priced lower than the curve would indicate (see Table 3). This results in loans and bonds of similar terms to the same borrower being priced very differently: bonds are a public instrument compared to loans – the market and anyone interested can see the cost of borrowing by bonds - and issuers compete for the best pricing. Banks, on the other hand, are motivated by added compensation from the issuer from other supplemental businesses. All involved know full well that, as mentioned, the MOF yield curve is a fiction and, as one Chinese banker put it, “Bond underwriting is policy business.”

It is precisely because corporate and other bonds are set lower than equivalent loan pricing that there is effectively no secondary trading market in China despite the massive primary market. And because there is no trading, there can be no real yield curve. For example, on January 4, 2010, the entire bond market saw only 615 trades (see Table 4), among which government bonds traded the least of all, representing only 3.3 percent of the total value traded. In contrast to the US$25 billion equivalent in bond value traded that day in China, the average daily trading volume in the US debt markets is around US$565 billion, a figure itself far in excess of the average total daily *global* equity trading of US$420 billion. With such trading volume across all maturities a market-defined yield curve easily emerges from the pattern of trading.

Table 4: Interbank bond trading summary, *January 4, 2010*

	Value Traded *(RMB mm)*	**No. of Trades**	**% Value Traded**
MTNs	31,050	149	18.3
Enterprise bonds	10,909	97	6.4
Government bonds	5,570	32	3.3
PBOC notes	31,550	74	18.6
CP	15,220	144	9.0
Financial bonds	75,390	119	44.4
Total	169,689	615	100%

Source: Wind Information

The catatonic nature of the bond markets is of great significance to the banks since they are the ultimate holders of some 70 percent of all bonds outstanding. As Figure 6 shows, bond portfolios account for 25-30 percent of the total assets of the Big 4 banks. These bonds are overwhelmingly held in investment accounts so there is no need to mark them to market. Given the discrepancy between bond portfolio values and secondary market values as suggested by loan pricing, any liberalization of interest rates would inevitably have a major impact on bond portfolio valuation and, consequently, on bank profitability and capitalization.

Bank asset quality

Based on the audited financial statements provided by international auditing companies to the overseas regulators and minority shareholders of the Big 4 banks the quality of their loan portfolios is outstanding. Non-performing loan ratios are less than one percent (see Figure 7). One might ask how this can be when bank lending over the years 2009-2012 approached 30 percent of GDP each year. Bankers everywhere routinely make mistakes, but the performance of China's largest banks during this period indicates either that no mistakes were made or that, somehow, the mistakes have been hidden because without a doubt there are non-performing assets out there in China's financial system.

What might be the size of the bad debt problem? Any answer to this question must be speculative, but here are two simple ways to think about it. In the 1999-2005 period the Big 4+ banks were restructured and ultimately listed on the Hong Kong Stock Exchange. Approximately RMB3 trillion (US$400 billion) in bad loans were removed from bank balance sheets during this process. These bad loans constituted about 25 percent of total loans, which themselves equaled 75 percent of GDP. Using the same logic, assume that just 12 percent of total loans as of 2011 have gone bad. This would equal approximately RMB7 trillion (US$1.1 trillion) on total loans of RMB60 trillion, at FY2011 138 percent of GDP. A second way would be simply to say 25 percent of RMB60 trillion, or RMB15 trillion (US$2.3 trillion). The actual number, which no one anywhere can know with any certainty, may lie somewhere between the two.

This is just the calculation of problem loans; there are also the bond portfolios to consider; a decade ago there were only government bonds. At year-end 2011, banks held a total bond portfolio of RMB14.6 trillion of which RMB4.2 trillion were corporate loans. If 12 percent were to go bad the figure would add another RMB500 billion to the bad loan portfolio figure above. With total bank capital equal to RMB2.9 trillion, these are huge numbers and would indicate the need at some point in the future for a massive round of bank capitalization.

If the amount is so large and bank auditors aren't catching it, then where has it gone? China's experience with bank restructuring a decade ago and the apparent growth of its debt capital markets, including certain kinds of asset-backed securities, have provided the channels by which problem loans are either removed from bank balance sheets or transformed into contingent liabilities.

First, the four asset management companies that relieved the banks of their bad loans portfolios a decade ago are back in business. At the start of 2012 there was noise that these entities would be incorporated and listed and the most successful of the four, Cinda, has indeed incorporated and even accepted two foreign "strategic" investors. All have hired international audit firms to go over their books and Cinda had even made public its accounts for 2010. These show a doubling of assets from US$8 billion to US$17 billion in a portfolio of "marketable securities" that includes both bonds and wealth management products. Unfortunately, but not surprisingly, accounts since 2010 have not been provided and the IPOs of these four companies have been delayed. With funding provided by the central bank and the banks themselves, these companies will play a major role once again.

Second, the bank/trust company nexus has grown rapidly since 2007. At that time banks were under pressure to control loan growth and used trust companies to securitize loan portfolios for sale to wealthy Chinese bank retail clients; the loans disappeared off-balance sheet. After the green light went on for stimulus lending in late 2008, banks had similar problems: with loans expanding so rapidly, how could they stay within the regulatory liquidity ratio (the loans to deposits ration is 0.75 for all except the Big 4+ where it is 0.60). Even more loans were moved off bank balance sheets as loan and trade bills were securitized and sold to investors. One result was that bank depositors rapidly got used to rates of return better than the PBOC mandated deposit rates. Banks suddenly found themselves in competition to provide higher yield products to keep an increasingly fickle depositor base. According to Fitch, as of FY2012 these "wealth management products" now equal 13 percent of total Big 4+ bank deposits and a similar amount of bank loans. Problems with these securities are beginning to emerge as this off-balance sheet business is illiquid and depends on on-balance sheet resources in the event of problem. The size of this business increasingly calls the integrity of bank assets into question.

Third, local governments have actively accessed the bond market to restructure loans and extend maturities of their obligations. At FY2010 outstanding bank loans and bonds to such borrowers totaled RMB9.2 trillion according to the government auditing agency; of this over 40 percent was to have been repaid by FY2012. Recently, however, a senior bank regulator noted that actual outstandings as of FY2012 was RMB9.1 trillion. The only explanation is that these loans and bonds were refinanced (see Figure 8). Maturities were also extended; bank loan portfolios are opaque, but China's bond markets are not and this data supports the conclusion.

In 2012 corporate bond issuance increased nearly three times over 2011, while bank loans declined slightly to their lowest level in years. Local corporates, including the notorious local government borrowing platforms, accounted for nearly 25 percent or RMB1.5 trillion of total corporate bond issuance in 2012. Of these new issues 95 percent had maturities over five years. It seems reasonable to suggest that at least a portion of these bonds were used to refinance bank loans; others were used to restructure existing debt securities. From the bank point of view this simply represents a transfer from the loan to its investment security portfolio and kicking the problem down the road.

Fourth, the role of China Development Bank (CDB) in restructuring local government debt cannot go unmentioned. CDB is funded approximately 80 percent by the bond markets, ultimately the Big 4 banks are its principal investors, and 20 percent by loans from the central bank. In terms of annual bond issuance, in some years CDB has rivaled and even surpassed the Ministry of Finance. According to its mission statement, this policy bank invests in infrastructure projects across the country. But in the last two years it has begun to work with local governments to restructure short-term commercial bank borrowings into its own long-term loans. Basically, CDB is buying up the local government loans made by the commercial banks. To what degree this has happened is unknown – CDB does not publish detailed financial statements. Nonetheless this is another example of how bank loan portfolios are being transformed into bank investment security portfolios.

For the banks all of this represents a huge challenge in managing its funding activities. While its loan and bond portfolios are increasingly long term, they are being funded by short term deposits a good portion of which are being taken off balance sheet by the new wealth management products. If this trend continues, bank balance sheets will become increasingly illiquid. This will make it increasingly difficult for China's economic growth to be driven by bank lending into investment projects; without such lending growth might drop significantly.

Stepping back a bit, this refinancing activity also shows how loans and other debt obligations of local governments are being assumed by central government agencies. The scope of China's fiscal debt, in other words, is expanding beyond the simple definition of bonds issued by the Ministry of Finance. Through its capitalization of the asset management companies, special purpose vehicles holding the problem loans of two of the Big 4 banks, its outright ownership of the Big 4 banks themselves and the activity of the China Development Bank, the ongoing clean up of the 2009-2012 binge lending is dramatically increasing central government fiscal burdens to levels rapidly approaching those of the developed world (see Figure 10). Put another way, China's growth miracle has been build on debt.

How stable are China's financial institutions?

If the question relates only to China's banks, then the answer is that taken alone the government has the resources and the will to make the banks stable. Since the banking system is the very core of the financial system, which itself is the foundation of Party rule, there is no question but that the Party will do everything it can to ensure both perceived and actual financial soundness. History has shown that the Party has used all necessary means to strengthen the banking system when crises have broken out. The most recent example occurred when the Asia Financial Crisis broke out in 1997. The Party immediately brought bank capital up to international required levels and embarked on a path that further strengthened bank capital by using its, at the time, scarce foreign exchange reserves.

With the massive reserves of today and the experience of the first found of restructuring, there is no question that the banks can be maintained as stable institutions *as they now operate*. But as the wealth management products illustrate, liberalization of the framework now bounding the financial system will potentially be very destabilizing and, at a minimum, will require a second restructuring of bank balance sheets and a large recapitalization. This points to the bigger question: the impact that massive levels of debt will have on government capacity and, ultimately, the country's economic growth.

The role of rural credit cooperatives in China's financial system

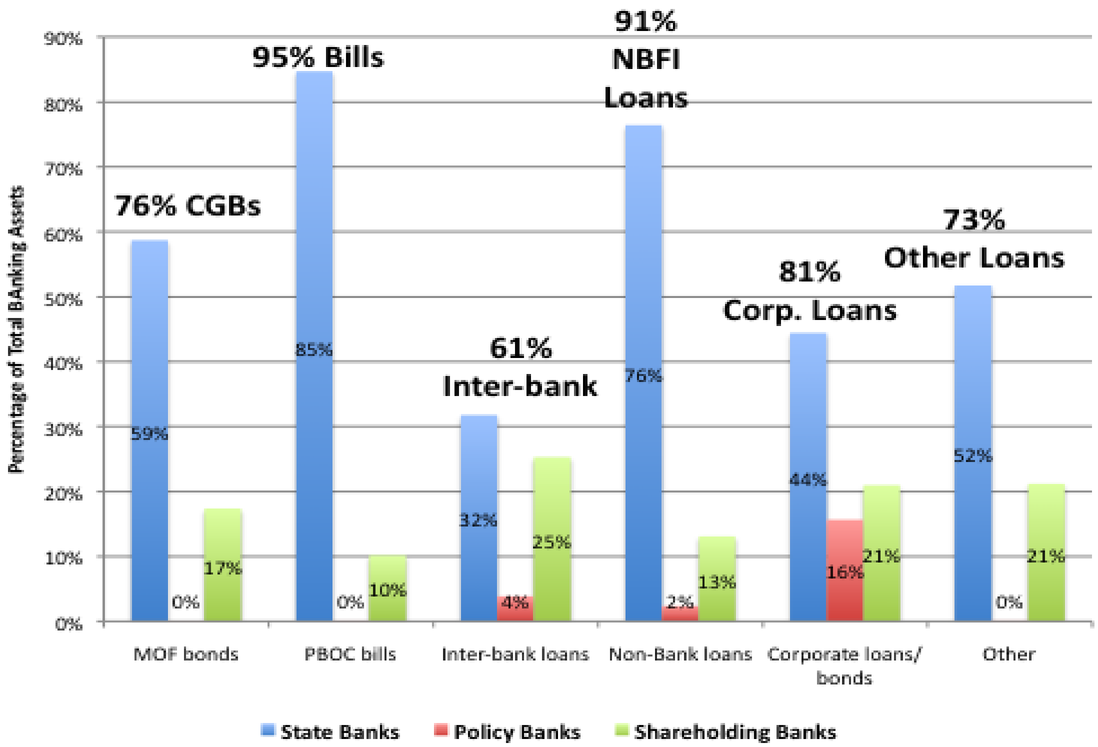
Rural credit cooperatives have proven to be a headache over the past 30 years of China's development. Their mission is to help finance farmers, but because they hold significant amounts of deposits they have always been a rich source of capital for cash-strapped local governments. Efforts are ongoing to transform these entities into larger and better-managed rural commercial banks just as was done a decade ago with urban credit co-ops. The process has not been fast given the interests involved.

The central bank provides financial data on a consolidated basis for each broad type of financial institution. As of FY2010, the most recent data, rural credit co-ops held around 12 percent of total national household deposits (see Figure 11); the same data shows that rural commercial banks are still very few and very small. On the asset side, these deposits are used to help fund the interbank market (about 8 percent), invest in corporate bonds (about 6 percent) and "other" (about 19 percent of the national "other" category; see Figure 12). In Chinese "Other" translates directly as "Other Resident Departments," which apparently refers to local government entities.

During the period of 1997-2002, the first effort at a real financial clean-up, the cost to the central bank, in effect China's deposit insurance agency, of making good on the household deposits of failed institutions including rural credit co-ops was RMB141 billion. There can be no question but that the central bank would make good on the deposits of farmers in the event of the collapse of a rural credit co-operative.

Appendix: Testimony before the US-China Economic and Security Review Commission
China's banking system and access to credit
March 7, 2013
Carl E. Walter

Table 1: Bank Holdings of Financial Assets, FY2010



Source: PBOC 2010

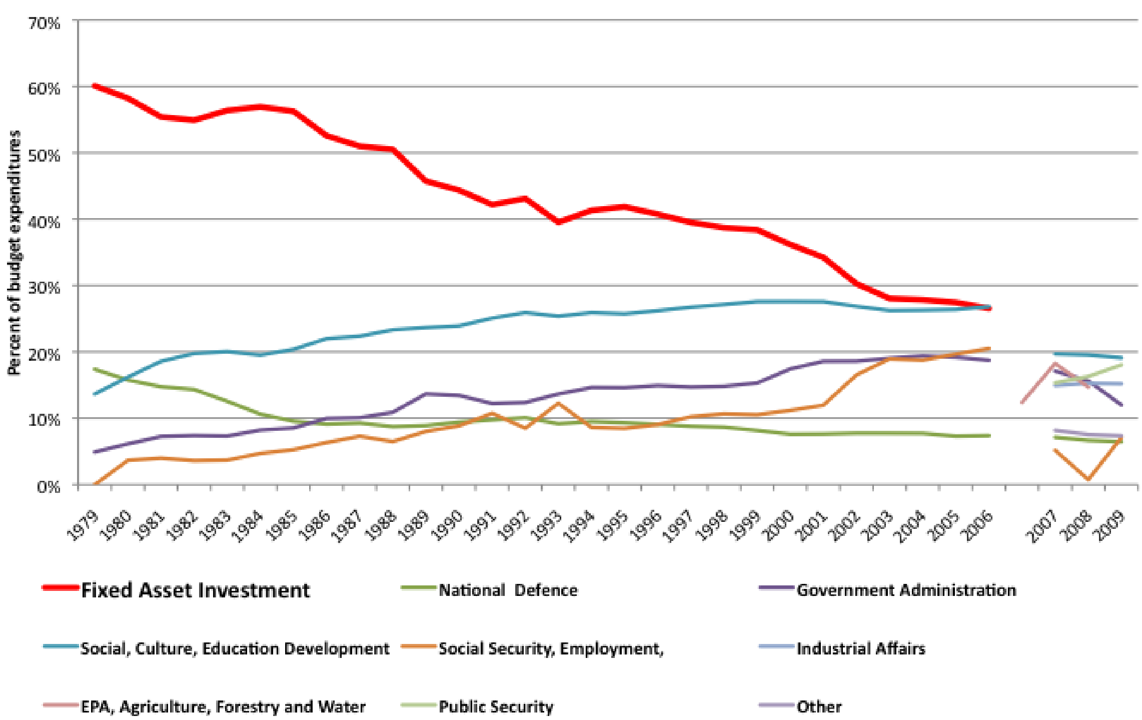
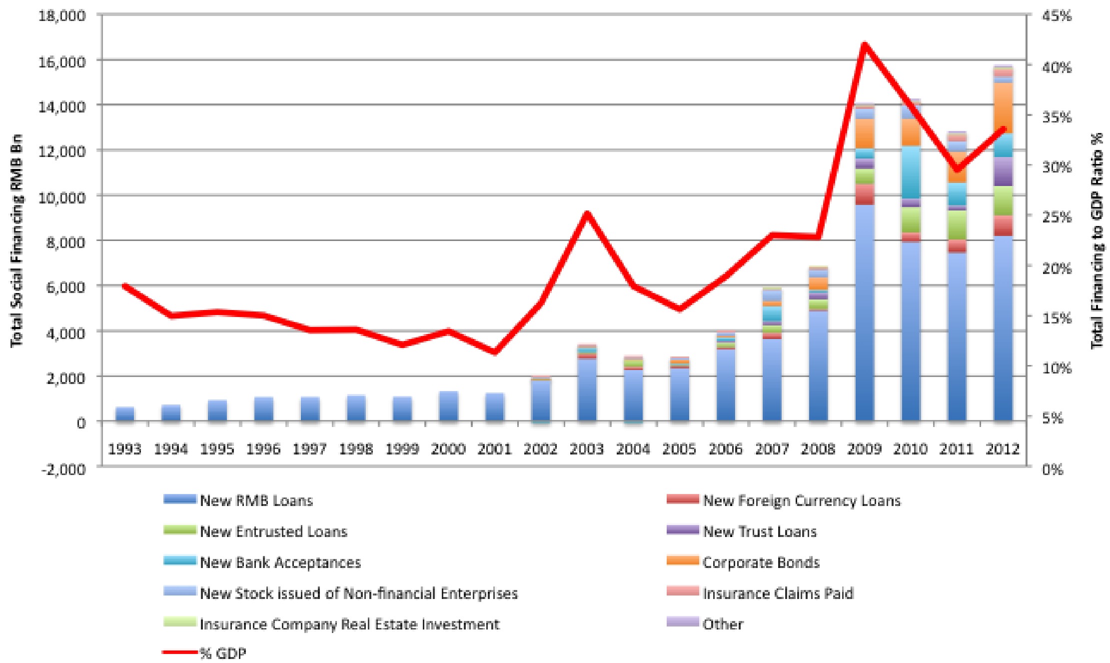
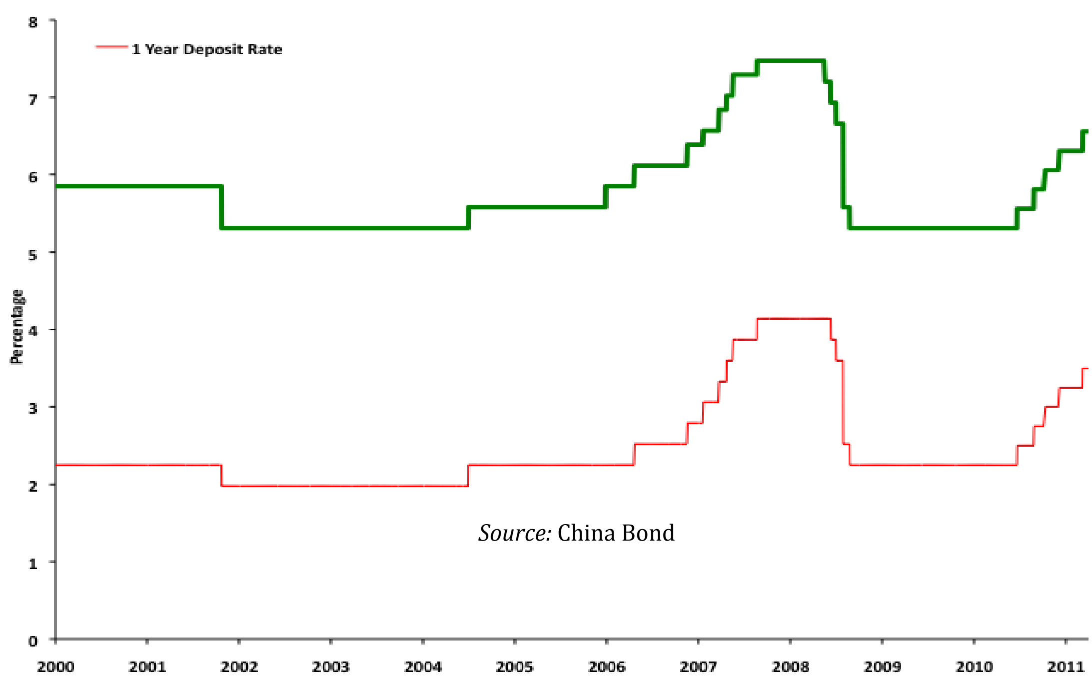


Figure 2: Fixed asset investment as proportion of total national budget expenditures
Figure 3: Total Societal Financing, 1993 - 2012



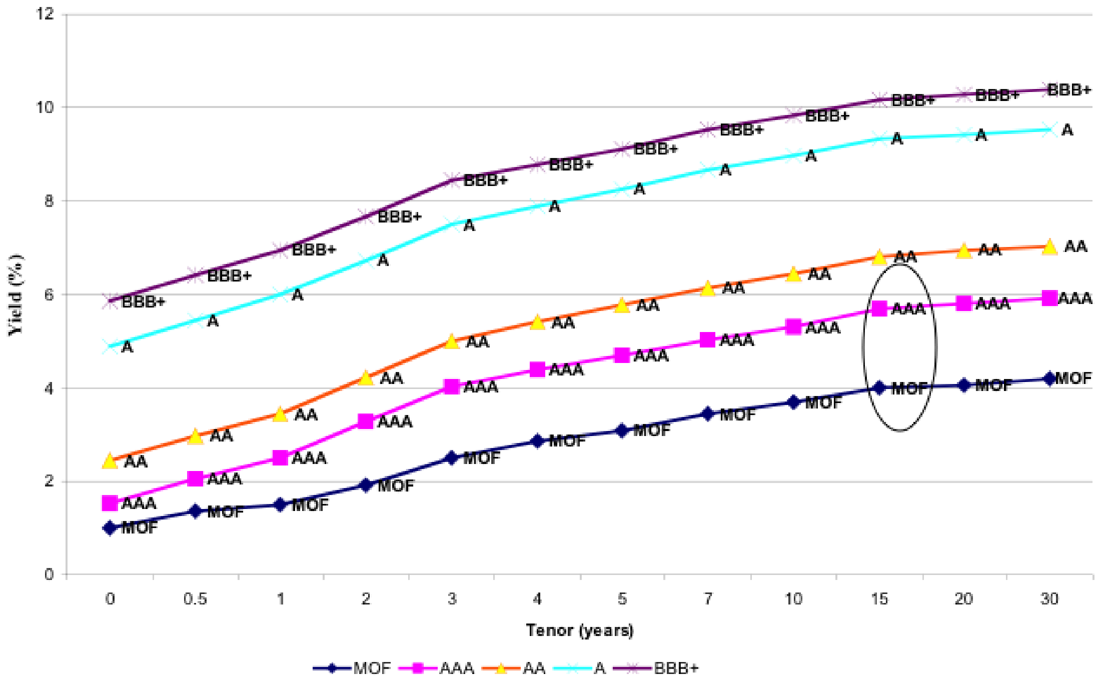
Source: People's Bank of China

Figure 4: One-year PBOC RMB deposit versus loan rates, 2002 - 2010



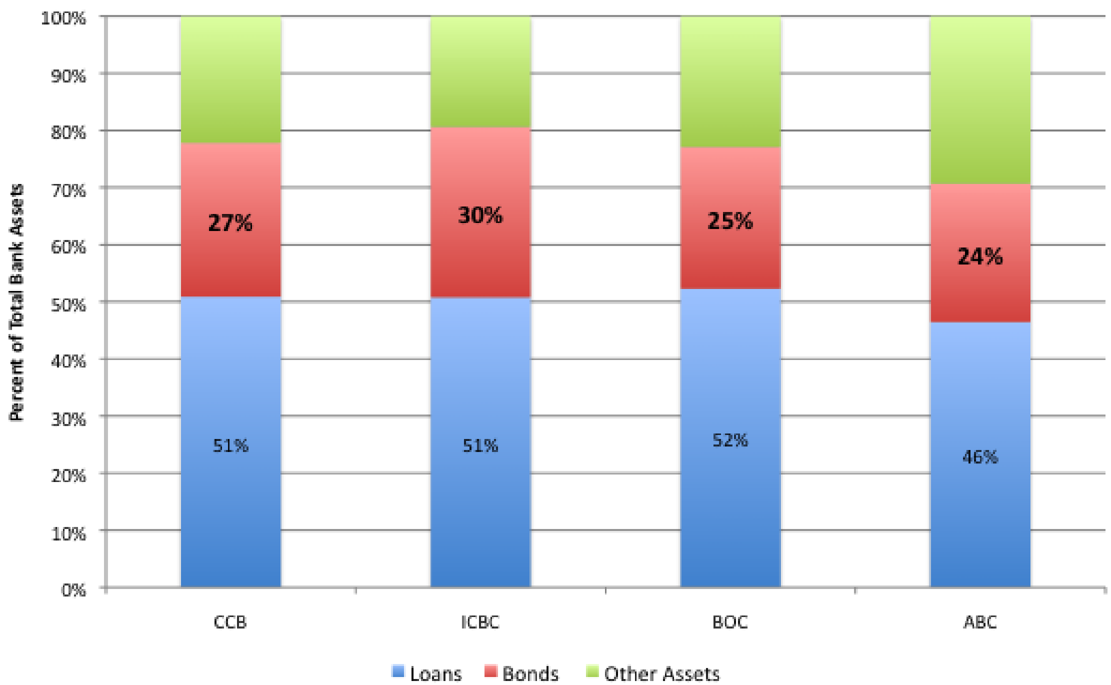
Source: China Bond

Figure 5: PBOC mandated minimum spreads over MOF by tenor and credit rating



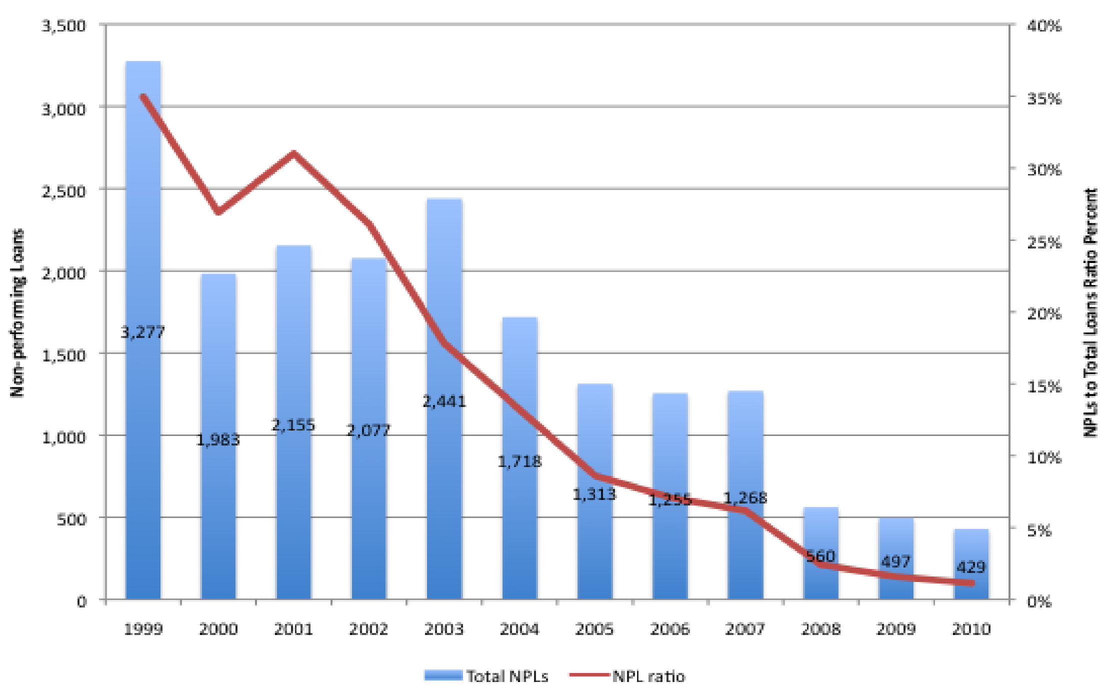
Source: China Bond, as of October 20, 2009

Figure 6: Big 4 bond portfolios as a percent of total assets



Source: Bank 2010 H-share financial statements

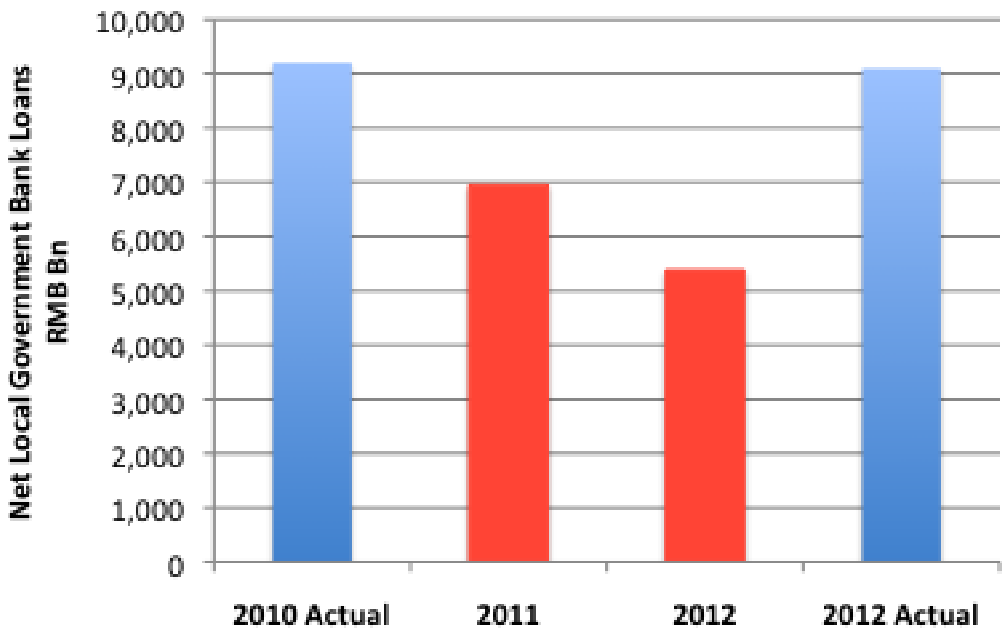
Figure 7: Non-performing loan trends, top 17 Chinese banks, 1999-2010



Note: Data for 1999–2002 based on Chinese classification system; from 2003 on based on international classification system.

Source: 1999–2002, Li Liming: 195; 2003–2010, Chinese Banking Regulatory Commission.

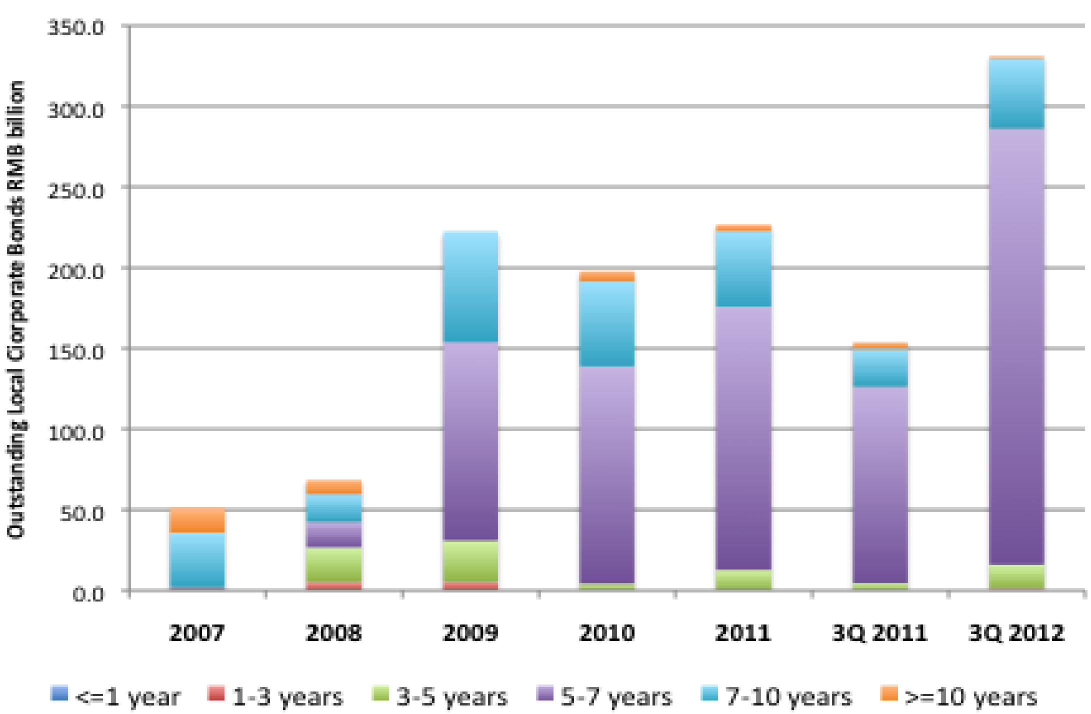
Figure 8: Local government net loan and bond outstandings



Source: National Audit Office; author's calculations

Figure 9: Trends in outstanding local corporate bonds by maturity, 2007-3Q 2012

Source: Wind

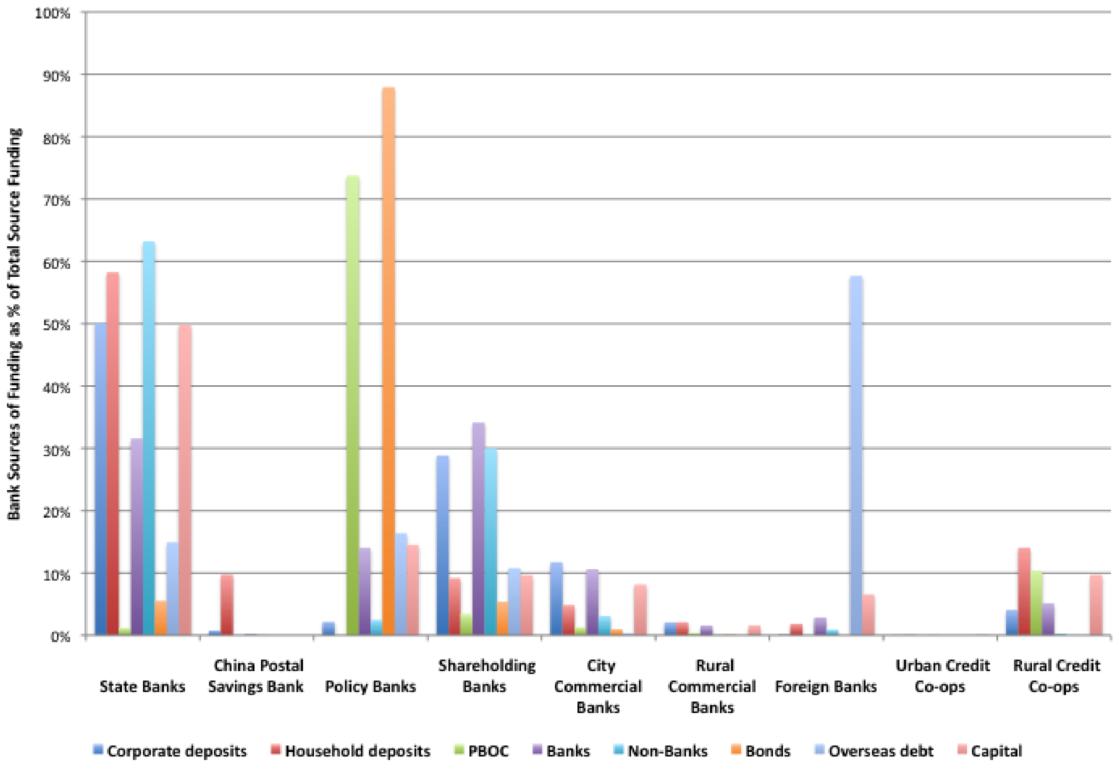


Information; does not include MTNs as breakdown by issuer is not available

Figure 10: Trends in outstanding public debt: US, Europe and China, 1990-3Q 2012

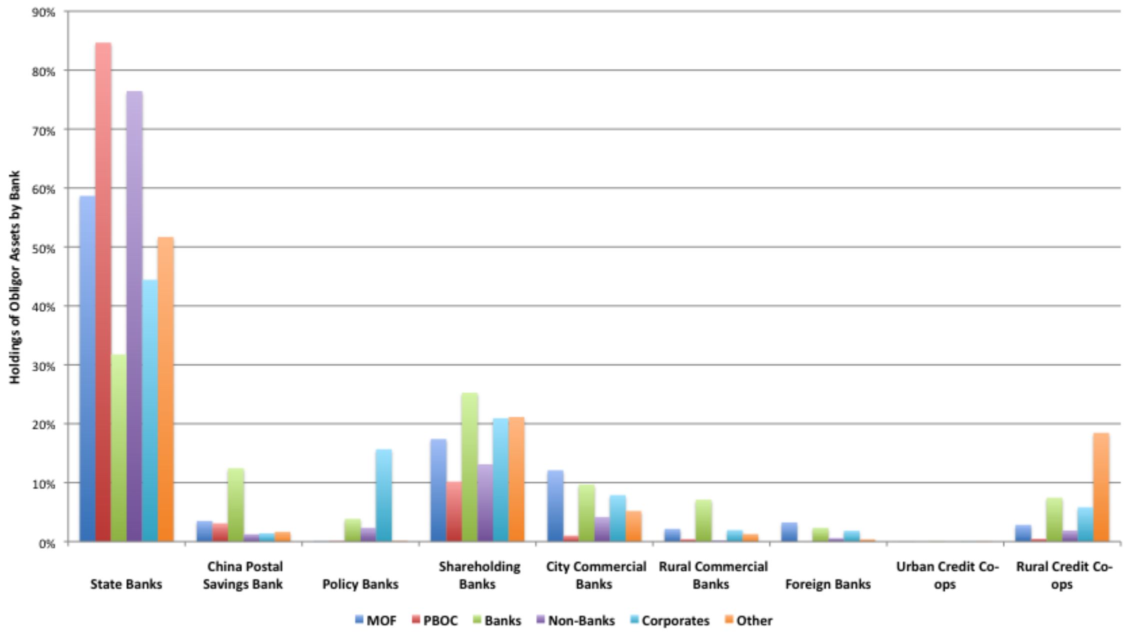
Note: China Narrow = MOF + policy banks + Ministry of Railways + bank sub debt; China Wide adds local gov't debt + estimated NPLs; China 2012 projected.
Source: EuroStat; IMF; China Bond; Wind Information; see Walter and Howie, Table 8.1

Figure 11: Sources of Financial Institution Funding, FY2010
Note: Each funding source totals 100% so, for example, rural credit co-ops have approximately 12 percent of total



household deposits.
Source: PBOC, Financial Stability Report 2011

Figure 12: Financial Institution Composition of Assets, FY2010



Source: PBOC Financial Stability Report, 2011

PREPARED STATEMENT OF LYNETTE ONG
ASSOCIATE PROFESSOR OF POLITICAL SCIENCE
UNIVERSITY OF TORONTO
(WRITTEN TESTIMONY ONLY)

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

"China's Banking System and Access to Credit"

By

Dr. Lynette H. Ong

Department of Political Science and Asian Institute, Munk School of Global Affairs

The University of Toronto

March 7, 2013

Commissioners Cleveland and Goodwin, and other members of the Commission, it is my pleasure to provide testimony on China's banking system. My name is Lynette Ong. I am an associate professor at the Munk School of Global Affairs at the University of Toronto in Canada. My comments will focus on the rural credit sector in China, particularly the rural credit cooperative system, looking at its importance to the rural sector, its lending patterns, and the role of local governments in loan allocation.

Introduction

Rural credit cooperatives (RCCs) are the backbone of official finance in rural China. They collectively account for 80 percent of rural deposits and loans. Despite their overwhelming importance to the rural economy, they have long been the weakest link in China's financial system. Saddled with mountains of bad loans, the official non-performing loan rate stood at 50 percent in the late 1990s.[1]

The ownership nature of RCCs has always been ambiguous. Prior to 1996, they were subsidiaries of the state-owned Agricultural Bank of China. Between 1996 and 2003, they were rural credit institutions loosely managed by local branches of the central bank, the People's Bank of China (PBoC). Since 2003, they have been managed by provincial credit unions, which report to their respective provincial governments.

Notwithstanding the frequent changes in the reporting structure of RCCs, local party or government influence over loan allocation has been a constant throughout. This has resulted in a large proportion of loans being allocated to local government-related borrowers, who often fail to repay in full.

Starting in 2003, a restructuring process for RCCs has seen the better-performing ones privatized and transformed into rural commercial banks and rural cooperative banks. As of 2010, the RCC system included 2,646 RCC county unions, 223 rural cooperative banks, and 85 rural commercial banks. Collectively, RCCs are still the dominant credit institutions in rural areas, covering about 50 percent of all townships in the country. This dominance continues despite shrinking coverage and smaller networks in rural areas since the late 1990s due to ongoing cost-cutting by the central government. Beijing is now pushing for the transformation of all county RCC unions into a shareholding system, paving the way for them to become rural commercial banks. The underlying motive is to make RCCs self-sustaining commercial institutions.

To put them in a national perspective, RCCs account for 10 percent of total deposits and loans nationwide (Table 1). Overall, the financial sector is still dominated by the state-owned commercial banks,[2] which account for about half of total deposits and loans. Shareholding commercial banks,

[1] The unofficial rate was likely much higher, around 70-80 percent.

[2] Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and

such as China Merchants Bank and Shanghai Pudong Development Bank, come second with a collective share of about 16 percent of total deposits and loans.

Table 1 Financial Institution by Size of Loans and Deposits (2010)

	LOANS	%	DEPOSITS	%
State-owned commercial banks	24,137	47.4%	38,536	52.6%
Shareholding commercial banks	8,098	15.9%	11,264	15.4%
State-owned policy banks	6,721	13.2%	801	1.1%
Rural comm. banks and rural credit co-ops	4,752	9.3%	7,276	9.9%
City comm. banks and urban credit co-ops	3,567	7.0%	6,047	8.3%
Postal Savings Banks	841	1.7%	3,238	4.4%
New rural financial institutions[1]	60	0.1%	75	0.1%
Others[2]	2,724	5.4%	6,063	8.3%
Total	**50,900**	**100.0%**	**73,300**	**100.0%**

Source: Author's own calculation from *Almanac of China's Banking and Finance* (2011), and *Report of the Implementation of the Monetary Policy of China* (4th quarter, 2010)
All figures in billion *yuan*, 2010 year-end.

1. New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.
2. Others consist of non-bank finance companies and overseas banks.

The Rural Credit Cooperative (RCC) system and its reform

In contrast with their earlier weak performance, RCCs enjoyed a net profit of 23.3 billion *yuan* and an official non-performing loan rate of just 5.6 percent in 2010. The remarkable improvement in their asset quality can be largely attributed to subsidies and bailouts from the central government.

In the late 1990s it became abundantly clear to central policymakers that without a capital injection the RCC system was simply unsustainable. The capital adequacy ratio and net equity of RCCs were in negative territory, meaning their liabilities were so enormous that they were eating into shareholders' equity. Furthermore, more than half of RCCs nationwide (55 percent, or 19,542 credit cooperatives) were technically bankrupt at the time. By this, I mean that their asset value was smaller than the sum of their liabilities and equity, implying that they would have closed down if they had operated under market conditions.

The problem was that for the central government, shutting down RCCs was very much out of the question. RCCs are both the primary holders of rural households' savings and the primary providers of households' credit. Closing them down would deprive rural residents of a major formal credit service and expose many to abject poverty. More importantly, as I have argued in my new book,

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Bank of Communications.

Prosper or Perish: Credit and Fiscal Systems in Rural China, because RCCs hold the bulk of rural savings, signs of financial instability would trigger panic and social unrest in the countryside; there have been several instances of failed credit institutions triggering social unrest in rural China. In other words, RCCs were "too big to fail" because of their political significance.

This risk of social instability is buttressed by rural residents' perception that their savings at credit cooperatives are guaranteed by the central government. Although the central government is under no formal obligation to do anything should RCCs fail, it has strong incentives to keep the RCC system from collapsing. Indeed, while the central government got rid of many unstable financial institutions after the Asian Financial Crisis in the late 1990s, RCCs have remained in business despite having negative net assets. In 2007, the PBoC provided two forms of financial assistance— 168 billion *yuan* in debt-for-bonds swaps and 830 million *yuan* in earmarked loans— to assist RCCs in disposing bad assets and writing off historical losses.

As part of the restructuring, RCC management rights were transferred from the PBoC to the provincial RCC unions, which represent their respective provincial governments in managing the credit cooperatives in their territories. The policy intention is to make regional governments financially responsible for RCCs in their jurisdictions.

RCCs are best understood as a myriad of locality-based credit institutions with varying financial performance and asset quality. Reforms have also transformed some credit cooperatives with better asset quality in economically developed regions into rural commercial banks and rural cooperative banks.

Rural commercial banks conduct business like any urban commercial bank and are similarly bound by few policy requirements. Rural cooperative banks are a hybrid of rural commercial banks and credit cooperatives. While they can raise equity by bringing in individual and enterprise investors, they are required to allocate a certain proportion of their loan portfolios to agricultural projects. Though rural credit cooperatives are largely profit-oriented institutions, they are strongly encouraged to lend to rural households and agricultural borrowers.

Of the three kinds of institutions, credit cooperatives have the fewest workers per unit (208), followed by cooperative banks (363) and commercial banks (1137) (Table 2). This indicates that rural credit cooperatives are still predominantly small-scale credit institutions serving local rural communities, while rural commercial banks, at the other end of the spectrum, are relatively large banks in urbanized areas.

Table 2 Rural Credit Institutions by Type (2010)

	No. of units	**No. of workers**	**No. of workers/unit**
Rural credit cooperatives	2,646	550,859	208
Rural commercial banks	85	96,721	1137
Rural cooperative banks	223	81,076	363
New rural financial institutions & Postal Savings Banks	396	152,820	385
Total	3,350	881,476	263

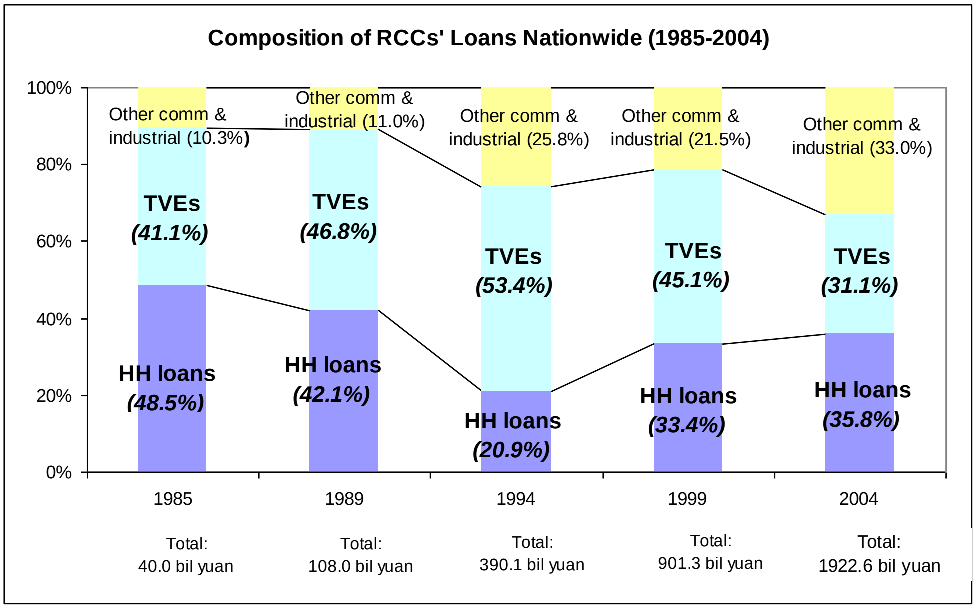
Note: New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.
Source: *Almanac of China's Banking and Finance* (2011), p.471

Lending decisions and loan allocation patterns

Historically, an overwhelming proportion of rural savings had been directed to finance the development of collective township and village enterprises (TVEs). TVEs were largely local government-owned enterprises before their privatization in the mid- to late-1990s. They accounted for more than half of RCCs' loans in the mid-1990s, while rural households took up only one-fifth of the total (Figure 1). While TVEs contributed to economic development by creating jobs in the countryside and augmenting local government coffers, they undoubtedly crowded out credit that could have been allocated to farmers and private small and medium-sized enterprises. This loan allocation pattern basically persisted through to the 2000s, though some or all of the TVEs had been privatized by then.[3]

[3] Data for RCC loan allocation nationwide is not available after 2004.

Figure 1 Composition of RCC Loans Nationwide (1985-2004)



Source: Almanac of China's Finance and Banking, *various years*.

Up until the mid- to late-1990s, RCC personnel decisions were made by local Chinese Communist Party leaders. Since credit managers were appointed and evaluated by local party secretaries, they were first and foremost accountable to the party, rather than to depositors or shareholders. This is an institutional feature that is not unique to RCCs, but common across all state-related financial and non-financial institutions in China. RCCs are often urged to support local government enterprises and projects in order to help promote local development. Even though local party leaders no longer appoint bank managers, they can still influence loan allocation decisions.

How stable are the RCCs? They have become much more financially sound after the central bailout. However, RCCs—like all other banks in China—were drawn upon to support the 2008-09 stimulus program. Despite the lack of concrete data, we are almost certain that their asset quality has deteriorated in recent years, even though not all the loans have immediate maturity dates, meaning that indicators may not manifest themselves until later. That said, given the locality-based nature of RCCs, any financial contagion is likely to be contained and would not spread across different regions.[4]

Fiscal decentralization and local governments' fiscal constraints

To fully appreciate why local governments interfere in loan allocations, it is important to understand the nature of China's intergovernmental tax system. It is too simplistic to dismiss the interference as

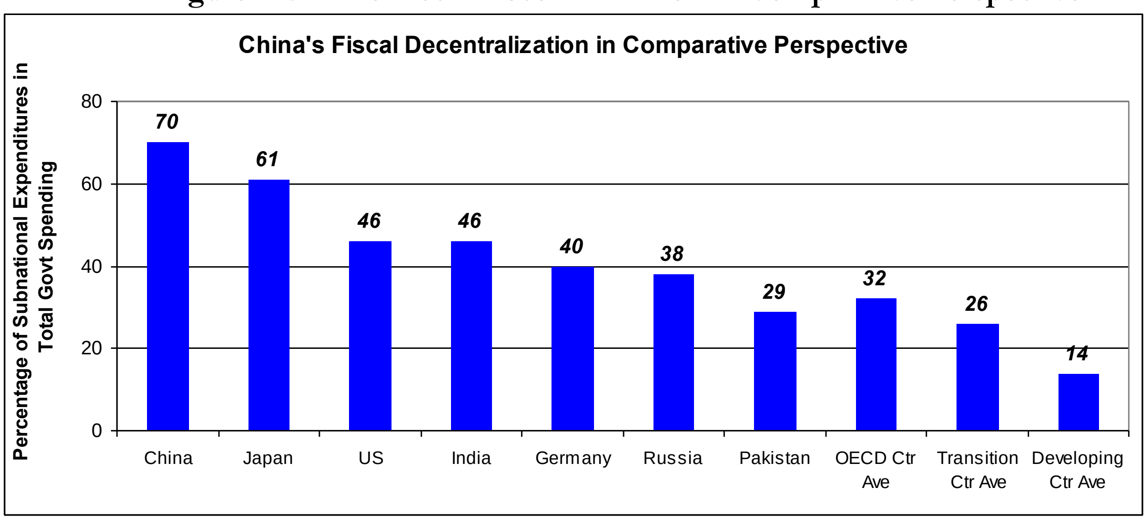
[4] An exception may be if negative news about RCCs in neighboring towns prompts depositors to rush to withdraw their savings from local credit cooperatives *en masse*. This could trigger bank runs and cause financial instability to spread.

a form of corruption, though venality does account for the less-than-arm's-length relationship to some extent.

With Deng Xiaoping's reform and opening in the early 1980s, China underwent tremendous fiscal decentralization, with fiscal powers being devolved from the central to subnational governments. Local authorities were given the prerogative to collect and retain tax revenues, giving them the incentive to promote industrialization and local economic growth. Meanwhile, subnational governments were made responsible for providing social services to local residents, including education, healthcare, pensions, and unemployment benefits.

However, in 1994, the central government recentralized major tax revenue sources, while leaving local expenditure responsibilities unchanged. This has resulted in highly lopsided revenue-expenditure ratios for local governments. Although China is a unitary state, the World Bank has called it one of the world's most decentralized countries in terms of the share of subnational expenditures in total government spending.

Figure 2 China's Fiscal Decentralization in Comparative Perspective



Local governments require resources to promote economic activities and fulfill their fiscal functions. Under severe revenue constraints, local officials tap into the financial resources of local credit institutions. Traditionally, the state-owned banks have played an important role in supporting state-owned enterprises. In rural areas, RCCs perform a similar function, acting as indispensable financiers for local government projects. Throughout the 1980s and 1990s, RCC loans were mostly used to support development of local government-owned TVEs. Despite the privatization of TVEs and the collapse of many unprofitable ones, RCC loans are still channeled to finance local government projects, including infrastructure spending and real estate development.

What are the implications of channeling savings to finance fiscal expenditures? As we know, financial and fiscal systems are supposed to play different functions. Financial systems intermediate capital between savers and borrowers, while fiscal systems allow governments to draw resources from taxpayers to redistribute income and provide essential public goods and services. High bad debt levels in the financial system can be partly attributed to the fact that financial resources have been siphoned off—at various levels of government—to fulfill fiscal functions. While public goods and services bring benefits to the general population, this comes at the expense of efficiency of capital allocation and creates instability in the financial system.

Recent rural credit market liberalization

Liberalization of the rural credit market in the mid-2000s was premised on the belief that existing financial institutions had limited coverage in rural areas, and that the sector suffered from limited competition and shortages of capital supply. In a regulatory break from the long-standing pattern of government control of the rural financial sector that gave rise to the monopoly of RCCs, new types of financial institutions were introduced in late 2006: township and village banks (contrary to the name, these are primarily based in county-level cities), microcredit companies, and rural community-based mutual aid funds.

Of the three new forms of institutions, township and village banks have attracted the most enthusiasm from private domestic banks and foreign banks. In December 2007 in Hubei province, London-based HSBC became the first international investor to open a wholly owned subsidiary in a rural county, offering deposit and loan services to local residents and agricultural businesses. Some domestic regional banks have also acquired township-and-village-bank licenses, enabling them to conduct business in rural areas that would otherwise be beyond their territorial boundaries.

In contrast to township and village banks, microcredit companies can provide loans to individuals and companies, but are not allowed to absorb savings. Formal rural mutual aid funds, which are regulated by the China Banking Regulatory Commission (CBRC), are typically set up in either townships or villages and are not allowed to operate across regions. They are essentially community-based banking institutions; they absorb savings from and provide loans to local communities.

Thank you for the opportunity to testify today.

PREPARED STATEMENT OF SHERIDAN PRASSO
EDITOR-AT-LARGE, ASIA PACIFIC REGION
BLOOMBERG NEWS
(WRITTEN TESTIMONY ONLY)

March 7, 2013

Luo Jun, China Finance Reporter
Sheridan Prasso, Editor-at-Large, Finance
Bloomberg News

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

China's Banking System and Access to Credit

This testimony seeks to address the facts, risks, and concerns regarding China's official banking system as well as those of the shadow-banking system operating in parallel and performing financial services in China not currently fulfilled by banks or formal financial institutions.

How stable are China's financial institutions, especially the major state banks?

The stability of China's banks has been significantly enhanced over the past decade after they received government bailouts, offloaded non-performing loans, brought in foreign investors for minority stakes, sold stock to the public, upgraded transparency, and improved their earnings ability and internal controls.

The size of China's banks, with 128 trillion yuan ($21 trillion) in assets as of end-September, is second only to the U.S. This figure has increased from 28 trillion yuan ($3 trillion) in 2003. The Big Five state-owned banks -- Industrial & Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, and Bank of Communications -- account for almost half, or 47 percent, of total banking assets.

The banks have significantly lessened their risks from non-performing loans. The ratio of bad loans to all loans was 0.95 percent as of Sept. 31, a significant decrease from the 19.6 percent of 2003. [In the U.S., the number was 3.9 percent as of Dec. 31; Spain had 10.7 percent.] While the numbers may be slightly understated, and the true figures could be a few percentage points higher in some cases at some banks, this still would generally be considered low by the standards of developing countries. Therefore, it is not an area of great concern at this time, nor is it expected to be when trillions of yuan in loans to local-government-financing vehicles (LGFVs - see details below) come due over the next two years.

The Big Five banks have been enormously profitable, benefiting from the government-mandated spread between fixed interest rates for what they pay out on deposits compared with what they earn from loans. Their combined profit rose to 674 billion yuan ($108 billion) in 2011, compared with 121 billion yuan ($19.4 billion) in 2005.

China's foreign exchange reserves valued at $3.3 trillion as of the end of last year will help state banks withstand unexpected internal and external shocks, including any potential crisis from a rise in non-performing loans.

Policy makers are aware of the need for interest-rate reform and are starting a process of allowing banks greater flexibility in setting their own interest rates for loans and deposits. This will introduce more competition into the market, narrow banks' net interest margins, and thus erode their earnings ability over the long term.

Disintermediation -- meaning a reduction in use of the banking system to perform basic functions of finance, including holding the savings of the populace and lending to businesses and consumers -- is taking place faster in China than policy makers would like. Banks are no longer the main sources of long-term financing, as they provided only 25 percent of medium- and long-term loans to corporations in China in 2012, down from an average 70 percent in 2008-2010. Bond-issuance, stock listings, and loans from trust investment funds, which can be categorized as shadow-financing, are making up the difference.

Currently, 97 percent of China's 42 million small-and-medium sized companies are unable to or don't seek loans from banks. Many of them turn to shadow-financing (see statistics below), including private loans from family, acquaintences and the pooled investments of unknown lenders. Due to its unregulated nature, this practice and its recent rapid growth increases the risks to China's financial stability as a whole, but not to the stability of the banking system itself, which maintains its stability through its insulation from the riskier loans and financial operations that would otherwise be incurred if the banking system were enhanced to include all financial services needed to grow China's economy, including lending to small businesses.

China's slowly unfolding efforts at banking reform are aimed at calibrating the balance between this distermediation process -- and consequent reliance on shadow banking to provide otherwise-unobtainable financial services -- and maintaining the stability of the banking system including its continued profitability.

What role do these banks play in the nation's economic development and how are their lending practices driven and defined? Whom do they lend to? What is their portfolio of

loans, both good and bad? What are the interest rates, repayment procedures, etc.?

State banks are key drivers of China's economic development, as they are the biggest providers of financing to state-owned enterprises (SOEs) and local governments. While their share of China's total social financing, which includes bank loans, non-financial bond and equity sales, trust loans, entrusted loans and bankers' acceptance bills, fell to record low in 2012, bank loans still provided 52 percent of the nation's total financing.

While SOEs are still the most coveted clients for banks, Big Five banks are increasingly lending to small and medium-sized firms, in part because of government directives, but also because loans to smaller borrowers can now offer higher yields, and many SOEs now opt to go to the bond market for financing instead of taking out bank loans.

Interest rates charged by the Big Five banks now based on the creditworthiness of borrowers. China now has a formal credit-scoring system similar to the one in the U.S., with 800 million people and 18 million companies in the data base. Chinese banks have also developed their own sophisticated internal screening systems to gauge customers' ability to repay. In most cases, corporate loans need to be approved by the regional branch headquarters instead of a local outlet, reducing risk and political influence. Official policy currently allows banks to offer a discount of up to 30 percent on benchmark lending rates to its most creditworthy customers; however, no state banks are willing to do that, as loans are still in short supply and the central bank sets a lending quota every month. Instead, big banks normally offer a maximum 10 percent discount to their best corporate customers, mostly SOEs, while for others they charge a premium over the benchmark lending rates.

In order to keep non-performing loan rates low, China's big banks will speed up the loan-collection process if they see signs of a weakening in the borrower's repayment ability. Bank managers are hyper aware of non-performing loan levels, and each branch closely monitors loans in danger of turning bad.

What are the roles of local governments in China's economic development and the avenues of credit available at the local level? What are Rural Credit Cooperatives (RCCs), to whom are RCC loans most readily available, and what are the forces influencing availability of these loans? Are RCCs too big to fail?

Local governments are the key forces that led China's economic recovery after the financial crisis in 2009, as they borrowed heavily from banks to fund local infrastructure projects. As China's law prohibits local governments to borrow directly from banks, they set up so-called local-government-financing vehicles (LGFVs) to borrow on their behalf. Such loans are sometimes guaranteed by local government's land and fiscal revenue.

China's banking regulator since 2011 has strictly limited borrowing by LGFVs, as many projects initiated by LGFVs are unable to generate enough cash flow to make interest payments. Bank loans to LGFVs totaled 10.7 trillion yuan ($1.72 trillion) by the end of 2010, with 62 percent to which the government has responsibility to make repayment, according to the National Audit Office. About 3 trillion yuan ($480 billion) of LGFVs loans will mature between 2013 and 2015, and another 3.2 trillion yuan ($515 billion) is to mature after 2016.

This may seem to pose a looming upcoming risk; however, based on China's experiences of 2012, when 1.8 trillion yuan ($288 billion) worth of LGFV loans already came due, banks didn't experience an increase in bad loans. Therefore, the risks are still considered to be under control, especially with the current pickup in economic growth and return to growth of the property sector, increasing the projects' ability to generate revenue.

Rural Credit Cooperatives were established starting in 1951 in rural counties and towns to serve farmers and agricultural development. By the end of 2011, there were 77,000 rural cooperatives with 760,000 employees. These institutions are the major credit and banking service providers in China's countryside, financing 77 percent of borrowing by Chinese farmers. China started reforming rural credit cooperatives in 2003 by transforming some into commercial banks and applying to them the same capital-adequacy and non-performing loan ratio requirements as banks. Capital strength and healthiness of balance sheets at such rural banks have improved considerably since then.

The term "shadow banking" encompasses a variety of unofficial avenues of credit. Can you elaborate on the kinds of practices that define the Chinese shadow-banking industry, the drivers behind the growth of this industry, and any associated risks? How does China's shadow banking system figure into the Chinese economy's overall financial health and developmental trajectory? What regulatory concerns does it raise?

China's shadow banking universe includes underground banking, trust products (investment funds with a fixed interest rate and fixed date of maturity), wealth management products (WMPs), and other off-balance-sheet loan-like claims held by commercial banks. According to UBS chief China economist Tao Wang, the total is an estimated $3.35 trillion -- about 45 percent of GDP.

China's underground lending, mainly private lending and borrowing activities among individuals and small companies, are not subject to regulation. Only lending rates in excess of four times the benchmark interest rate (currently that would be more than 24 percent annually), is illegal. A survey by the central bank estimated the size of underground lending at about 3.4 trillion yuan ($545 billion) as of May 2011. Such activities have declined since then as a spate of bankruptcies and borrowers evading their debts have made people more cautious in lending money.

China's shadow-banking began growing tremendously after China adopted a tighter monetary policy in 2011 making credit even scarcer for small- and medium-sized firms, which have to resort to non-bank sources for financing. Also low and negative real deposit interest rates -- meaning that the rate banks had paid in interest on savings deposits had been lower than inflation until inflation rates fell in 2012 -- pushed households to move their savings out of banks to seek high returns, thus spurring off-balance-sheet activities of banks and surge of WMPs as banks needed to come up with higher-yielding products to retain depositors.

A lack of regulatory oversight and transparency of the shadowing banking activities poses serious risk to China's financial and social stability. In cities such as Wenzhou, in the coastal province of Zhejiang south of Shanghai, more than 90 percent of families and 60 percent of small firms took part in underground lending. One default often leads to a wave of failures as companies often provide loan guarantees for each other.

Growing shadow banking activities have also eroded the stability of formal banking system by siphoning away deposits, the most important source of funds for banks to support their lending. Many shadow-banking funds, such as WMPs and trusts loans, went to property sector and local government financing vehicles, areas that are being cracked down upon by policy makers.

China has been increasing regulations for WMPs and trust investments after a few defaults have occurred. But the size has continued to grow partly because Chinese people want higher-yielding products and have few other investment options.

China's trusts sector is the fastest-growing shadow banking sector over the past few years with 7.47 trillion yuan ($1.2 trillion) of assets under management, second only to banks. They make up a quarter of the estimated size of the shadow-banking sector. The sector's repayment ability will be tested this year as an estimated 310 billion yuan ($50 billion) of property-linked investments will come due and there have already been some cases of delayed repayments. Again, like China's LGFV loans, the chances of a debt crisis such as what China experienced in the late 1990s is unlikely, as the nation's banks or trust issuers can roll over the debt and sell off collateral, and local governments can also seek and would likely obtain bailouts from the central government.

How much of China's GDP is accounted for by the public sector vs. the private sector? To what extent is the private sector able to access official lines of credit? What are the social stability implications of issues surrounding access to credit?

China's 42 million small and medium-sized private businesses contribute 60 percent of the nation's GDP and 80 percent of urban employment. They are increasingly unable to access loans from banks. In 2008, bank loans accounted for 13 percent of Chinese small enterprises' funding needs; 36 percent came from underground or private lenders, and 41 percent came from their own savings, according to Citic Securities. Last year, only 3 percent of China's SMEs were able or willing to take out bank loans, a number demonstrating the decrease in private enterprise's dependence on banks and increase in dependence on shadow financing.

The primary risk to the government lies in its potential inability to intervene if a large number of underground loans suddenly go bad in a crisis; there's no centralized place to put the money, as in a bank bailout. In Wenzhou, more than 80 suicides or bankruptcies by indebted businessmen in a four-month period in late 2011 prompted Premier Wen Jiabao to visit the city last year and pledge to increase lending to small businesses. The State Council subsequently, in March 2012, announced this pilot financial reform program in Wenzhou to bring the city's rampant shadow-banking activities under control. Key measures include launching private lending services and a monitoring center by introducing authorized agencies for lending and contract notarization; allowing private funds to start and participate in rural banks; and exploring setting up small-loan companies to issue bonds designated for SMEs. So far the reforms are in early stages. [We will be checking on the progress of this project in mid-March.] Various reports of unrest were reported in late 2011 and early 2012 over people losing their investments in the shadow-banking system. Through such efforts at reform, the government hopes to keep investors, who might then turn to unrest to air grievances and seek redress, from further losses.

Another risk to the government is its inability to implement effective monetary policy -- when so much lending through shadow financing takes place outside of government control at interest rates the government does not set, the levers of the economy, including fiscal stimulus and controlling inflation, are more difficult for the government to maneuver. This poses potential risks should there be a fiscal or economic crisis.

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PANEL II QUESTION AND ANSWER

VICE CHAIRMAN SHEA: Well, thank you both for being here. I share Madam Chairwoman's sentiment that your book is really very good, Dr. Walter. I'm going to read something that has stuck with me for a couple of years that you wrote in your book.

VICE CHAIRMAN SHEA: It's a section called "China is a Family Business." And you say what moves China's political structure is not a market economy and its laws of supply and demand, but a carefully balanced social mechanism built around the particular interests of the revolutionary families who constitute the political elite. China is a family-run business. When ruling groups change, there will be an inevitable change in the balance of interests, but these families have one shared interest above all others: the stability of the system. Social stability allows their pursuit of special interests. This is what is meant by a call for a harmonious society.

It sounds a little bit like the Gambinos and the Bonannos, and--it sounds like a Mafia state that you're describing here, and maybe that's too strong an observation, but I'd like you to sort of comment on that and explain how the banking system supports the family-run business?

DR. WALTER: I guess I wouldn't be quite so blunt, although I'm obviously pretty blunt. I guess you have to look back at how China's government has been constructed over the last hundreds of years, thousands of years, whatever you want. It's a family-based government even in the Imperial times. So you really have--it's not quite the same thing.

This is a society that is built on mutual trust, and blood trust is the best trust. The revolution is the source of authority for these 300 families, and I think there are 300. It's commonly acknowledged. The banking system is the wallet that these guys have to create. In this case, I think they've agreed that economic development will be the best way to keep social instability down, although that not necessarily has proved to be the case. So the banks are the source of money that they use to run the country.

DR. ABRAMI: I think I would add to that, as well, that an important piece of this is also the placement of key figures at the pinnacle of certain financial organizations as well as state- owned corporations, and that sense it's not just the Mafia taking from government, but also actually having an operational hand in the success of its financial enterprises, and that's an important piece of this.

And to the point around socialist harmony, you could flip that over and say that it's not Mafia where they're in control. Their worst or greatest fear is that they lose control of financing entities, as it would mean a loss of legitimacy with society too.

VICE CHAIRMAN SHEA: Okay. Let's talk about that for a second. Clearly, Dr. Walter, you say that, put another way, China's growth miracle has been built on debt. Could you, maybe both of you, sort of layer that up? I understand the central government debt is about 40 percent of GDP. Could you just put the layers up as a percentage of GDP?

DR. WALTER: There's a chart in the back of my testimony.

VICE CHAIRMAN SHEA: Oh, I'm sorry.

DR. WALTER: I forgot which one it is, but there's two takes on that. One is that if you just include the central government debt, which is the Ministry of Finance issued bonds, you have to take the Ministry of Railroads because they are certainly part of the central government. They've been issuing bonds. You got to take the policy banks. They don't care. They are definitely sovereign banks. They issue bonds. If you add all that up, it's 40 percent.

VICE CHAIRMAN SHEA: Okay. Then what's beyond that?

DR. WALTER: Then you have the local governments in the problem loan calculation. So based on a quick calculation I did recently, it's 95 percent of GDP if you add all those.

VICE CHAIRMAN SHEA: What about debt issued by state-owned enterprises? Corporate debt issued by--

DR. WALTER: That's counted in as the bank problem loans if it's bad. So there's a calculation in there. It's not a huge percentage of the total. I think one of the strategies that they've used over the last ten years is to drive the economy hard enough so that the proportion of bad loans that have been created grows smaller to the size of the GDP although I'm not sure that's happened in the last four years.

DR. ABRAMI: You would also want to add in vertical loans or entrusted loans between business partners. There's also sort of a horizontal movement that goes on between businesses keeping each other in business by borrowing. So that's another whole layering of the debt that occurs as well.

VICE CHAIRMAN SHEA: So exceeding 100 percent of GDP?

DR. WALTER: If you look at another chart there that shows the total social financing, which includes a lot of the underground financing that Regina was talking about. It's 140 percent or so.

DR. ABRAMI: Yes.

VICE CHAIRMAN SHEA: Is that a destabilizing level?

DR. ABRAMI: This is where it gets fun.

DR. WALTER: You want to answer first.

[Laughter.]

DR. ABRAMI: My first inclination is to say no, but I should qualify that, many different angles. So why would I say no? How can I possibly say this is not destabilizing? Well, one part of it is because it's not just a shell game about trying to hide the debt, but it's about trying to do everything to prevent any of this from falling apart, and everybody is buying into that game. It's not just the 300 families.

The mom-and-pop shop is buying into it. Everybody is buying into it. In some sense it may not be called investor confidence, but it's some kind of drive for certainty to make sure that things don't fall apart. There's a piece of that at work that makes me say, okay, yes, too big to fail.

The other part of it that I think is relevant here is looking at the track record, the adaptability of Chinese institutions, and whether it is just moving the debt from one place to the other to maneuver around these crises that continue to marvel. So, I'm less worried about it.

I can give you a scenario which makes me worry about it, and that simply would be the loss of investor confidence. If that grounded to a halt, then you're going to run into some of the liquidity crunches that we saw in the private sector because they don't have the benefit of the central government bailing them out like the banks do. That has social stability ramifications. But in the broader sense, I'm probably less nervous than you might want me to be.

VICE CHAIRMAN SHEA: Okay.

DR. WALTER: The investor confidence part, when you talk about these trust products or wealth management products, does that represent a deposit or a confidence in investing in these? I would say yes, because the Chinese will not let their banks be impugned. They really are too big to fail, but as I said before, you can make the banks look good, but that doesn't make everything else look good.

The book is full of the little special purpose vehicles that were created to offload bank bad debt ten years ago, and those things are still working. I also add the China Development Bank, the biggest policy bank, which has been intermediating and buying out bank loans and replacing it with long-term money which it borrows from the banks through the bond market.

I think this scheme can go on for quite awhile. I have to say that China has never been leveraged quite as much as it is today. I think the last ten years are an outstanding example of laissez-faire capitalism, and I think that over time you're going to have a slowdown in the economy, as we've been seeing, and that that will cause social disharmony. That's--

VICE CHAIRMAN SHEA: Thank you very much.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you, Madam Chair, and thank you both for being here.

Dr. Abrami, I want to understand what all of this means.

DR. ABRAMI: Sure.

COMMISSIONER WESSEL: I'd like to understand from two perspectives. The first is the cost of capital, because increasingly the Chinese firms have a go-out strategy, whether it's to the U.S. or other markets. And can you provide some guidance in terms of the cost of capital versus a state-run or state-invested or sponsored entity versus the entities that engage in shadow banking in terms of what their cost of capital might be?

Can you give me some idea of what the differentials might be, and also what comparable international rates might be?

DR. ABRAMI: I don't know that I can speak to the international context, but I can try my best to give you some sense of what the borrowing market looks like for various economic actors. For certain, starting at the large state-owned enterprises, they do have access to the largest banks, including the policy banks, and to larger pools of capital.

In my conversations with many of them, in terms of what they go through to get those huge loans, they speak of an internal due diligence process where they have to put forth documents showing the commercial viability of whatever they're proposing.

And then, estimates of what they're paying to borrow vary. I can't give you the information as no one has given me actual interest rates as much as ballpark rates. What I have heard is always just a few percentage points above LIBOR. So within these chosen enterprises, there's no question there's a larger pool of funds available to them, and that many of them access these funds through social relationships.

COMMISSIONER WESSEL: Could I just ask a related question to that because you said you haven't been told? Going back to the previous panel on transparency, PCAOB, are these Chinese SOEs identifying their cost of capital in their public filings when they go to market?

DR. ABRAMI: I'm not aware of that. No.

COMMISSIONER WESSEL: Okay.

DR. ABRAMI: But I'm sure it's easy enough to have someone look that up for you.

COMMISSIONER WESSEL: Okay.

DR. ABRAMI: So going a level down in terms of the sort of local small enterprises, it's a similar process. Where you see the big differential is in terms of wherecapital coming for private enterprises and what the cost of capital will be for them? The cost of capital for them in the formal banking system is higher and they often bring in guarantee companies and others to help them access the formal banking system.

The next layer down might be these entrusted loans, which will have a peer-to-peer negotiated interest rate. I'm still working at the company side. If we go down a lower level, then there are the underground banks. There, it’s shorter term And often people or companies with the worst kind of credit portfolio.

So when you look down a step further, there you're seeing figures as wide-ranging as 30 percent to 120 percent per annum… exorbitant loan sharking, for lack of a better term.

At the lower level, but a more formalized are things such aspeer-to-peer lending where borrower rates are not allowed to run higher than four times whatever the bank rates are so under 24 percent. I would say the pricing that you see in some of the peer-to-peer runs between 19 and 23 percent.

COMMISSIONER WESSEL: Okay. Dr. Walter, anything to add?

DR. WALTER: You can calculate the cost of capital if they're listed in Hong Kong or elsewhere and are audited by real auditing firms.

COMMISSIONER WESSEL: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Fiedler.

COMMISSIONER FIEDLER: I think I now better understand earlier this morning's testimony and why they don't want audit work papers available.

[Laughter.]

COMMISSIONER FIEDLER: Two questions. One is what's the effect in terms of managing inflation with this debt situation of 140 percent of GDP being pushed out?

DR. WALTER: Well, the central bank is very busy. It has two ways to do this. One, it began about seven years ago to issue what are called PBOC bills to the banks, especially the Big Four banks, and I've forgotten the number, but it's a huge amount.

And the second way is there's a deposit reserve ratio that you have to satisfy. It's around 20 percent of the deposits of the banks are now held by the central bank. So all this money has gone in the system. It's transferred to the banks and it's gone back to the central bank, and the central bank balance sheet has gone like this over the last five years. And that's how it's been. That's the market-based sort of way of controlling inflation. You don't control it through interest rates. They will control it through administrative measures. You can't lend to that sector. You can't lend to real estate companies.

COMMISSIONER FIEDLER: When does the music stop on that?

DR. ABRAMI: Can I respond to your initial piece?

COMMISSIONER FIEDLER: Yes.

DR. ABRAMI: Certainly if you look at the reserve ratio requirement, that had increased numerous times. From 2007 to 2011, it just kept increasing, and then it declined recently. So the central bank does use some sort of monetary policy tools to address inflation.

Regarding Dr. Walter's comment, I would say that they do actually issue statements saying you can't lend to certain sectors. It's just that they're not very successful because the secondary market devices like trusts and the like do lend to them. But t through things like the 12th Five-Year Plans, those in power do issue statements saying which sector is or is not favored.

And these are taken as very serious market signals, or political signals, as it were, and banks and other agencies respond to it.

DR. WALTER: So let's think, if you're the branch manager of a bank in a province somewhere, and the central regulator says to you that you can't loan to the real estate industry developers in your province, and the local Party secretary tells you let's do it another way, you're going to do it. The problem with this system is that it's not a system based on rules as we've been talking about this morning. It is a system based on who's the boss, and it's not the government, and it's not the market. The Party is the market.

COMMISSIONER FIEDLER: I agree with that. Let me throw one other new ingredient into this, and that is the effectiveness or ineffectiveness of capital controls. We are now seeing large amounts of money leaving the country. If we're to characterize that as smart money, and we're to juxtapose that against who's got it, being the 300 families, we are talking about the primary people who benefit personally from the economy shifting huge amounts of money into safer places.

So if we shouldn't be concerned that this pyramid scheme is about to collapse, they seem to be concerned. The smart money seems to be concerned that the pyramid is collapsing. Am I wrong about that? Or what are the capital controls? Are there any? They talk about them, but--

DR. WALTER: First of all, they have $3.6 trillion sitting in New York, right? So what happens to all that? It's all under the central bank, and there's a bunch of sub-accounts and so on. Where does the interest go and so on? Who has the right to manage that?

I think there can be a lot of slippage there. Anybody who runs a state-owned enterprise has the ability to get money out of the country. One SOE chairman said to me it's not who owns the money; it's who gets to use the money.

COMMISSIONER FIEDLER: Right.

DR. WALTER: Right. So you can get the money out legally or illegally because when you're doing exports, you're investing abroad, you're paying fees, or you're paying for things. It's easy to get money out through transfer pricing. You know this story.

So does that speak to investor confidence, so to speak? On the one hand, people believe in the government, the government will not let the banks fail, and so they invest in these wealth management products for approximately 13 percent of total deposits now. On the other hand, people are worried about social harmony, so I do believe there is a lot of capital flight.

DR. ABRAMI: There is a lot of capital flight. It really hits on the family issue as well. I don't think it was an accident that a very concerted effort was made in response to the various newspaper exposes that came out in recent months to say that the matter was about family members, not the

Party.

We can sniffle at it and think it's ridiculous, but at the end of the day, it is the dilemma that the Party faces right now, which is how to maintain its brand, as a Party, as a political entity, versus the conflicts and tensions they're feeling with the activities of their own family members.

DR. WALTER: Yeah. I guess if you think about China, it's a huge number of silos.

DR. ABRAMI: Yeah.

DR. WALTER: And everywhere you look it's a silo. That's why it takes so long for things to change, from our point of view. If you want to play by the game, it's extremely time consuming and it's very exhausting. But everybody, the people who run these various silos, the heads of these 300 families, or the heads of an SOE or whatever, they control everything that happens in that silo.

DR. ABRAMI: Yes.

DR. WALTER: And their authority is sufficient to do anything they want, and so if you're a top ranked Party official, nobody is going to challenge you because then you have the right to challenge them. So it's not like it's a unified entity. The problem that the new leadership has in that is that Bo Xilai is not the only guy that does that stuff. You know, Wen Jiabao is not the only guy that's got a lot of friends with money. They all have friends with money.

DR. ABRAMI: Thinking of it in game theoretic terms, you could say that there is a large number of veto players in China today, and each can check the other.

COMMISSIONER FIEDLER: Or certainly a new set of veto players.

DR. ABRAMI: Yes, yes. Perhaps. But if you think about that idea, one could also say that the more that there are, the more likely they are to move to some, hopefully, less extreme position because at the end of the day, it's all in their interests to make this thing work, and I think some of the blow back you've seen after the Bo Xilai case is a part of that.

COMMISSIONER FIEDLER: Well, to use your veto analogy, if you take it to the U.N., there's been a lot of abstentions in their behavior, not a lot of vetoing going on.

Thank you very much.

HEARING CO-CHAIR CLEVELAND: Commissioner Wortzel.

COMMISSIONER WORTZEL: Dr. Walter, in your Figure 11, you show the policy banks as really giving out substantial funding, as a substantial source of funding, and Dr. Abrami, your Harvard Business Review article on risk financing in Exhibit 18 lists three state policy banks to support development, import-export and agriculture.

So I've got two related questions. I'd like a better explanation, if you could, on what a policy bank is and who sets that policy. Probably the Party. And second, if those are the three, maybe the only three, but the three big state policy banks, are there provincial policy banks or county policy banks, and are they regulated?

Thank you.

DR. WALTER: Want to go first?

DR. ABRAMI: Sure. I can speak mostly to the Export-Import Bank of China as a policy bank and, obviously, as it sounds, its purpose is to help Chinese companies to become competitive overseas by providing for seller and buyer credits, and without question, the explosion of Chinese companies overseas cannot be understood apart from the role of the Export-Import Bank.

If we were to chart--and I'm sorry I don't have it here. I could e-mail it to any of you later. But if you'd like to chart a comparison of the U.S. Import-Export Bank's lending compared to what the Chinese bank is giving, you would wonder how any U.S. company is possibly going to succeed under these terms. Chinese companies are able to offer potential customers a very favorablelevel of financial support to obtaining their products. So that is one of the policy banks, and in terms of where their mission comes from, yes, it's true, you could say it comes from the Party, but to go a step further, the Bankis also keenly aware of what the identified growth sectors are. China has identified I believe seven strategic sectors, so certainly companies that are working in those sectors have an easier sell .

And if the company is not in a key sector, well, gosh, they'll certainly market it that way.

The China Development Bank does offer financing that aid in external environments but primarily by lending to a Chinese company is looking to expand overseas. In this sense, CDB remains a domestic-focused bank.

DR. WALTER: Yeah. I guess these policy banks were set up back in 1994. They were meant to be asset management companies, the first round, but that is to say they were meant to take all the bad loans off of the other banks which were meant to become commercial banks. Chen Yuan, who runs the biggest of these policy banks, succeeded in stopping that, and so they delayed a restructuring of the banks another eight years.

So these banks fund themselves entirely on bonds that are issued into the inter-bank market and are invested in by the commercial banks, so-called commercial banks.

Policy banks are really an extension of the commercial banks. While at the same time, the commercial banks--I'm trying to argue anyway--are really nothing more than an extension of the policy banks. They're all policy banks. So they all do what the Party would like to do as expressed in a five-year plan or in the Party documents. So there really isn't a distinction now. There was meant to have been a distinction. That distinction fell apart in 2008.

COMMISSIONER WORTZEL: What about regulations? Are they regulated like a commercial bank?

DR. WALTER: There is a regulator. And I think the original regulator who set up the China Banking Regulation Committee did the best he could, but he's also a Party member. What are you going to do? You're a minister level guy who runs a regulator, and you're going to run up against these guys, the banks, which provide all the capital for the state sector. How are you going to win that? You've got to be very careful. There are regulations.

COMMISSIONER WORTZEL: Madam Chairman, if I may, one, the last part of that question was, are there provincial policy banks?

DR. WALTER: Ah. I think that it's too bad that Lynette Ong isn't here today. She could talk about the role of credit cooperatives. There's a brief paragraph in the back of mine. These are supposed to be owned by the farmers, but, in fact, and you'll see on these charts here, they have a significant amount of deposits there.

Because local budgets are so constrained, China's taxing capacity is very limited, and these guys are at the bottom of the ladder. The rural credit cooperatives are the funders of local projects. So, in that sense, yes, they are. They are also policy banks.

DR. ABRAMI: I would add to that that there are also the micro-credit companies that while not policy banks are licensed by local governments, and to a degree, local governments are using them to evade some of the constraints of the rural credit cooperatives and the policy environment. In addition, there are the sovereign wealth funds at the national level, and also at the provincial level, they are creating funds

DR. WALTER: In China, everything is a sovereign wealth fund.

DR. ABRAMI: Yeah. I guess you could say that.

DR. WALTER: Come on.

[Laughter.]

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Slane.

COMMISSIONER SLANE: Thank you. Thanks for coming. It's been very, very helpful.

Everything I've read indicates that most of the employment that's being created in China is being created by small and medium sized companies that are non-SOEs, but yet they don't have an easy access to capital, and maybe you can help me. I've never understood why the Chinese government doesn't make access to capital in a formal way similar to our country where we have commercial banks and promote entrepreneurs and promote the growth of these small and medium-sized companies. Instead, they make them jump through all these shadow banking hoops.

And I don't know how they can control their monetary policy when they don't have formal control over this type of lending.

DR. ABRAMI: I think there's a couple of ways to cut at that, and, yes, it is stunning when your engine of growth, your largest employer, and the source of the largest number of enterprises is basically ignored and not given the support that it needs. But you could flip that on the other hand and say would you want to be a Communist shown as supporting a capitalist? Probably not.

So if you put the situation in the historical context of how this sector evolved, you know, the private sector evolved from very small mom-and-pop type shops. It eventually grew larger, but large is risky in China, and it's certainly risky for private enterprises.

You know, there's an expression in Chinese that the tallest tree catches all the wind. In that sense, nobody is trying to look like big business in China such that even when we present to you data that says 60 percent of GDP is small and medium-size enterprises, for all I know, 80 of those are owned by one person.

This is one of the challenges of trying to get a sense of what's going on in the micro economy and I'd say in the real economy. So the government has to give institutional supports through increasing regulatory acknowledgements that it values what the private sector does as a partner of growth. What it hasn't done is made access to formal bank credit easy, and there I think there are institutional reasons. If you're the banker, you can't really price the risk of lending to these particular folks, even if you wanted to.

So it's an institutional problem that has to do with the broader banking system, and, at least historically, I think the state was somewhat insulated from it because the bulk of the lending, the big large cap lending was between SOEs and state-owned banks. It was a bifurcated system.

It's only recently that there's growng enmeshment, and partly by state-owned trust companies investing in many of these private entities, as well as the government's new growth model, which aims to move toward a more consumer-based model. Well, if you want to move to a more consumer-based model, it means that those very same people you won't provide lending to better have more money they're willing to spend on consumption.

So suddenly there's a greater need for the government to provide the private economy with support, and to address the real dangers of not providing that support, which is obviously the liquidity crisis we've seen in the underground markets.

DR. WALTER: Just to go back in history a little bit more, when in Chinese history have capitalists ever had the upper hand? Merchants were at the bottom of the totem pole for 2,000 years in terms of which class was the top, the farmers being the top. That's one comment.

The second comment is if you just look back at the last 30 years, there have been continual efforts by local governments, and by local governments, I really mean provincial governments and city governments and below--there are five levels in the administration system--to try and pay for the social services they're being forced to provide by the central government policies.

And it has forced local governments to go outside of the norms, and they now have things called "extra-budgetary funds" and "extra-system funds" and you really don't have any idea what the real size of the Chinese budget is right now, and so I think that, yes, you can get hold of capital, but it costs you, but in China nobody worries about paying the cost. If you can get the money, you can make it.

But on the other hand, when you make it, you can't get too big because then the--mine is "the nailhead that sticks up gets hammered down." So you cannot, like the guy who--a couple of years ago, there was a huge scandal. The guy had the biggest, he had the Best Buy in China. He got too big for his britches. He didn't make somebody happy so they went after him and got him. He's in jail now.

So you can't get too big. So think about what that means for Chinese innovation or for real growth.

COMMISSIONER SLANE: Thank you.

HEARING CO-CHAIR CLEVELAND: Senator Talent.

COMMISSIONER TALENT: Thank you.

I want to follow up on the comment about the Ponzi scheme comment and ask you a question about the broader implications for Chinese economic policy. Okay. A Ponzi, and I think I understand it, at least conceptually, that you have all these enterprises that are linked to the state that are shifting around bad debt or keeping it off books in order to sort of hide it and to allow the system to continue.

Ponzi schemes, of course, have to have some real assets that are not just created, and it seems to me as I look through the system, okay, where are they are getting the real assets? Well, the Chinese people are saving a lot of money, and they're forced to do it really, and they put it into these banks and those are real assets that are providing enough money so they can keep this going, at least temporarily.

Okay. If that's the foundation of the Ponzi scheme, and they in order to grow economically are saying they want people to consume more, isn't there a contradiction there because if people start consuming more, they're going to be saving less? Now, I know they're hoping to get more economic growth, but they're not going to be putting as much money into the foundation of this scheme, and they're certainly threatening, it seems to me, the viability of it all.

So would you comment on that and whether they, if that's true, whether the leadership realizes that, and whether that might be one of the constraints on their trying to promote more consumption?

DR. ABRAMI: Okay. I think with regard to the Ponzi scheme, I was referring to Chairman Xiao Gang's quote with the specific reference to the trust companies where they issue a specific product with a short-term maturity. If they are in fear of default, they may just raise more funds through new products using Product B to pay for Product A, and, yes, underpinning all of that are savers, without a doubt.

So could it all come down like a deck of cards? Yes, that is the great fear that this could, in fact, happen. But it's definitely a fear that the government is aware of, that it is concerned with and they have begun to put in place policy recommendations, including some restrictions that hopefully prevent it from happening.

In terms of the contradiction of consumption versus savings, Chinese people save a lot of money. You know I used to do this thing in class where I would have--I just have a little side bar here-- my students when we were teaching monetary policy, raise their hand based on savings rates. Okay, students, how much of your income do you save? And my Chinese students invariably would tell me they were saving 70 percent of their monthly income.

I won't tell you what the Americans were saving. But let me just say--

DR. WALTER: They got credit cards.

COMMISSIONER SLANE: We know the answer.

DR. ABRAMI: Yeah. Let me just say that in that context, a little less savings won't be the end of the day.The issue is about the link to developing a consumer market, and that is, to develop credible investment vehicles for people. With these trust products, it's not really clear what they'reinvesting in and so on, but if more credible investment vehicles existed, then it’s more likely that as people make returns on these investments, and they’re clearly hungry for greater returns, they will spend some of that money.

China is today the largest luxury goods market in the world. There is desire to spend here. Where the spending isn't happening is at the lower ends where most folks are underwater. So, yeah, improved credibility of investment products would increase spending, I think.

DR. WALTER: Yeah, on the last point, on luxury goods, when I first went to China, the second time, in 1992, I'd go through these hotels, and they'd all have Armani shops in there, and said, you know, how can you have Armani shops in this place? I was flipping forward to 2008 when the Olympics were being held, I was pleased to see that the New York Times finally did some good reporting, and tried to ask the same question. Well, there's a scheme here.

This is not for the common mom-and-pop type person. You don't go in there and blow 10,000 bucks on one of these Louis Vuitton bags, but if people do go in and buy them, and then they give them to their friends, and their friends say, well, I really don't like that model, I'm going to go back and exchange it, they can exchange it for cash. This is a way of helping people along.

Now, how does the economy work and who's really paying for it? There's a wonderful piece of research that I've seen where a man tried to calculate the balance sheet of China Inc., and of course, the answer is just what you've said: it all comes back down to household deposits. These are the biggest shareholders in China Inc. But that number stopped in 1998.

If you brought that calculation forward, and I think you can, then I think what's happened over the last ten years really has changed the economy a lot. You have had a trillion bucks of foreign direct investment in China. It has created the most vibrant, competitive, as we all know, industry in the entire, the entire planet, for that matter.

These guys have created a tremendous amount of deposit savings as well so you have, you really have an enterprise that's being funded by the deposits of the guys who are creating capital, and that is not the state sector. What that might mean I don't think--what it means to me is if from an institutional basis, liberalizing the RMB or liberalizing interest rates is not in the cards unless the Party really decides that it wants to privatize the state sector, and I can't imagine that happening.

HEARING CO-CHAIR CLEVELAND: Senator Goodwin.

HEARING CO-CHAIR GOODWIN: Dr. Abrami, I'd like to talk a little bit about who these shadow banks actually lend to. You indicated in your testimony that the proliferation of the system has really been a significant driver of the stated government objective of shifting to a more consumer consumption model of economic growth.

In an op-ed in the Wall Street Journal last week, Ruchir Sharma actually wrote that these shadow banks tend to lend to borrowers like local governments who push increasingly low quality investment and spending projects.

So my question is how helpful are these banks actually in moving towards a more consumption-based model?

DR. ABRAMI: So the shadow banks are in a crowded space in that certainly the ones that are lending to local governments are, by and large, the trusts, wealth management products, and the trust companies that are lending to local government.

The other ones lending directly to the private sector are the underground banks. Credit guarantee companies also work with trusts to put together offerings that help private companies to raise capital. So how does this help shift to a consumer-based economy? A couple of things - First, China's biggest fear is that economic growth stalls. That's the killer. If that happens, it's over. So they have, a hungry dragon that accepts more and more deb as a way to survive--

DR. WALTER: And more capital.

DR. ABRAMI: --and more capital because it's got to sustain levels of growth, and you could say that right now we're looking at a model that is requiring ever larger amounts of capital or debt to sustain even an ever-lower amount of growth, and that may be worrying. On the other hand, as the economy, in the aggregate, grows larger, that's not surprising.

So how is this development going to increase consumer spending? If you don't have growth, you don't have jobs, you don't have people earning money. To aid growth, the government has to develop vehicles for private firms to raise capital since they're not going to get it from the state banks. And it has to put in place regulatory institutions that will maintain and sustain and expand investor confidence in these tools.

Right now we're at the pivot point where it's not clear that they've got investor confidence. We saw two, three defaults in December and November that raised the alarm, and where consumers said, but, wait a second, I invested in this trust product, and I'm not even getting back my principle--I'm not getting back anything on this.

So the government has stepped in and is starting to put in place various measures to instill confidence but it's not an immediate turn to a consumer-led economy Rather, I'm presenting a broader overview of the series of forces that have to come together to make this enormous economic shift toward a more consumer-based system happen. HEARING CO-CHAIR GOODWIN: Sure.

DR. WALTER: Let's not forget how old everybody is over there. Speaking for my own age, I can tell you that in 20 years, there are going to be over 400 million people there who are over 65. There is not a real social security system there that's going to support them. It's going to be a cash flow base.

There is a social security system in place that's run by the local governments. People contribute to it from their paychecks. Enterprises they work at are supposed to also contribute to it. These funds are managed by the local government. Local governments are extremely budgetarily constrained in terms of revenues.

They use these funds to support the kind of projects we've been talking about. There is a national backup, national social security fund in Beijing. It is supposed to provide a backup to these local firms. I've been told that that is meant to provide 80 percent. If it's meant to provide 80 percent, it is wildly underfunded. China has the assets to fund this thing, but it chooses not to put it in the social security fund.

Instead, I think they're just going to issue more debt and pay it out as it goes. So you have to look at the demographics of this. How can you transform China's current model into more of a domestic consumption society when you have such a demographic overhang?

HEARING CO-CHAIR GOODWIN: What about the effect of the shadow banks on the banking system itself? One of the witnesses who couldn't be here in the written testimony suggested that it might actually destabilize the formal banking system because it deprives the banks of the deposits that they need to lend all this money out.

DR. WALTER: My comment I guess is that these are all fairly short-term products, and they're used to manage bank balance sheets so that, yes, I think that now they've reached a level where it could be very destabilizing because there is a loan-to-deposit ratio. You're taking all these deposits off balance sheet. You're also taking a bunch of garbage loans off balance sheet. You're going to create a liquidity crisis at some point if you keep on growing this kind of a product. So I imagine there's going to have to be a crackdown.

DR. ABRAMI: Conversely, you could argue that that market pressure on these banks, which has driven them to create these wealth management products, is part of the process of moving toward a more liberalized system. You know, so, again, it’s a slower process, assuming that the Chinese government doesn’t allow the chips to fall where they may. If it does, then you have the liquidity crisis.

I think that it's important to keep in mind that the highest levels of government in China are not unaware of this issue, and certainly one of the biggest concerns is that these wealth management products initially were offered by the top tier banks, and they're now more and more being offered at the smaller level. There, the concern is that the loan-to-debt ratio is getting above 20, 30 percent, and in those cases, you're looking at potential for bank failure.

Will China let a bank fail? On that I'm not so sure.

DR. WALTER: No way.

DR. ABRAMI: Yeah. So--

DR. WALTER: No way.

HEARING CO-CHAIR GOODWIN: Thank you.

DR. WALTER: Now, I've lost my thought. But--no, I'll just shut up.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you.

Dr. Abrami, to begin with, and then both of you. Your testimony today explains and helps me understand a Wall Street Journal story I read last month on Jiang Jianqing.He built the Industrial and Commercial Bank of

China. It's the most profitable state-owned bank in China, according to this story. It has more assets than any other bank in the world and employs the latest techniques to manage risk and was the first Chinese bank to win approval to buy a retail banking network in the U.S.

Hank Paulson happens to feel he's a banker's banker. And yet the story talks about how he was politically put aside for reasons that kind of fit with your shell game story earlier.

Do you have any sense of what's going to happen? Will he be part, could he be part, of liberalization? Could he be part of the growth or has he really been pushed aside because he is not behaving within the normal game?

DR. ABRAMI: I think if he's had a story written about him in the press which is saying that, he's probably having a pretty bad day. Generally speaking, if the inner-workings are now out, your political career in China is probably not where it ought to be, and not just speaking of him, but certainly even at the level of the Politburo and some of China's top leaders, Bo Xilai, Wen Jiabao, all of them lose political chips when these issues came out.

Having said that, to the extent that he is regarded as not putting political drivers in his decision process ahead of all else, that still is a reality. It still is the largest bank. It still stands there as an example of an alternative. The bank hasn't collapsed. If anything, it's done well.

COMMISSIONER TOBIN: And if investors move that way--

DR. ABRAMI: Right.

COMMISSIONER TOBIN: Hope isn't reigning eternal here, but--

DR. ABRAMI: Right. So--

COMMISSIONER TOBIN: --it is an option.

DR. ABRAMI: I would say again that you can't underestimate the power of market forces in China. I don't think that the Party members are clueless to the fact that they need to recognize that these drivers matter. The fact that so many alternative non-bank financing schemes arose is partly because the biggest source of capital in China, the savers, said, hey, I want more return on my money.

So the banks have to adapt to these changes. In terms of Jiang, I don't know about his political career, but based on what you've told me, I'm not optimistic. In terms of what he's done for Chinese banking in broader second or third round effects, it's probably more positive than negative.

DR. WALTER: I really hesitate to give you my opinion because I'm going to come across as very curmudgeonly and cynical and so on, but having sat there for 20 years, I think my view is different. I do not believe these are banks. In this particular case, ICBC is the biggest bank. The Bank of China is the smallest bank. The Bank of China had the largest loan growth rates. The ICBC had the smallest one in terms of the support for the stimulus.

The guy who is head of Bank of China, Xiao Gang, is going to be the Party Secretary of the Central Bank. The guy Jiang Jianqing who runs ICBC was meant to have been the head of the CBRC, but was trumped by Wen Jiabao who sent his own guy there, and the way I heard it, he threw a fit. He was not a team player. So I sort of think that's what happened to Mr. Jiang.

I do not believe that his name has ever been mentioned in terms of economic or financial reform. So is he a loss to the system? He's still there. The people you really have to look at are not folks running the banks. You have to look at who's going to be the head of the central bank, and if it's true that the current head is going to be retained, I think that is a very good sign that, number one, they recognize there is a lot of trouble in the system as we've been discussing today, and number two, having this guy, keeping this guy on, is the best case for how to address it because he was the guy who developed the techniques to address it the last time around ten years ago.

All of this is really hard to fathom from 6,000 miles away. This is all personnel. It's all HR.

COMMISSIONER TOBIN: Thank you. Very helpful.

HEARING CO-CHAIR CLEVELAND: Dr. Walter, in your book, you say, talking about reform and the banks, by mid-2010, a new structure for Cinda had been rolled out, and Cinda was incorporated.

DR. WALTER: Right.

HEARING CO-CHAIR CLEVELAND: The MOF is the sole shareholder, and its valueless assets, including the loans it owes the PBOC, were spun off into a now increasingly ubiquitous co-managed account in return for IOUs. This left Cinda and its bevy of financial licenses able to begin the search for a strategic investor, which, of course, is expected to be the CCP.

DR. WALTER: And has succeeded in doing.

HEARING CO-CHAIR CLEVELAND: In this tight family context, is our concern about auditing at all relevant? I mean I find myself looking at these--

DR. WALTER: I enjoyed the testimony this morning. But I think one important point to make is that China has not listed a big company in New York on either exchange since China Life, maybe it was 2001, 2002, and China Life got tied up in what they interpreted as a Sarbanes-Oxley snit, and so they decided not to list there anymore. The huge bank IPOs that you mentioned were all done in Hong Kong and Shanghai, and there was a huge component of so-called strategic investors which were all their state-owned friends chunking in.

So from my point of view, when you list in Hong Kong--I've done listings in both places--when you try and satisfy the SEC for detail, it is really demanding, and you provide a lot of detail that investors can use. When you do the Hong Kong listing process, you are discouraged from providing detail because the guys who manage the process are the most junior guys, so your prospectus inevitably ends up very watered down, with the least amount of disclosure you can imagine.

Can you compare--I think you should try and compare the ICBC annual report with JP Morgan's, and see if you don't think there's a big gap in disclosure there, or Citibank's or anybody's.

So you worry about a lot of stuff, but the stuff that's coming this way is not the stuff you really want, in my opinion.

HEARING CO-CHAIR CLEVELAND: The "stuff" being?

DR. WALTER: The listed companies.

HEARING CO-CHAIR CLEVELAND: Oh, okay.

Dr. Abrami, you talked this morning about-- you skated over the question of real estate, and in reading a Bloomberg article, they talk about trusts which make up 1.2 trillion in assets with 50 billion linked to property investments, which all come due this year.

I'm wondering if you could talk about the stability of the real estate market. There's been a lot of speculation about the bubble bursting and the role of trusts in underwriting or preserving the market.

DR. ABRAMI: I think we have to take a step back first and think about what role property plays in China, and the irony of private property in a system such as China’s. But property does play an important role. It has been a critical investment vehicle for savers, leading to massive increases in prices in property markets, ultimately leading the government to take a stand, putting new policies in place so that households had higher borrowing restrictions if they wanted to buy a second home.

And this extended all the way down to pawnshops. I remember doing interviews in the pawnshops of Shanghai, and people would often present as part of their collateral sometimes a mortgage or a fully-owned property as a means to obtain some kind of loan, and they were told no, you cannot, that's not an acceptable form of collateral anymore.

So the government has used property as an alternative monetary policy lever as well, and in that context we have to ask, how risky is it if the portfolios of trust companies, or the wealth management products, are expanding to include more real estate.

On the one hand, you could say that as property values are increasing, which they are, it's not such a concern. The concern is more on the buy side of whether or not the glut of property is going to be the cause of problem, which is the amount of real estate that sits empty.

You know, there is the Inner Mongolia city that nobody lives in. You've been there. Yes. So there are such things. How does it affect the trust companies? Well, if what we're basically arguing here is correct, which is that they will continue to bail out these entities through the creation of new trust products, which helps keep other trust products to stay alive, then there is no concern.

The concern is, instead, more around what will happen if there's a default and what the government will do about it. So we have an example of that already. There was a default on one property developer. The name is escaping me right now, but the trust said we're not responsible for this, and the CBRC backed them in that. They said this is an investment vehicle; it's not a deposit. We owe you nothing. But the guarantee company stepped in and, paid back the principal.

So if you look at this situation in the broadest sense, you can say that it looks as if there's an awful lot of folks who are awfully afraid of Chinese consumers and savers and trying to figure out how to keep them happy. And that's where my not being as panicked as perhaps some of you may like me to be comes from. There is the shell game there, but it will just get played on to keep confidence going.

DR. WALTER: You know somebody asked me, well, China has the resources to cover all that kind of bad debt, and I said absolutely, but why are you paying for the same thing twice? So ultimately you're going to end up wasting a lot of capital on things that were not capital effective, and you're going to have slower economic growth since investment is 50 percent of GDP growth. And unless Western consumer markets come back and start having a demand-pull out of China's export industry, where is the liquidity in this picture going to come from? Because the liquidity comes from two things, household deposits and exports.

For every dollar that Foxconn gets paid for an iPad, they have to turn it into the central bank. That's where the foreign reserves turn in and as a consequence renminbi is created. This is where the real liquidity in the system has been coming from the last seven or eight years since WTO. It's financed a real, real bubble.

I guess these trust companies, if you go back, if you go back in history and look at all the financial bailouts that have happened, and there have been six at least since 1990, the government has always paid out the household investor. So I agree it's going to happen again.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea. Commissioner Fiedler.

COMMISSIONER FIEDLER: One technical number question. The bonds that we were talking about early in the testimony, all the variants, how much of them are held overseas by foreign investors?

DR. WALTER: I think none of them are held overseas. The renminbi is non-convertible; right? But there is a window punched in that account called the Qualified Financial Institutional Investor, and I believe the quota, the quota that has been allowed to be invested in the country through that window--that means you can take dollars, swap them and buy renminbi and invest in the stock market--it was originally a stock market pump priming tool but is now also allowed in the bond markets--it's 40 billion bucks.

I think the total value of what has been created by those investments is actually much, much more than that so there is a tremendous amount of profit sitting inside the country from the QFII, original QFII investments, but it's still a penny ante number in terms of the total market.

DR. ABRAMI: I have nothing to add to that except to say that certainly one would want to know a little bit about who's investing in some of these. Certainly what I was struck by was the number of universities and endowment funds that are looking to invest within--

COMMISSIONER FIEDLER: U.S. universities?

DR. ABRAMI: U.S. universities, yes.

COMMISSIONER FIEDLER: Yeah, I know.

DR. ABRAMI: Yeah, quite a number of endowments are tied into QFII funds.

COMMISSIONER FIEDLER: Yeah. There's no functional relationship between intelligence and the ability to make money.

[Laughter.]

COMMISSIONER FIEDLER: This is a clear example.

DR. ABRAMI: I did not say that.

COMMISSIONER FIEDLER: You, Dr. Abrami, made a comment earlier that banks cannot price risk. I want to transform that slightly. How then can anyone else do anything resembling due diligence in China regarding an investment?

DR. ABRAMI: Do you want me to start on that one? Okay. So I'll focus on one piece I know particularly well, which is the peer-to-peer lending, and it's a high-touch approach to due diligence which entails--

COMMISSIONER FIEDLER: Close. Close touch, you mean?

DR. ABRAMI: Close touch meaning the frequency of literally showing up at someone's door and trying to get a sense of how likely they are to repay by looking around and figuring out what assets they have in the house. So at that level, it goes on.

At a higher level, for certain, there are companies that do due diligence, and they do it quite well by basically double backing and checking on registration records, figuring out if a company says it's registered to do something, that it actually has permission to do that particular thing. You may know that Chinese companies, when they get their business licenses, are licensed to do a certain thing. Most of them would like to do other things.

That's not always easy in China, so if they're trying to raise capital to do that other thing, you'd want to know if they can legally do that other thing. So people do check licensing in terms of due diligence. I think once you start to get into the broader matrix of these larger holding companies, then it becomes far more difficult.

DR. WALTER: On a macro basis, I think, I think you really fail to understand the role that Wall Street has played in creating China's huge companies.

COMMISSIONER FIEDLER: Actually I don't.

DR. WALTER: They all created them. All these big national champions were all created by the Morgan Stanley and Goldman Sachses of the world. And what were they created out of? They were created out of--you want to talk about due diligence. I can tell you--I've done this kind of stuff--you really do a lot of due diligence. Nobody knows what a company even looks like when you start one of these things, and you gradually work with lawyers to see who owns what and with the accountants to see--what--okay, if you put a box like this, what does it mean until you finally come up with something that resembles a company.

And then you say, “All right, well, now that's a company.” How do I price the shares of this company? Well, I look at companies that are comparable to it overseas that are listed already. Then I do a little discount on the share price. You're taking companies that don't exist, that you've created yourself that have had no seasoning, as we've talked about, and putting a price on it using seasoned companies even though you do a discount.

The level of due diligence that goes into these larger transactions, not the ones that we've just been mentioning, is humongous. When China Construction Bank was listed, KPMG did 1.148 million man-hours of due diligence on that. So there's a lot of due diligence that goes in.

But when you're asking, “What are they finding?”, they are creating the numbers the first time. The numbers don't exist.

COMMISSIONER FIEDLER: In the case of investment banks, on an economy of scale, they can afford to do that kind of due diligence. An ordinary U.S. investor or a middle market company thinking of investing in China appears to me to be naked in its ability to really determine what they're doing.

DR. WALTER: I always believed that the only value that an investment bank had was its integrity. And the brand name on a security offering made it worthwhile if you had sufficient integrity, and the investor could rely on that. I think that's one part of the system that speaks to that.

If you're a small company, and there’re lots of small companies over in China doing business, then you go and learn yourself the hard way. That's the only way to do it. You have to learn how to do business there.

DR. ABRAMI: I would add--

DR. WALTER: And you can. People do.

DR. ABRAMI: I would add that for many of the listings you see in Hong Kong, the drive is also Chinese companies wanting to send a market signal to potential investors that they've gone through some kind of due diligence process. So they themselves are trying to think of external markets as a way to signal the credibility of their operations.

DR. WALTER: I'm a visiting scholar at Stanford this semester, and I sat down with a lovely young girl who is from Shanghai who is doing a dissertation on property development industry in China, and she showed me two companies. One was China's oldest and best property developer, private property developer, Vanke. The other was China Overseas Land, Incorporated. Which one made the most money? It was not the private company by a multiple. Both were listed in Hong Kong.

Okay. Why? Think of what that machine is. That is a machine--this is a company incorporated in Hong Kong with all of its assets in China doing property development and taking the profits out to Hong Kong again. Think of what that machine is for the state, for the Party people who run that machine. That's why it makes more money.

COMMISSIONER FIEDLER: Thank you very much.

HEARING CO-CHAIR CLEVELAND: Commissioner Wortzel.

COMMISSIONER WORTZEL: I'm afraid I might take you off track a little bit, but we routinely map regional affiliations, family relationships, and policy networks as a way to understand intra-Politburo conflict in the political system.

And what I've drawn from a lot of your comments today is that it may also be possible to map these financial relationships as a different insight into intra-Politburo conflict. Are you aware of any studies that have done that that you could point us to?

DR. WALTER: I don't know. Dr. Abrami may--I think I don't know, and I've been reading a lot of this stuff in the last two months. There's a man named Victor Shih who has written about these kind of issues recently. But there is a group of people that is very well known to everyone in the industry who are the financial reformers, and they really all--there's a man named Wang Qishan who was the Senior Vice Premier but is now head of the Disciplinary Committee. Maybe he by his seniority is the patron of these guys.

The current governor of the central banks--one of these guys--everybody knows who these guys are. The people at the sovereign wealth fund are these guys. There's a hard core group of people who have risen and fallen depending on whatever the government wants to do. So, yes, you can easily know who that bunch of folks are. The guy who is head of the CSRC, now was supposed to be the head of the PBOC, but apparently is a little bit too activist for everybody's taste.

DR. ABRAMI: Yeah. I would add Erica Downs who also did a wonderful study looking at the oil industry and the movement of officials between roles as heads of oil companies and roles as provincial governors and the like. I don't think there is a more blatant example of the connection between the—perhaps telecom as well-- Party and business.

I think that there's another avenue to look for as well, and that is to track the mobility of top CEOs in the top 200 state-owned enterprises and follow their career paths and their movement in and out of office. It will tell you quite a bit.

DR. WALTER: I don't want to blow my book's horn any at all, but if you look at the chapter on building the national champions, you'll have the guys who were on the Central Committee and on the Politburo in it, who run these national champions. These big companies are lock, stock and barrel part of the Party system.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR CLEVELAND: What's the average length of loan? I think you said in your testimony it's very, very short by our standards.

DR. ABRAMI: Short terms. In the trust companies, the longest I've heard was three years, but some of them can have a matter of month maturities, and that's why this mismatch between maturity dates and a property development project is so concerning.

DR. WALTER: But this isn't about property development. It's about taking things off balance sheets, and that's where the Ponzi scheme conversation comes in. So it's very, very short term so they can manage it all so at the end of the year, they have a lot of deposits so their loan-to-deposit ratio looks good.

But on the larger loans, the one-year rate is really the rate. People make one-year loans and they roll them. Most of the deposits are demand deposits. So you're really doing very short-term stuff.

If you look at the bonds, they are basically floating rate for the most part. If they're not floating rate, they're all short funded so there's a real issue. It just really makes it institutionally difficult to liberalize your interest rate structure.

HEARING CO-CHAIR CLEVELAND: Okay. Final question unless nobody else has any. I'm interested in the China Investment Corporation and your observations about its role in terms of the domestic economy?

DR. WALTER: Okay. Those guys--Lou Jiwei who runs it is going to be the new Minister of Finance apparently. We'll know, I guess, today or tomorrow. But how would you like to sit on top of $200 billion, and you've been told to invest it? You invest it in a great blue chip company in the United States, and the stock tanks. What do you think his Party pals are going to say to him?

You really can't imagine how difficult the sovereign wealth fund guys have it. There are really two sovereign wealth funds in China. One is run by SAFE. That has the other billions of dollars. They are very, very quiet. They lost 100 billion bucks in 2008. Did you hear anything about it? No. But the guys who are public are China Investment, those guys are public, and they have a tremendous amount of political pressure.

It's not a fun role to have. That's my comment on them. They don't have any role to play in the domestic economy. They're purely--their role is for overseas investment, trying to do something with the 3.6 trillion.

HEARING CO-CHAIR CLEVELAND: Are they succeeding, setting aside the?

DR. WALTER: $200 billion out of 3.6 trillion.

DR. ABRAMI: It's little in relative terms.

DR. WALTER: Put another way, these guys own the banks. When the banks listed, book value of the shares that the Investment Corporation owned in those banks was one renminbi. They all listed in a multiple of that. That profit carried them over for the first three years. I haven't looked at their latest statements. They're profitable nominally, but that doesn't mean that everybody in the Politburo is not looking at what they're investing in.

Do you think it's good to invest in Morgan Stanley? People must have agreed all the way to the Politburo.

HEARING CO-CHAIR CLEVELAND: Okay. Commissioner Shea.

VICE CHAIRMAN SHEA: If you could, just educate us a little bit about the mortgage market in China? Is there a mortgage market? What is the typical downpayment that one makes? How are borrowers underwritten? Are there any underwriting standards used? What's the interest rate?

DR. ABRAMI: I can't talk extensively about this. I would say in terms of underwriting, each bank has access to the PBOC's Credit Bureau, and then they develop their own algorithms to assess the risk of lending to a particular potential borrower.

That PBOC Credit Bureau is not available to all financing instruments. Obviously, underground bankers don’t access it. Trust companies may have access, and that's usually how they do their underwriting. The PBOC has credit data on millions and millions of people. In terms of down payments, it's not an area I'm very familiar with.

COMMISSIONER WORTZEL: The latest China Quarterly has a big article that covers just that.

VICE CHAIRMAN SHEA: Okay. I'd like to get a copy of that.

The issue of these trust instruments and these wealth management products, I mean looking at the elements there, there's moral hazard because--

there are assets of poor or unknown credit quality backing the investments. There's absence of any kind of risk-based pricing, and there seems to be a belief among some of these investors, maybe at the retail level, that the markets are going to go only in one direction, and that's up. And that to me sounds a lot like the subprime mortgage crisis that we had in the United

States. Is there a similarity here?

DR. ABRAMI: I would say that many people have made that comparison, although, by and large, in China, moral hazard is government policy. So I think that's a little bit of a different system in that regard. There is such confidence of bail out that it does make for a different scenario.

If we're talking objectively in terms of the structure of these things, yes, they do look like pooled capital collateralized debt obligations.. In China today, there too are new structure investment vehicles so, yes, there're parallels there. at least I hope that moral hazard is not the policy of the U.S. government, and in that context I think it's different.

DR. WALTER: It's a closed system. You are short funded by bank deposits, not by securities. Where are people going to go? Right? So the government is going to bail them out. How do they bail them out? They print money. And what do they do then? Then they take the money out of the banks by the reserve ratio or by issuing more bills. If you look at the--

VICE CHAIRMAN SHEA: So is this sustainable? Dr. Abrami thinks it is, but Dr. Walter, do you think it is sustainable?

DR. WALTER: I don't think it's in the long term sustainable.

DR. ABRAMI: Yes I would agree. In the long term, it's not, but I would say in the immediate term, based on what we already see underway, there's an awareness of a need to bring these trust companies under greater scrutiny, possibly even eliminate them, and move to other financing vehicles.

There's been much attention to the fact that trust companies were not mentioned in the 12th Fifth Year Plan, whereas mutual funds were. And I know this sounds like an odd detail , but such signaling devices are taken quite seriously in China.

DR. WALTER: Yes.

DR. ABRAMI: So maybe they will not be here in five years or two years. We just don't know.

DR. WALTER: The trust companies have had a long and illustrious history in China. Five years. If there's a recovery in the Western world in demand, then they'll get over it. If there's not, then they're going to have a real problem.

VICE CHAIRMAN SHEA: So the Chinese have a different temporal horizon than us. Long term might be a thousand years. So what's your definition of "long term," unsustainable in the long term? How would you define "long term"?

DR. WALTER: Five years.

VICE CHAIRMAN SHEA: Five years.

DR. ABRAMI: Yes. We work in five year plans.

[Laughter.]

DR. WALTER: Unless--yeah, exactly. I've been there so long, I can't think outside of five-year segments.

VICE CHAIRMAN SHEA: Thank you.

DR. WALTER: But unless there's a recovery.

DR. ABRAMI: Yes.

VICE CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR CLEVELAND: We're right on time. Thank you very much. Your testimony has been terrific.

DR. ABRAMI: Thank you.

HEARING CO-CHAIR CLEVELAND: Very informative. Thank you. Discouraging but informative.

[Whereupon, at 12:34 p.m., the hearing recessed, to reconvene at 2:01 p.m., this same day.]

PANEL III INTRODUCTION BY COMMISSIONER CARTE P. GOODWIN

HEARING CO-CHAIR GOODWIN: Thank you all. Our third and final panel today will examine market conditions and access issues for U.S. financial services firms looking to do business in China.

John Dearie is Executive Vice President for Policy at the Financial Services Forum, an economic policy organization comprised of CEOs of 19 of the largest financial institutions in the country.

Prior to that, Mr. Dearie spent nine years at the Federal Reserve in New York. He's also served as Managing Director of the Financial Services Volunteer Corporation, which helps to build sound banking and financial systems in developing countries.

Professor Paul Saulski is Adjunct Professor of Law at Georgetown University Law Center where he teaches courses on international securities regulation and China's financial markets.

His current research and teaching focuses on international securities regulation and the development and reform of Chinese capital markets.

Professor Saulski is also Senior Counsel in the Office of International Affairs at the SEC. He began his legal career in the Tokyo office of White and Case where he specialized in cross-border securities transactions, M&As, and the establishment of hedge funds.

Finally, Stephen Simchak serves as the Director of International Affairs for the American Insurance Association, overseeing the association's engagement on global trade and regulatory issues. AIA is the leading property casualty insurance trade organization in the U.S., representing approximately 300 major U.S. insurance companies.

Prior to joining AIA, Mr. Simchak was the Program Director for the Coalition of Service Industries where he managed international trade and investment negotiations.

He also previously served in the offices of Congressman J. Randy Forbes and Congressman Bill Shuster.

Thank you all very much for being here today, and Mr. Dearie, if you could start us off.

OPENING STATEMENT OF JOHN DEARIE
EXECUTIVE VICE PRESIDENT FOR POLICY
FINANCIAL SERVICES FORUM

MR. DEARIE: Thank you, Senator, and Commissioner Cleveland, and other members. I certainly appreciate the opportunity to be here.

As mentioned, I'm here in my capacity at the Financial Services Forum, which it is a financial and economic policy group comprised of the chief executives of 19 of the largest financial institutions here in the United States. The Forum also leads Engage China, which is a coalition of 12 financial services trade associations here in town united in our support of high-level engagement between the United States and China, with a particular emphasis on continued and even accelerated financial reform in China.

I've been watching the other panels on the Webcast, and all of which have been terrific, and I know you've already heard a great deal about the many and quite serious financial problems in China.

The analogy that I frequently use when I'm speaking to people on the Hill and elsewhere is that China is like a world-class athlete with cardiovascular disease, running an ever present risk of catastrophic breakdown, even as they continue to turn in robust economic performances.

The topic of today's hearing is enormously important, especially given the continued fragility of the economic recovery here in the United States and persistently high unemployment. The rate of China's economic growth in recent decades and the integration of a fifth of the world's population into the global economy is unprecedented in human history and has profound implications for U.S. economic growth and job creation.

For that promise to be realized, however, China must accelerate reform and modernization of its financial system, including, in our opinion, opening its financial sector to more significant foreign participation.

Progress has been made in recent years as part of the U.S. Strategic Economic Dialogue. But major barriers remain. While China may be compliant with the letter of its WTO obligations, such restrictions and regulations and the manner in which they are enforced, in our view, violate the spirit of China's WTO obligations by creating artificial and arbitrary barriers to greater foreign participation.

As you know and have heard a lot about today, China's economy has grown at an annual rate of nearly ten percent for more than two decades. The world's seventh largest economy as recently as 1999, it recently surpassed Japan to become the world's second-largest economy.

Since China joined the WTO in December of 2001, U.S. exports to China have increased more than sixfold, seven times the pace of U.S. exports to the rest of the world. Since 2001, 48 states have experienced at least triple digit growth in their exports to China, far outpacing the growth of their exports to the rest of the world. 20 states have recorded quadruple digit export growth.

China is now America's third-largest export market and the largest market for U.S. products outside of North America. So clearly, fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American manufacturers, service providers and farmers.

The good news is that after three decades of pursuing a manufacturing for export model, China's leadership now wisely seeks a more balanced economic model that relies less on exports and more on internal demand, in particular, a more active Chinese consumer.

But accomplishing that desired shift to a more consumption-based economy requires much more modern and sophisticated financial sector. Unfortunately, as I mentioned earlier, the world's second-largest and fastest growing economy is currently supported by one of the world's least developed and inefficient financial systems, even by emerging market standards.

Indeed, in a World Bank report released last year, which I'm sure you've heard about, entitled "China 2030," that report concluded that without major reforms to China's financial system, China runs the risk of a dramatic reduction in its economic growth with little or no warning.

As you may know, China's households currently depend on their families and private savings to pay for all aspects of their consumption, for their retirement, their health care, and for the economic consequences of accidents or disasters with the result that they save as much as half of their income. So activating the Chinese consumer requires the broad availability of financial products and services, personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products, that will eliminate the need for what's called precautionary savings and facilitate greater consumption.

The Strategic Economic Dialogue was created in 2006 in large part to accelerate financial reform in China. Since then, as I mentioned, some incremental progress has been made, specific examples of which are included in my written testimony. Still, China continues to impose substantial obstacles on U.S. financial institutions, including: caps on investment by U.S. firms in Chinese financial institutions; non-prudential restrictions on licensing and corporate form; arbitrary restrictions on permitted products and services; and arbitrary and discriminatory regulatory treatment.

Just to give you a quick sense of the impact of China's ownership and branching restrictions, consider that Citigroup, which first established a presence in China in 1902, operates just 50 branches in China, but, by contrast, the bank operates approximately 70 branches in Taiwan, which has a population of just 23 million.

The fastest way for China to get the modern financial system it needs, like other developing countries, is to open its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, credit analysis, risk management, internal controls, and corporate governance.

By providing the financial products and services that China citizens and businesses need to save, invest, insure against risks, raise living standards, and therefore consume at higher levels, foreign financial institutions, including American firms, would help China develop an economy that's less dependent on exports, more consumption driven, and therefore an enormously important expanding market for American-made products and services.

Thanks. Be happy to answer your questions.

PREPARED STATEMENT OF JOHN DEARIE
EXECUTIVE VICE PRESIDENT FOR POLICY
FINANCIAL SERVICES FORUM

Statement of
John R. Dearie
Executive Vice President
The Financial Services Forum

Testimony Before the
U.S. China Economic and Security Review Commission's
Hearing on China's Financial Conditions and Their Impacts on U.S. Interests

March 7, 2013

Introduction

Commissioners Cleveland and Goodwin, other members of the Commission, thank you for the opportunity to participate in this important and timely hearing.

My name is John Dearie and I currently serve as Executive Vice President at the Financial Services Forum, a financial and economic policy group comprised of the chief executive officers of 19 of the largest financial institutions with business operations in the United States. The Forum also leads Engage China – a coalition of 12 financial services trade associations united in support of high-level engagement between the United States and China, with a particular emphasis on accelerated financial reform and modernization in China.

The topic of today's hearing is enormously important, particularly given the continued fragility of the economic recovery and elevated unemployment. The rate of China's economic emergence and the impact of its integration into the global economy are unprecedented – with profound implications for U.S. economic growth and job creation.

For that promise to be realized, however, China must reform and modernize its financial system – including opening its financial sector to more significant and extensive foreign participation. Progress has been made in recent years as part of the U.S.-China Strategic and Economic Dialogue, but major barriers remain. While China may be compliant with the letter of its WTO obligations, such restrictions and regulations – and the manner in which they are enforced – violate the spirit of China's WTO obligations by creating artificial and arbitrary barriers to greater foreign participation.

Importance of Growing China to U.S. Growth and Job Creation

As you will recall, China's economy has grown at an annual rate of nearly 10 percent for more than two decades. The world's 7th largest economy in 1999, China has now surpassed Japan to become the world's 2nd largest economy.

Since China joined the World Trade Organization (WTO) in December of 2001, U.S. exports to China have increased more than six-fold – growing at seven times the pace of U.S. exports to the rest of the world. China is now America's third largest export market, and the largest market for U.S. products outside of North America. According to an analysis by the *Washington Post*, exports to China from almost every U.S. state and Congressional district have grown dramatically in recent years.[1]

As a specific example, Commissioner Cleveland, exports from Virginia to China have increased 787 percent since 2000, as compared to growth of just 42 percent in Virginia's exports to the rest of the world. Similarly, Commissioner Goodwin, exports from West Virginia to China have increased more than 1,000 percent since 2000, as compared to growth of just 293 percent in West Virginia's exports to the rest of the world.[2] Other states have posted similarly impressive growth. Clearly, fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American manufacturers, services providers, and farmers.

Let me give you a quick sense of what an expanding Chinese economy can mean for U.S. economic growth and job creation. Last year, U.S. exports to Japan totaled $70 billion, while U.S. exports to China totaled $110.5 billion. But China's population is *ten times* that of Japan. If China's citizens were to eventually consume American-made goods and services *at the same rate* as the Japanese do, U.S. exports to China would grow to $700 billion annually.

That's seven times what America exported to China last year, an amount equivalent to nearly 5 percent of U.S. GDP, and nearly twice what we imported from China last year – potentially turning a $300 billion trade deficit into a $300 billion surplus.

Perhaps more importantly, if we apply the Commerce Department's metric of 5,000 new American jobs for every $1 billion in additional exports, increasing exports to China to $700 billion a year would create some 3 million new American jobs. That won't happen overnight. But with the right reforms in place – and sufficient pressure applied – it certainly will happen over time.

Critical Importance of Financial Sector Reform in China

In our view, one of the most fundamental and important reforms necessary for the United

[1] "U.S. Exports to China Boom, Despite Trade Tensions," Keith B. Richburg, *The Washington Post*, March 11, 2012.

[2] Export statistics provided by the U.S.-China Business Council.

States to harness the job-creation power of a rapidly growing China is modernization of China's underdeveloped financial system.

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. As the institutional and technological infrastructure for the mobilization and allocation of investment capital, an effective and efficient financial system is essential to the health and productive vitality of any economy.

As a financial sector becomes more developed and sophisticated, capital formation becomes more effective, efficient, and diverse, broadening the availability of investment capital and lowering costs. A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk – from derivatives instruments used by businesses to avoid price and interest rate risks, to insurance products that help mitigate the risk of accidents and natural disasters. Finally, the depth and flexibility of the financial sector is critical to the broader economy's resilience – its ability to weather, absorb, and move beyond the inevitable difficulties and adjustments experienced by any dynamic economy.

For all these reasons, an effective and efficient financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend.

Unfortunately, the world's second largest and fastest growing economy is currently supported by one of the world's least developed and inefficient financial systems. Like a world-class athlete with cardiovascular disease, China runs an ever-mounting risk of catastrophic breakdown even as it continues to turn in robust economic growth performances.

China's financial sector challenges are many. For example:

- China's financial system is very bank-centric, with banks intermediating more than three-quarters of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies.

- Non-commercial lending – or "policy lending" – to state-owned enterprises continues.[3]

- As a result, the stock of nonperforming loans on banks' balance sheets remains high.

- Off-balance sheet and non-bank lending through trust companies, especially to local government run state-owned companies, has greatly expanded and is largely unregulated.[4]

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[3] See "For Top Chinese Banker, Profits Hinder Political Rise," Lingling Wei and Bob Davis, *The Wall Street Journa*l, February 18, 2013.

- China's banks remain undercapitalized compared to western counterparts and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain sub-standard.

- Prudential supervision and regulation of the financial sector remains opaque, is applied inconsistently, and lags behind international best practices.

- China's equity market, the world's sixth largest by total capitalization, is also one of the most restrictive in terms of foreign participation. Foreign investors currently hold only about 1.5 percent of China's domestic share market and can only invest in Chinese companies through funds managed by brokerage firms, banks, and other financial institutions.

- Despite significant growth since 2008 and especially more recently, China's bond markets, remain comparatively small and underdeveloped.[5] The big five state-owned banks hold over 60 percent of all outstanding bonds, other state-owned entities hold another 30 percent, and 95 percent of all corporate issuers are state-owned enterprises.[7]

- Low penetration of insurance creates unmitigated risks and retards investment and family security.

More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

Simply stated, China's underdeveloped financial sector presents substantial risk to the continued growth and diversification of the Chinese economy – and, given the importance of China's economy, to the U.S. and global economies as well.[8]

China's Commitment to Financial Reform

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[4] "In China, Hidden Risk of Shadow Finance," Lingling Wei and Dinny McMahon, *The Wall Street Journal*, November 26, 2012.
[5] "China's Corporate Bond Market Booms," Simon Rabinovitch, *Financial Times*, July 12, 2012.
[7] *Red Capitalism: The Fragile Financial Foundations of China's Extraordinary Rise*, Carl E. Walter and Fraser J.T. Howe, Wiley, 2010. Also see "Of China's Financial Bondage," Carl E. Walter and Fraser J.T. Howe, *The Wall Street Journal*, January 17, 2013.
[8] See "Why Financial Reform is Crucial for China's Growth," Arthur R. Kroeber, The Brookings Institution, March 19, 2012

In its 12th Five-Year Plan, approved by the National People's Congress in March of last year, China's leadership acknowledged that its manufacturing-for-export economic model of the past three decades has left it vulnerable to slow-downs in external demand. China's leadership now seeks a more balanced economic model that relies less on exports and more on internal demand – primarily, a more active Chinese consumer.

A more consumption-based Chinese economy is very much in the interest of the United States. As I noted earlier, a more active Chinese consumer will dramatically expand demand for U.S.-made products and services.

But accelerating the shift to a more consumption-based Chinese economy requires a more modern and sophisticated financial sector.[9] Chinese households currently save as much as half of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state, and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, education, and the economic consequences of accidents or disasters.

Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products – that will eliminate the need for such "precautionary savings" and facilitate consumption.

This observation was confirmed by an important report entitled "China 2030," jointly issued a year ago by the World Bank and China's Development Research Center. The report emphasized that achieving China's macroeconomic goals requires a number of urgent reforms, including "commercializing the banking system, gradually allowing interest rates to be set by market forces, deepening the capital market, and developing the legal and supervisory infrastructure to ensure financial stability and build the credible foundations for the internationalization of China's financial sector."[10]

Given the unique and critical role an effective financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals.

Fortunately, China's leadership has recognized the connection between faster financial reform and the goal of a more consumption-based economy. In a speech opening the National People's Congress last March, Premier Wen Jiabao confirmed that China seeks more balanced and sustainable development, stating "we will move faster to set up a permanent mechanism for boosting consumption." Importantly, as part of the restructuring strategy, Wen also appeared to endorse further reform of China's financial system, stating: "We will improve both initial public

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[9] "Financial Sector Reform Vital to Rebalance, Sustain China's Growth," International Monetary Fund, November 14, 2011.
[10] "New Push for Reform in China," Bob Davis, *The Wall Street Journal*, February 23, 2012.

offerings…and ensure better protection of return on investors' money and their rights and interests."[11]

The same day, Guo Shuqing, Chairman of the China Securities Regulatory Commission commented to reporters: "Market risk is concentrated in the banking system. Developing equity financing…can reduce the burden on the government, and open new investment channels to funds and wealthy citizens."

More recently, on January 14th of this year, Mr. Guo startled global markets when he said during a speech in Hong Kong that foreign participation in China's stock market could be increased by as much as ten times. "For our capital markets to mature, they must be open more in the future," Mr Guo said. "Our goal is to make it easier for non-residents to issue and trade securities in the domestic markets."[12] Mr. Guo's statement was interpreted by some observers as an indication that foreign individuals may soon be permitted to buy shares directly in Chinese companies.

A very recent indication that China's new leadership remains committed to financial reform is the decision that Zhou Xiaochuan, Governor of the People's Bank of China (PBOC), will remain at that post. It was originally reported that Zhou would leave the Bank this month.[13] Zhou has been Governor since 2002 and is the longest serving head of the PBOC. He has been a key reformer, presiding over the Bank during the financial crisis and helping implement important reforms, including the further appreciation of the yuan, as well as liberalization of the corporate bond market and bank deposit and lending rates.[14]

The fastest way for any developing economy to acquire the modern financial sector it needs is to import it – that is, to allow foreign financial institutions to establish in-country operations though the establishment of branches and subsidiaries, partnerships with domestic institutions, and cross-border mergers and acquisitions. Foreign institutions – including U.S. institutions – bring to China world-class expertise and best practices with regard to products and services, credit analysis, risk management, internal controls, and corporate governance.

The U.S.-China Strategic & Economic Dialogue

To enhance the management of the growing bilateral relationship, President George W. Bush and President Hu Jintao established the U.S.-China Strategic Economic Dialogue (SED) in

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[11] "China Premier Backs Blueprint for Financial Reform," Dinny McMahon, *The Wall Street Journal*, March 5, 2012.
[12] "China Hints at Far Wider Welcome to Overseas Investors," Neil Gough, *The New York Times*, January 14, 2013. Also see "Forget China's Leaders – Watch This Man for Reforms, *CNBC.com*, January 22, 2013.
[13] "China Bank Chief Set to Keep Job in Reshuffle," Benjamin Kang Lim and Victoria Bi, *Reuters*, February 20, 2013.
[14] "China Extending Zhou Stay Seen As Aid to Financial Overhaul," Kevin Hamlin and Scott Lanman, *Bloomberg*, February 21, 2013.

September of 2006. The SED – led by then-Treasury Secretary Hank Paulson and Chinese Vice Premier Wang Qishan – created an unprecedented channel of communication between Cabinet-level U.S. and Chinese policymakers, and provided an overarching framework for the examination of long-term strategic issues, as well as coordination of ongoing bilateral policy discussions (e.g., the Joint Commission on Commerce and Trade, the Joint Economic Committee). A central focus of the SED was accelerating financial reform in China.

Upon taking office, the Obama Administration renamed the Dialogue as the "Strategic & Economic Dialogue," broadening the talks to include other issues such as human rights, environmental issues, and diplomatic cooperation.

Limited but meaningful progress has been made by way of the Dialogue. For example:

- China has agreed to allow qualified foreign companies to list on its stock exchanges by issuing shares or depository receipts;

- China has expanded its Qualified Foreign Institutional Investor (QFII) program and reduced the initial "lock-up period" for certain investors, creating new opportunities for foreign mutual funds and money managers to invest in China;

- China has agreed to allow non-deposit taking foreign financial institutions to provide consumer financing;

- China has agreed to ease qualifications for foreign banks to issue yuan-denominated subordinated bonds, which will allow foreign banks to raise capital in China;

- China has issued regulations specifying requirements to allow insurance companies – including foreign-owned companies – to invest assets overseas; and,

- Since July of 2005, the yuan has appreciated against the U.S. dollar by more than 25 percent in nominal terms and almost 40 percent in real terms. [15] Last April, China widened the yuan's trading band to allow market forces to play a greater role in setting the exchange rate.[16] Some analysts believe the PBOC hopes to make the yuan fully convertible by as early as 2015.

Additional progress achieved at the most recent S&ED meetings last May included:

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[15] "The Outlook for China's Currency," Laura D'Andrea Tyson, *The New York Times*, May 6, 2011. Also see "China Bashing is Popular But Could Do More Harm Than Good," Editorial, *Bloomberg*, April 25, 2012.

[16] "Chinese 'Currency Manipulation' Is Not the Problem," Edward Lazear, *The Wall Street Journal*, January 7, 2013.

- China now has amended its regulations to implement last year's S&ED commitment to allow U.S. and other foreign insurance companies to sell mandatory auto liability insurance in what is the world's largest market for automobiles.

- China committed that foreign and domestic auto financing companies – currently dependent on China's state-owned banks for funding – will be able to issue bonds regularly, including issuing securitized bonds. This will help boost the competitive edge in China of U.S. auto firms, which are global leaders in auto financing.

- China committed to increase the total dollar amount that foreigners can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor (QFII) program from $30 to $80 billion. This will reduce restrictions on the free flow of capital and increase opportunities for U.S. pension and mutual funds and other investment management firms.

- China committed to allow foreign investors to take up to 49 percent equity stakes in domestic securities joint ventures, going beyond China's WTO commitment of 33 percent. China also agreed to shorten the waiting period ("seasoning period") for securities joint ventures to apply to expand into brokerage, fund management, and trading activities that are essential to building competitive securities businesses.

- China agreed to allow investors from the U.S. and other economies to establish joint venture brokerages to trade commodity and financial futures and hold up to 49 percent of the equity in those joint ventures. And,

- China reaffirmed its intention to promote more market-based interest rates, which will allow Chinese households to earn a higher return on their savings, supporting greater household consumption.

U.S. Institutions Still Confront Major Restrictions

Despite such important progress, U.S. financial institutions continue to face a number of substantial obstacles in China. For example, foreign investment in Chinese banks is limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Foreign ownership amounts to less than 2 percent of the Chinese banking system, the lowest foreign share among major emerging markets according to the IMF.[17] Foreign banks also face a number of regulatory restrictions on their ability to branch within China (see Appendix for details). According to Treasury Department data, as of December 2011, only eight U.S. banks were operating in China with a total of just 76 branches.[18]

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[17] "Foreign Banks: Trends, Impact, and Financial Stability," Stijn Claessens and Neeltje van Horen, International Monetary Fund, January 2012.
[18] "Banks Find Promise Unfulfilled in China Forays," Alison Tudor, *The Wall Street Journal*, January 13, 2013.

To give you a sense of the impact of China's ownership and branching restrictions, consider that Citigroup, which first established a presence in China in 1902, operates just 50 branches in China. By contrast, Citigroup operates approximately 70 branches in Taiwan – which has a population of just 23 million.[19]

Foreign-owned securities and asset management firms are limited to joint-ventures in which foreign ownership is capped at 49 percent. Meanwhile, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies.

While such caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market nation and stand in the way of a level playing field for financial service providers. More importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of economic growth, and that China's businesses and citizens need to save, invest, and create and protect wealth.

Such investment caps also stand in stark contrast to the Federal Reserve's decision last year to approve Industrial & Commercial Bank of China's acquisition of the Bank of East Asia's U.S. banking subsidiary,[20] Bank of China's application to expand its U.S. operations to Chicago[21], and the application by Agricultural Bank of China Ltd. to establish a branch in New York.[22] As strong proponents of cross-border trade and investment, the U.S. financial services industry applauds the Fed's decision – but also calls on China to lift remaining restrictions to U.S. investment in China's financial system.

Other remaining barriers to U.S. activity in China include non-prudential restrictions on licensing and corporate form; arbitrary limitations of permitted products and services; and, arbitrary and discriminatory regulatory treatment.

With these problems in mind, U.S. effort within the S&ED and other bilateral exchanges should focus on:

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[19] "China Wall Hit by Global Banks with 2 Percent Market Share," Jun Luo, *Bloomberg*, June 5, 2012.
[20] The subsidiary has assets of $780 million and 13 branches in New York and California. ICBC, China's largest bank, already operates in the United States through a New York branch. Under the terms of the approval, ICBC, China Investment Corp. and Central Huijin Investment Ltd. will become bank holding companies. The Chinese government owns 70.7 percent of ICBC's shares. See "Fed Allows Three Chinese Banks to Expand in U.S.," Greg Robb, *MarketWatch*, May 9, 2012.
[21] Bank of China, China's third largest bank, currently operates two branches in New York City and a limited branch in Los Angeles.
[22] ABC, China's fourth largest bank, currently operates a representative office in New York City.

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the services- and consumption-led economic growth that China's leaders seek;

- The clear benefits to China of increased market access for foreign financial services firms – namely the introduction of world-class expertise, technology, and best practices – and the importance of removing remaining obstacles to greater access;

- Non-discriminatory national treatment with regard to licensing, corporate form, and permitted products and services;

- Non-discriminatory national treatment with regard to regulation and supervision;

- Regulatory and procedural transparency; and,

- Further increasing institutional investors' participation in China's capital markets by expanding the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

For a more detailed discussion of the U.S. financial services industry's priorities in China, please see the provided Appendix.

Conclusion

The fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to open its financial sector to greater participation by foreign financial services firms.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help China develop an economy that is less dependent on exports, more consumption-driven and, therefore, an enormously important and expanding market for American-made products and services. In doing so, U.S. financial services firms can help China become a more stable and responsible stakeholder in the global economy and trading system.

It is also important to emphasize that Congress has an important contribution to make toward expanding market access generally, and encouraging faster financial reform in China specifically, by bringing the same kind of attention and pressure to these issues as it has to the relative value of China's currency. Chinese policymakers care what members of Congress think and carefully monitor the content of statements, speeches, and hearings as they gauge the state of the bilateral relationship. For example, the letter that Senators Warner and Johanns sent to Secretary Geithner on April 24, 2012 just prior to the S&ED in May, urging him to ensure that accelerated financial reform be a central aspect of the Dialogue, is an excellent example of the kind of pressure that makes a real difference.

Again, thank you for the opportunity to appear at this important hearing.

**OPENING STATEMENT OF PAUL SAULSKI
ADJUNCT PROFESSOR
GEORGETOWN UNIVERSITY LAW CENTER**

MR. SAULSKI: Yes. I'd like to thank Senator Goodwin, Commissioner Cleveland, and the other distinguished members of the Commission and its staff. Having the opportunity to speak with you here today on this very interesting topic, it's a real honor to be invited.

As has been noted, in addition to being an adjunct professor, I serve at the SEC, and therefore, I have to give you this required disclaimer that I speak for myself as a professor at Georgetown and not for the SEC, its Commissioners or the SEC staff. So with that aside, I'll turn to this very interesting and important topic.

So the transformation that has been witnessed in China in its 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.

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

As a consequence, all sectors of China's financial markets 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 of non-performing loans. This, of course, was discussed in detail in our last panel. And also discussed at that time was the fact that private companies are unable to access much of that capital from the state-owned banks, and that Chinese households are forced to put their savings in accounts that are providing them negative real interest rates, or extremely low, in any event.

These distortions have led to the development of a shadow banking system that, although providing possible competition for credit, is also generating possibly unseen risks to the greater financial system.

As for China's insurance sector, it is characterized by a limited variety of available insurance products and resulting small percentages of insured assets. This, in turn, hinders diversification of China's business sector and contributes to the high level of precautionary savings among China's households.

In China's securities markets, listings on China's stock markets 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 stock markets fail to serve as a venue for capital raising by the private entrepreneurial 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 the state-owned enterprises, of government interference in the stock market, and a perception, not unwarranted, of rampant market manipulation and insider dealing in China's securities markets, it has not become a viable option for Chinese households for investment.

Turning to the topic of access to China's financial sectors by foreign market participants, despite some recent progress in this area, access to China's financial markets and the financial services industry remains 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 G-20. In fact, in regard to inward investment in financial services, China is by far the most restrictive of the BRIC nations.

In the banking sector, equity ownership of Chinese banks is limited to 20 percent by a single foreign investor with a total of 25 percent collective ownership by foreigners.

Setting aside these minority strategic investments, foreign banks still only have a small percentage in China's banking sector. China has taken a number of steps to implement its WTO banking service commitments, including access to the RMB market. However, the USTR reports that some of these efforts have generated concerns such as in regard to Chinese foreign joint banks and bank branches.

Despite this, banking is still probably the most open to foreign competition of China's financial sectors. Today, most of the major foreign banks have incorporated as wholly-owned subsidiaries and can compete with local banks in the RMB-denominated products.

Access to the insurance sector is extremely 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 stake. Access by foreign investors and service providers to China's security markets is also significantly restricted. Foreign portfolio investment in China is limited for all intents and purposes to certain designated institutional investors. This was partially touched on in the last panel.

These are the Qualified Foreign Institutional Investors. Under that program, certain designated institutional investors, principally foreign banks and investment funds, can invest a certain quota into the market. That quota actually recently was raised from 30 billion to 80 billion. However, even with this quota, that still only represents one percent or less than one percent of the total market value of the tradable shares in China.

As for securities firms, there are also significant restrictions placed on foreign access. Again, despite recent progress being made in this area, last year in accordance with the S&ED commitments, China increased the upper limit of foreign equity ownership in foreign joint venture, securities company joint ventures from 33 to 49 percent.

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, I believe, is unfortunate, as increased participation by foreign investors and institutions in China's financial sector would aid development in 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, restricts access to capital by non-state-owned firms. Furthermore, the lack of competition in China's financial markets facilitates destructive rent seeking behavior 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 China's long-term best interest is to open up the financial markets to foreign investors and service providers. I believe it is appropriate for the U.S. to continue to press China in this area through venues such as the U.S.-China Security and Economic Dialogue.

However, that being said, I would like to caution against viewing access by foreign financial firms, foreign financial service providers, as a panacea to all the ills in China's financial markets. 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 the imbalances in its economy.

In addition to financial market development, of which participation through foreign competition is an important part, China needs to improve the quality and enforcement of its regulations and its supervision in those areas. It needs to liberalize its interest rate policy and open up its capital account. And these reforms need to be coordinated so I also would urge that in addition to the issues of access, that the U.S. continue to press China in developing in all of these areas.

Thank you.

PREPARED STATEMENT OF PAUL SAULSKI
ADJUNCT PROFESSOR
GEORGETOWN UNIVERSITY LAW CENTER

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

March 7, 2013

Paul Saulski
Adjunct Professor
Georgetown University Law Center

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-sate-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.

OPENING STATEMENT OF STEVE SIMCHAK
DIRECTOR OF INTERNATIONAL AFFAIRS
AMERICAN INSURANCE ASSOCIATION

MR. SIMCHAK: Chairman Reinsch, Commissioner Cleveland, and Senator Goodwin, and other members of the Commission, thank you very much for having me here today. It's an honor to be here to testify in front of you.

The American Insurance Association is the leading property-casualty insurance trade organization in the U.S. Our members write approximately $225 billion annually in worldwide property-casualty premiums, and our members make up some of the most active property-casualty insurers abroad.

That's important because it's become very clear that when U.S. property-casualty insurers do well abroad, it creates jobs here at home. Though China's economy is not growing at the breakneck pace it was in recent years, it continues to present enormous potential for insurers because it has faster overall economic growth than developed economies, its insurance sector continues to grow quickly, and its insurance penetration remains quite low.

Economic growth and demand for insurance go hand-in-hand. As Chinese corporations grow in size and number, they need to insure their property and products and protect themselves from liability. Furthermore, China's rapidly growing middle class is demanding insurance. A recent study from PricewaterhouseCoopers found that non-Chinese property-casualty insurers expect that there will be a 20 percent growth in total premiums in China by 2015.

It has been predicted that China alone will account for 21 percent of global gross premiums by 2020. At the same time, property-casualty insurance penetration in China remains extremely low, at around two percent. But China's insurance sector is not as developed and efficient as it could be.

Dynamic, diverse insurance markets feature strong competition in products, services, pricing, specialization, innovation, technology, and have a variety of business models. Many of these key elements are either missing or are poorly developed in China. As a result, Chinese companies and the public are underserved at a time when insurance should be playing a major role, both as a catalyst and safety net for growth and prosperity.

A developed insurance sector would also have a stabilizing impact in China. Insurance generates an income smoothing effect, providing for greater financial and societal stability.

One reason for the underdevelopment of China's insurance sector is limited participation by foreign insurers in the market. For instance, there are only 21 foreign property-casualty insurers in China, and they hold only a 1.2 percent market share. That is not to say that the ability of foreign insurers to participate in China has not improved dramatically since it acceded to the WTO in 2001.

And on the whole, China's commitments in the property-casualty insurance sector are strong. For example, foreign property-casualty insurers are permitted to own 100 percent of their operations in China, which is not the case in many other countries, including major emerging economies. Though, as Paul pointed out, our counterparts on the life side are only able to own 50 percent of their companies there.

One notable recent positive development is the opening of China's compulsory auto insurance sector to foreigners, which could be a major source of growth for the insurance sector in China in the years to come.

However, there is clearly room for improvement that would benefit both foreign insurers and the Chinese economy and consumers. All too often, foreign insurers are discouraged from operating fully in China. They face numerous licensing and other regulatory hurdles that stifle their ability to participate fully in China.

These barriers explain the contradiction between the tiny 1.2 percent market share held by foreign property-casualty insurers and the expectations of massive growth opportunities. And despite the projections of rapid growth in China's insurance sector, pessimism that foreign insurers will be able to be a part of it abounds. Foreign property-casualty insurers surveyed by PwC believe that their share of the Chinese insurance sector will remain the same for the next three years.

In contrast, in 2007, those same foreign insurers believed that their market share would increase to ten to 20 percent.

I offer the following suggestions which would reduce barriers in China's insurance market to the benefit of both Chinese consumers and U.S. property-casualty insurers:

One, the China Insurance Regulatory Commission should focus on regulating and not be responsible for developing domestic insurance companies. CIRC has a dual mission to both regulate the industry and develop China's domestic industry. That will inevitably lead to conflicts with its supervisory objectives, as the IMF and the World Bank recently pointed out.

Two, CIRC should harmonize treatment of domestic and foreign insurers. Maintaining a separate International Affairs Department is not justified for prudential reasons.

Three, foreign insurers should receive national treatment and receive multiple new internal branch licenses at the same time.

Four, the burdensome administrative and regulatory costs for foreign insurers should be reduced.

Five, the Chinese government should help advance an understanding of the 2010 Tort Liability Law and its relevance to the insurance sector.

Six, international brokers should be given national treatment and allowed to serve as Chinese small-and-medium enterprises. Currently, foreign brokers are very limited in the types of policies they are permitted to service.

The best path forward is continued engagement between the two governments. An ambitious U.S.-China Bilateral Investment Treaty negotiation was recently launched by the USTR, and we support that and hope that it will address the problem of state-owned enterprises in China.

The Insurance Dialogue, part of the U.S.-China Joint Commission on Commerce and Trade, should continue to be a priority, and as should the Strategic and Economic Dialogue.

We also look forward to continuing our direct engagement with CIRC, as well as those ministries and government agencies that are involved in the development of strategic emerging industries in China. Though progress never moves as fast as one would hope, we have seen remarkable improvements in the last decade that we will build upon. What we must continue to do is demonstrate why long-term foreign involvement in China's insurance sector benefits China.

Thank you for the opportunity to testify today, and I look forward to answering any questions you may have for me.

PREPARED STATEMENT OF STEVE SIMCHAK
DIRECTOR OF INTERNATIONAL AFFAIRS
AMERICAN INSURANCE ASSOCIATION

TESTIMONY OF THE

AMERICAN INSURANCE ASSOCIATION

Before the

U.S.-China Economic and Security Review Commission

Hearing on

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

Panel on

Market Conditions and Access Issues for Banking, Investment, Insurance and other Services Firms

Thursday, March 7, 2013

Presented by:
Stephen M.H. Simchak
Director, International Affairs
American Insurance Association

On behalf of the American Insurance Association (AIA), I am pleased to offer this testimony to the U.S.-China Economic and Security Review Commission.

AIA is the leading property-casualty insurance trade organization in the U.S., representing approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses in the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums. AIA members make up some of the most globally active property-casualty insurers.

AIA works closely with the Office of the U.S. Trade Representative (USTR), the Treasury Department, the State Department, the Department of Commerce, and other government agencies on issues confronting U.S. property-casualty insurers in China. We particularly appreciate the work of USTR and the Department of Commerce on the U.S.-China Insurance Dialogue, part of the U.S.-China Joint Commission on Commerce and Trade (JCCT). Our trade negotiators are among the most dedicated in the world. We maintain a very strong relationship with the National Association of Insurance Commissioners (NAIC). NAIC has been very helpful in supporting U.S. property-casualty insurers that have operations in China.

China remains a very important market for U.S. property and casualty insurers. Though China's economy is not growing at the breakneck pace that it was in recent years, it continues to present enormous potential for insurers because 1) it is experiencing faster overall economic growth than developed economies, 2) its insurance sector continues to grow faster than those of developed economies, and 3) insurance penetration remains quite low relative to other economies.

U.S. insurers offer the experience and know-how to develop a first-rate insurance system in China that can meet the demands of China's population. They offer specialized, innovative products and global networks, in contrast to local insurance companies that offer scaled-down, standard products not suited for the dynamic environment of the 21st century economy.

China's Potential for Insurers and the Benefits of Insurance

Economic growth and demand for insurance go hand in hand. As Chinese corporations grow in size and number, they need to insure their property and products, and protect themselves from liability. Furthermore, China's urbanized middle class growth is increasing demand for insurance. The China Institute for Reform and Development, a government think tank, predicts that the middle class will encompass 600 million people by 2020. Members of China's middle class are buying cars, homes and other insurable assets. They need a way to safeguard and protect those assets that they've worked hard to earn. By pooling risk in an efficient insurance system, companies and individual consumers are able to grow and invest with confidence.

Facing a largely mature market and stagnant growth at home, U.S. insurers see a potential growth story in China and other Asian markets. In fact, a recent study from PricewaterhouseCoopers (PwC) found that non-Chinese property-casualty insurers expect that there will be a 20% growth in total premiums in China by 2015. It has been predicted that China alone will account for 21% of global gross premiums by 2020. At the same time, China remains an underinsured market compared to the rest of Asia. Property-casualty insurance penetration in China remains extremely low, at around 2%.

China's insurance sector is not as developed and efficient as it could be, to the detriment of insurers and consumers alike. The insurance markets around the world that most-successfully serve their domestic constituencies and support national economic development are typically composed of diverse players: domestic and international, large and small companies. Dynamic, diverse insurance markets feature strong competition in products, services, pricing, specialization, innovation, technology, and variety of business models. Higher economic growth is driven by competition and consumer choice. This is true of every country that has done well economically in the long term. Many of these key elements are either missing or are poorly developed in China, however. It remains dominated by state-owned insurers such as the PICC Property and Casualty Company. As a result, Chinese companies and the public are underserved at a time when insurance should be playing a major role both as a catalyst and safety-net for growth and prosperity.

A developed insurance sector would help encourage those sectors that China has identified as "strategic emerging industries" (SEIs). These industries, which include energy conservation and environmental protection, next generation information technology, bio-technology, advanced equipment manufacturing, new energy, new materials and new-energy vehicles, are all technology heavy. Their development will require sophisticated specialty insurance products that we take from granted in the U.S., but which largely are not available in China.

A developed insurance sector would also have a stabilizing impact in China. Insurance generates an income smoothing effect, providing for greater financial and societal stability. Insurance enables businesses and individuals to embark on higher risk, higher return activities that they would otherwise not be able to undertake, supporting productivity and growth. This is especially relevant for those most susceptible to economic downturn and social upheaval, as increasing access to insurance helps people to manage risk and obtain security, which is a key goal of financial inclusion. A developed insurance sector would also lead to long-term investment in China's infrastructure, from roads and bridges to schools and hospitals.

Foreign Participation and Underdevelopment of the Insurance Sector

One reason for the underdevelopment of China's insurance sector is limited participation of foreign insurers in the market. For instance, there are only twenty-one foreign property-casualty insurers in China, and those twenty-one foreign insurers held only a 1.2% share of the Chinese insurance market in 2012.

That is not to say that the ability of foreign insurers to participate in China has not improved dramatically. There have been remarkable improvements in China's insurance legal and regulatory regime since it acceded to the World Trade Organization (WTO) in 2001, and on the whole China's commitments in the property-casualty insurance sector are strong. For example, foreign property-casualty insurers are permitted to own 100% of their operations in China, which is not the case in many other countries, including major emerging economies. One notable recent development is the opening of China's compulsory motor vehicle third party liability (MTPL) insurance sector to foreign insurers. Being able to offer MTPL insurance is important to offering the full suite of auto insurance. Auto insurance is one of the most crucial emerging sectors in China and accounts for roughly 70% of China's property-casualty market.

We have also been encouraged by China's willingness to open the lines of communication between the two governments and also between the Chinese government and foreign business. For instance, the China Insurance Regulatory Commission (CIRC) has agreed to notice-and-comment periods for proposed regulations, though sometimes we wish those periods were longer.[1] CIRC officials meet regularly with insurance leaders in China and in the U.S., which has gone a long way to dispel much of the misunderstanding between the regulator and those foreign companies it regulates.

However, there is clearly room for improvement in China's insurance sector that will benefit both foreign insurers and the Chinese economy and consumers. The State Council has already overseen fundamental reform of other financial services sectors, but insurance reform has lagged.

All too often, foreign insurers are discouraged from operating fully in China. They face numerous licensing and other hurdles that stifle their ability to participate fully in China's insurance sector. These barriers explain the contradiction between the tiny 1.2% share of the Chinese property-casualty insurance market held by foreign insurers and the expectations of massive growth opportunities. Despite the projections of rapid growth in China's insurance sector, pessimism that foreign insurers will be able to be part of it abounds. Foreign property-casualty insurers surveyed by PwC believe their share of the Chinese insurance sector will remain the same for the next three years. In 2007, those foreign insurers believed that their market share would increase to 10-20%.

Furthermore, once in the Chinese market, the cost of doing business associated with regulatory hurdles and other factors limit the ability of foreign insurers to make a profit, which calls into question the long-term sustainability of foreign operations in China. Though there are twenty-one foreign property-casualty insurers in China, only three have been able to turn a significant profit in China.

To that end, I offer the following specific recommendations which I believe would greatly increase foreign participation in China's insurance sector to the benefit of US insurers and Chinese consumers alike:

[1] Most recently, CIRC released draft affiliate reinsurance regulations on December 24, 2012 with a comment deadline of December 31st. We believe this to be an unreasonably short time frame for comment coinciding with internationally recognized holidays.

Specific Recommendations

- **CIRC should focus on regulating and not be responsible for developing domestic insurance companies.** CIRC is charged with a dual mission: to both regulate the industry and develop China's domestic industry. A central tenet of good regulatory practice is that regulators must be independent and impartial. The social objectives and regulatory objectives of CIRC create an enormous potential for conflicts of interest. As the International Monetary Fund (IMF) and World Bank's 2012 Financial Sector Assessment Program (FSAP) report for China pointed out, "the range of commercial and social objectives almost inevitably will lead to conflicts with the supervisory objectives."

- **CIRC should harmonize treatment of domestic and foreign insurers.** Central to CIRC's emphasis on regulation should be harmonization of treatment for domestic and foreign insurers. Separate regulatory structures – one for domestic and one for foreign companies through the International Affairs department – are no longer justified and not in keeping with either international best practices or the International Association of Insurance Supervisors' (IAIS) core principles.

- **Foreign insurers should receive national treatment and be allowed to apply for and be awarded multiple new internal branch licenses at the same time, if the company chooses to apply for multiple licenses simultaneously.** The abilities to expand geographically and diversify risk portfolios are basic, fundamentally important insurance principles. Insurance companies need to be able to develop geographic reach and risk diversification in order to avoid concentration of risk and unbalanced, over-exposed books of business. CIRC should make it clear that foreign-invested insurers are able to submit multiple applications for branch approval, and if qualified, CIRC should approve them concurrently.

- **The burdensome costs for foreign insurers to operate in China should be reduced**. The cost of operating in China is very high compared to most other markets. Administrative burdens and compliance are particularly onerous, including CIRC's I/T requirements and rules regarding claims, finance and compliance personnel for new internal branches. CIRC should adopt global best practices in terms of regulatory maintenance and compliance costs.

- **In line with the State Council's explicit goal to build a liability culture and improve food and product safety, CIRC should help advance an understanding of the new Tort Liability Law and its relevance to the insurance sector**. To shift financial burdens away from the state, it is essential that Chinese companies purchase liability insurance to protect their balance sheets. In particular, product liability insurance should be required for companies bidding on government contracts.

- **International brokers should be given national treatment and allowed to service Chinese small and medium enterprises (SMEs).** If approved, this development would lead to a better understanding of loss control and risk-management techniques among companies currently not being served by foreign brokers. Currently, foreign brokers are very limited in the types of policies they are permitted to service.

Conclusion

The best path forward to bring about positive change in international insurance trade between the U.S. and China is continued engagement between CIRC, the Chinese Ministry of Finance, the NAIC, USTR, and other relevant U.S. Government agencies.

USTR has launched an ambitious round of negotiations for a US-China Bilateral Investment Treaty (BIT) that we hope will bring greater access and protection for U.S. insurers. The BIT should also address growing issues such as competition with state-owned commercial operations.

The Strategic and Economic Dialogue and the JCCT, mentioned earlier, also offer opportunities for the U.S. Government to continue to address specific issues in China. We will continue to work with USTR and other US Government agencies on identifying and advocating for the U.S. property-casualty sector's priorities in those dialogues.

We also look forward to continuing our direct engagement with CIRC, as well those ministries and government agencies that are involved in the development of strategic emerging industries (SEIs) in China, including the Ministry of Commerce, the National Development and Reform Commission, the Ministry of Science and Technology and the Ministry of Industry and Information Technology.

Though progress never moves as fast as one would hope, we have seen remarkable improvements in the last decade that we will build upon. Like any dutiful regulator, CIRC wants to protect Chinese consumers and grow the Chinese economy. What we have to continue to do is demonstrate why long-term foreign involvement in China's insurance sector will do just that.

Thank you for the opportunity to testify today.

PANEL III QUESTION AND ANSWER

COMMISSIONER WESSEL: Thank you. Thank you, gentlemen, for being here.

I understand that some of you are aware of our earlier discussions this morning about state secrets and a number of other things as they relate to doing business in China and transparency and those issues. From the financial services sector, if you were able to get greater access to China, is there a conflict with Chinese laws in terms of your ability to do proper due diligence?

So in the insurance side, P&C, are you going to be able to have confidence in the audited balance sheets of entities to know that your exposure is, in fact, the right risk profile? If you're a Goldman or an investment bank doing certain activities in China, are you able to have independent confidence in the information you're given or does your due diligence run up against Chinese laws and practices?

I'm trying to understand what do we actually get if we get into the Chinese market? I know everyone is looking for profits, but are we also increasing our risk profile in a sense that maybe they're not yet ready for the best we have to offer. Please, for each of the participants.

MR. DEARIE: I'll start if that's all right. Commissioner, I think you raise a very, very important and valid point, and there is no question that you're right. I'm sure that you have read about some of the difficulties with regard to accounting information, financial disclosure, and all the information associated with IPOs on the Chinese marketplace. There have been a lot of problems.

And so you're right. It is risky to do business in China. There is no question about that. Financial institutions who are active in China will have to take that into account in terms of the risk management, and in terms of reserving all of the usual things that financial institutions do to manage risk.

I would add to that, however, that I don't think that's a reason to not be there and be doing business. Quite the contrary. I think that the point that you raise is a perfect example of how important it is and how consequential and influential foreign participation can be in not just the Chinese financial sector but also the Chinese economy.

Having foreign financial institutions bringing what you would call world-class expertise standards from the standpoint of credit analysis, financial information disclosure, corporate governance, et cetera, and asking the kinds of questions of economic entities who might be seeking capital for this kind of information and reliability of this kind of standard, you can see how that would have a very, very positive and accelerating effect to progress in China in terms of raising all aspects of China's economy starting with the financial sector toward globally recognized best practices.

MR. SIMCHAK: Thank you very much. That's a very important question. I did see the panel this morning, and it raised some issues that are very concerning. I can't say I'm an expert in auditing or in accounting standards, but I don't think that a lot of the U.S. insurance companies are going to invest in companies in China that they're not able to feel that they have done full due diligence on. And, of course, that's what they do best, is due diligence and analyzing risk. That's their specialty.

I suspect that that could be an impediment to them getting into the market, but I don't think they will be in the market if they aren't confident in what they're doing. I also think that as they get into the market, that's going to increase the overall ability of the economy to analyze risk because that is what insurance companies do.

Thank you.

COMMISSIONER WESSEL: And, again, let me make sure I understand. Earlier you said that we have 1.2 percent of the market --am I correct?

MR. SIMCHAK: Foreign insurers.

COMMISSIONER WESSEL: Foreign insurers. As they're doing, and not looking at any individual company's activities, but in terms of the actuarial activities, the risk profile, all the risk analysis, is there a difference? To the extent you know, or if not, can you try and get back to us, as to how doing business in China is based on world-class standards? Or are there certain shortcuts one has to take at this point, either because of the quality of information or, as we heard earlier, because of impediments like the state secrets law?

Is there a difference in terms of access, activities, and does that have to be part of an aggressive agenda going forward-- understanding your companies are all world-class? Are there certain higher risks that take place there now that hopefully over time will be ameliorated? And what can policymakers help do to raise those issues?

MR. SIMCHAK: I can certainly get back to the Commission. My understanding is that a lot of the actuarial work that's done for U.S. property-casualty insurers in China is actually done in the United States. That's one of the reasons that operating abroad creates jobs here in the U.S.

Now, of course, that doesn't address the issue of whether that information is available, and I haven't heard that concern from our member companies, but I will check with them and get back to the Commission.

COMMISSIONER WESSEL: If you could let us know and also from the financial services--broader financial services, not just insurance--whether there is an information gap that has to be filled over time.

MR. DEARIE: If I could just mention very quickly--I certainly will--to add to my previous comment. The restrictions in terms of ownership that the three of us referred to and part of the reason why those restrictions are so serious and so damaging is that while it's true that if foreign financial institutions are in China and operating even in a minority capacity, they can contribute to the kind of progress and improvement that I spoke about earlier. But that is limited when you're a minority partner.

It would be--that progress and that accelerated development would be more accelerated if foreign financial institutions could operate as a majority partners or full ownership because then you'd really drive the process.

COMMISSIONER WESSEL: Understand. Thank you.

HEARING CO-CHAIR GOODWIN: Commissioner Fiedler.

COMMISSIONER FIEDLER: A couple of things. If all the access regulations, impediments, were removed, and you were allowed in, what does the lack of rule of law in the country present as an operating problem? So we're talking, you know, access. I'd like to own a lot, but what about the underlying legal system or lack of it in terms of risk to yourselves and risk doing business? Aren't you worried about it?

MR. DEARIE: Very. It's an excellent point, and it's not unrelated to the point that Commissioner Wessel made. It is--doing business in China is tough, for all of those reasons is risky, and that risk has to be taken on board, as I said, in terms of risk management procedures. The risk that you're talking about is legal risk or even operational risk pertaining to legal deficiencies. All of that has to be taken on board by financial institutions in terms of the threshold decision of whether or not they ought to even be in China and to what extent, in what way, in terms of capital and other kinds of risk management.

But, again, we're of the view that legal reform, to be sure, is one of the major reforms that needs to happen in China, and that greater foreign participation in the financial sector and in other sectors, having the world there and laying down demands and insisting on doing business in certain ways would accelerate progress in China. But you're right, it's a very, very big risk.

MR. SAULSKI: I also think your question does go right to the point of Commissioner Wessel's question. It highlights, I think, the point I was trying to make, and maybe not very well, in my opening remarks in how important it is that access by foreign financial firms is done in conjunction with our working with China through S&ED and imposing S&ED commitments, or working with China through S&ED or other fora to provide technical assistance and as a means to try to develop their regulatory oversight enforcement capabilities and to seek to open up and create more transparency in their markets.

Without that being done in conjunction with the greater access by U.S. financial service firms, I worry about what could happen to the U.S.

firms and the dangers this could place on the firms. There is a danger of not just possibly violating Chinese laws, but perhaps being put in a position where they will violate our own U.S. laws.

MR. SIMCHAK: Absolutely. I echo the comments of the gentlemen here. It's extremely important to our companies. I mentioned in my testimony the Tort Liability Law, which is the law which reforms China's tort system, legal liability. That's extremely important to insurers because obviously insurers cover that kind of liability.

COMMISSIONER FIEDLER: You're getting into auto accidents there.

MR. SIMCHAK: Absolutely. Absolutely. And so that's extremely important, and that's why we call for more public awareness of those laws and clarifications on them. I'd also add that regulatory transparency is extremely important to insurers as a highly regulated industry, and so we appreciate the work that CIRC, the insurance regulator, has done in terms of having notice and comment periods for new regulations. However, sometimes we find that there either is no notice and comment period or those notice and comment periods are extremely short.

I recall that on December 24th of last year, a new reinsurance regulation came out from CIRC with a notice and comment period ending on, I believe, December 29th. So you can see that that's not exactly a good period or a good time to notice or comment.

COMMISSIONER FIEDLER: I don't know if this is really a question or an observation. AIG obviously couldn't manage sophisticated risk, right? So we had to bail them out, right? Measurement of unsophisticated risk--and I think you guys are seeing the difference. Very sophisticated financial instruments are one thing, established legal systems in countries that are predictable, and managing unsophisticated risk--I would characterize China as an unsophisticated risk writ large--seems to present a lot of different operational and entry problems.

Now, insurance companies, investment banks, and a number of regular banking institutions also wear another hat in China. They invest. You take premium money in; you put it somewhere. You're not going to be able to take that money out as easily, right? The premium money you collect inside China.

So there is also the added risk of investment in the country. I mean sort of byproduct investment, if you will. That all seems, absent a real legal system, a horrendous set of risks that I don't know-- I suppose you could do sophisticated algorithms on it, but, you know, they're not going to be right. I don't know how you take unsophisticated risk and do all these algorithms with any degree of predictability. You could do them theoretically. Long Term Capital did a lot of algorithms. I don't know why you want to be there.

MR. DEARIE: I think your point is well-taken. And as I said, firms have to make these decisions individually. The only point I would offer that is some comfort is the WTO. China is a member of the WTO, and the great significance and importance of the WTO is that it is, in effect, a supranational dispute resolution. It’s almost a quasi-legal framework for the very purpose of administering and agreeing to global trade rules, as agreed to by the members of the WTO and a judicial-like process for dispute resolution when conflict arises.

Now, it's not perfect, to be sure. But at least it does add an element of certainty and recourse to what might otherwise be more of a Wild West environment there.

COMMISSIONER FIEDLER: Thank you.

HEARING CO-CHAIR GOODWIN: Commissioner Wortzel.

COMMISSIONER WORTZEL: Mr. Simchak, in your statement, you mentioned that the Strategic and Economic Dialogue and the Joint Commission on Commerce and Trade talks offer opportunities to address specific issues with China.

And Mr. Saulski, you also mentioned the S&ED and JCCT as dialogues where you hope China will improve and open itself up for business.

Please describe for us the results to date your industries have seen from these high-level dialogues. What have they produced for your industries?

MR. SIMCHAK: Absolutely. Thank you. That's a very important question.

The opening of China's mandatory third-party liability auto insurance market was a direct result of the S&ED and the JCCT and other government-to-government dialogues. That, the insurance industry believes, is going to be essential in the years to come in making China a profitable insurance market for them.

Basically, 70 percent of P&C insurance policies, insurance premiums in China, come from auto insurance, and that mandatory auto insurance is not all of the auto insurance. I think it's about 30 percent, but everyone who has a car has to have that. The rest of it is like extras --they're not going to buy the extras from one company and the mandatory stuff from another company. They're going to get it all as a package--a consumer will. So from wherever they get that mandatory part, they are going to then get the rest of it.

By allowing foreign insurers, U.S. insurers, to sell that mandatory insurance, it opens the door to selling larger property packages to consumers.

Also, these dialogues are a good way to remind China of their commitment to have notice and comment periods for new regulations that have been proposed, which are crucial for regulatory transparency for U.S. property-casualty insurers.

MR. SAULSKI: As for me, I don't represent an industry so I can't speak for an industry. But I mentioned in my opening remarks that actually the increased ownership by foreign firms in the securities sector, of securities firms, which was increased just recently in the last couple of months from 33 to 49 percent, was a direct result of S&ED negotiations and a commitment by the Chinese based on that.

Also, I'm aware of a number of commitments over the past couple of years focusing on the development of China's bond market. One of the areas that I think the U.S. and the Department of Treasury has always seen as an important area to press China on is the development of their corporate bond market.

That is an area where they feel will help to greater transparency and rationality to the pricing of risk to corporations. So, yes, there has been some positive developments out of that the U.S. dialogues with China. There has been important work on the technical assistance side, and also in development of the bond market and, again, to Qualified Foreign Institutional Investor program, et cetera.

COMMISSIONER WORTZEL: Mr. Simchak, if your companies are able to get these premiums from Chinese policyholders, are they covering your losses or liabilities, or do you have to go into global profits to handle the losses and liabilities?

MR. SIMCHAK: Actually, being a foreign insurer in China, you're almost guaranteed to be losing money at the moment. Of the 21 foreign insurers in China, I believe only three make a profit annually. That is due to the high administrative costs in China, the regulatory barriers to expanding your business, but it's also due to the amount of time that companies have been in China. It takes a long time to understand the market, and these are very sophisticated algorithms that they're using. I couldn't possibly understand them if I tried for the rest of my life.

But it takes time to get the right data and the right information to find those right price points.

HEARING CO-CHAIR GOODWIN: Commissioner Slane.

COMMISSIONER SLANE: Thank you.

Mr. Simchak, we have repeatedly had complaints from your industry about the Chinese keeping you out. I can understand financial services and some other areas, but why do the Chinese want to keep out casualty insurance companies? You would think that it would be in their interest. That's number one.

And the other thing I can't understand, to Jeff's point, is your industry is predicated upon an independent legal system with defined rules and regulations. Vagueness in rules and regulations is the hallmark of the Chinese economy. They intentionally make rules vague so that they can game the system the way they want it.

How can you run an insurance company in a country that doesn't have an independent legal system and why are they trying to keep you out in the first place?

MR. SIMCHAK: Well, I absolutely agree that it's to the benefit of the Chinese market to have U.S. property and casualty insurers in there. That is I think the only way that we've been able to make progress in the Chinese market--demonstrating how it is a good thing for the Chinese market and for Chinese consumers to have us there. And we have made progress. As I said, there have been a number of examples, and China's commitments to the WTO are pretty strong.

One issue that I think would go a long way to breaking down those barriers would be to separate the two functions that are currently part of China's insurance regulator, CIRC. One function is to regulate, of course, and then the second function is to promote the domestic industry.

And so there is an inherent conflict of interest there that I see. The IMF and the World Bank have said as much, and so I think that separate--

COMMISSIONER SLANE: I'm sorry to interrupt you--but, you know, they intend to have the large majority of the automobile industry in China. They have about 48 percent of domestic automobile manufacturing, and they want to get to a much higher number. But they're willing to sacrifice that market until they're able to get there.

If I were the Chinese government, I would want you in there, and I don't understand. I can see protecting domestic companies, but I mean two percent is pretty bad.

MR. SIMCHAK: Yeah, absolutely.

COMMISSIONER SLANE: I mean is there something else going on here?

MR. SIMCHAK: No. I think you've got it. I think that it absolutely would help the Chinese economy and Chinese consumers if U.S. property-casualty insurers were allowed into China with no barriers. That would absolutely be to the benefit of China's economy and to consumers.

COMMISSIONER SLANE: How do you operate in a system in which somebody runs through a stop sign and it's up to the court to decide how they're going to award, and there are no rules? I don't even know--if I had an insurance company, how would I even begin to operate there without understanding that going through a stop sign is liability?

MR. SIMCHAK: It's very challenging.

[Laughter.]

HEARING CO-CHAIR GOODWIN: Vice Chairman Shea.

VICE CHAIRMAN SHEA: Thank you all for being here, and Mr. Saulski, I recall you wrote a really good paper on financial repression for the Commission a couple of years ago--was it last year or two years?

MR. SAULSKI: It was last year, yes.

VICE CHAIRMAN SHEA: Yeah. It was really helpful. It was very short and succinct and helpful.

MR. SAULSKI: I always write very short, succinct pieces because--

VICE CHAIRMAN SHEA: It was good.

MR. SAULSKI: Not because--just because that's all I can really do.

[Laughter.]

VICE CHAIRMAN SHEA: This is for Mr. Dearie. You mentioned that it would benefit China to have the introduction of world-class financial standards that U.S. companies can bring. I'm thinking about the financial collapse in 2006, and Jeff mentioned AIG. I'm thinking about a couple of the investment banks that went bankrupt or got absorbed. I'm thinking about credit rating agencies that gave subprime-backed mortgage securities AAA ratings, and I think the United States got a black eye.

The financial services industry got a black eye in that process. After that process, we heard a lot more about the Beijing model being the alternative to the Washington model. I'm just curious as to your views on how the global financial crisis may have impacted the thinking within the Chinese leadership about the introduction of Western financial practices into the country?

MR. DEARIE: Well, I knew I was going to get this question.

VICE CHAIRMAN SHEA: Oh, you did. I'm very predictable. Okay.

[Laughter.]

MR. DEARIE: But it's a very, very good and a very fair question, so I'm delighted to get it. And you should know that as part of the Forum's chairing of Engage China, which by the way you'll be interested to know Hank Paulson was the chair of the Forum--Goldman Sachs being a member of ours, and one of our CEOs serves as chair for two years. Mr. Paulson was our chair at the time that he was asked to go and be Treasury Secretary. As you will recall, among his priorities before the financial crisis hit, his domestic priority was reform of the U.S. regulatory system in finance here, and then his foreign priority was regulatory reform in China.

He wanted a private sector partner, if you will, to also push the Chinese in the same direction. So we started going over to China in 2005, and essentially delivering the message that I delivered here, and we go over this on an annual basis. You can imagine how the perspective changed on the other side of the table around 2009.

We actually sat down with the number two person at the Shanghai Stock Exchange who was telling us how disillusioning it had been because, as he put it, "the master has been proven to be a fool."

VICE CHAIRMAN SHEA: You were there with that comment?

MR. DEARIE: I was there for that, yes, absolutely. And it was a fair observation. They were trying to figure out what the U.S. financial crisis meant for them because, as he put it, you have been our North Star, and these institutions like Lehman and Merrill Lynch have been institutions that we have greatly admired. And then, here, look what's happened, and so what does that mean for us when you find out that your model, your hero, in a sense, has, you know.

So our response to that is fair point, number one. Number two, I think it's fair to say our financial crisis was the result of a very complex array of factors. Not all of these were financial and some political. But more importantly the kinds of, as I mentioned, world-class best practices with regard to things like credit analysis, corporate governance, risk management, things like that--what we mean by that is fairly basic stuff.

We're not talking about the need to go into China and create a highly sophisticated credit default swap system.

VICE CHAIRMAN SHEA: Right.

MR. DEARIE: But rather a fairly basic--

VICE CHAIRMAN SHEA: But I guess the point of my question was not to--

MR. DEARIE: Right.

VICE CHAIRMAN SHEA: --was simply to understand the impact--

MR. DEARIE: Yes.

VICE CHAIRMAN SHEA: --on your ability to access the Chinese market?

MR. DEARIE: It was damaging. However, I hasten to add that since the passage of Dodd-Frank, the Chinese watched that very quickly or very carefully. They were very impressed with how quick the United States responded to the crisis and how comprehensive the response was. We detected quite immediately after the passage of Dodd-Frank a renewed attitude and a renewed openness to continuing to talk with us and learn from us. I think you've seen that reflected in some of the rhetoric that continues to come out of the reformers at the financial regulatory agencies in China.

VICE CHAIRMAN SHEA: Okay. I have another question, Mr. Chairman.

HEARING CO-CHAIR GOODWIN: Go ahead.

VICE CHAIRMAN SHEA: Just an observation. We often talk in the West about how it's in the Chinese self-interest. We need to show to the Chinese that this is in their self-interest as if they don't have an acute sense of their own self-interest.

So, you know, we talked about it being a family-run business, and wondering whether there is a simple explanation for the lack of financial liberalization in China. That's simply because they don't want someone mucking around in their family business, and they don't feel it is in their own national self-interest to offer up a more liberalized framework for Western financial engagement. That's more of an observation than a question.

MR. DEARIE: I think that is exactly right. I think that's exactly the reason why they're hesitant. They see the financial sector as a critical aspect of their economic infrastructure, and they want to maintain control.

Our job is to point out to them, as principally, if you want to accomplish this shift in your macro economy away from a manufacturing for export economy to a consumer-led economy, which they understand they must do, you cannot accomplish that without a world-class financial system, and you ain't got one.

MR. SAULSKI: If you don't mind, if I can just jump in and take a few minutes. Sorry. I think the answer to that question is that it's dependent on whose self-interests you're looking at and vested self-interests in China. So we can talk about what is going to be in the best interests, especially in the long run, for China writ large and for its citizens. But that doesn't necessarily coincide with the vested self-interests at the short-term basis for certain well-connected individuals and for the long-term control by the Communist Party.

VICE CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR GOODWIN: Chairman Reinsch.

CHAIRMAN REINSCH: From what Mr. Dearie just said, it sounds like Dodd-Frank is more popular in China than it might be here. On the other hand, they haven't done it. We have, and it's easy to take that position from the outside.

But not entirely unrelated, I want to come back to something that Commissioner Slane said. Steve, on the insurance side, if they let you in, do you have a more competitive product in the minds of Chinese consumers because they assume that American companies are more likely to pay claims than Chinese companies?

MR. SIMCHAK: Well, first off, some American companies already are in, and they do allow them.

CHAIRMAN REINSCH: Yes.

MR. SIMCHAK: There are those barriers, those behind the--

CHAIRMAN REINSCH: What's been their experience, recognizing that it's early and so on and so forth?

MR. SIMCHAK: They have not made profits, but there are a lot of reasons for that. As for whether consumers in China believe that a U.S. insurer is more likely to pay out a claim than a Chinese insurer, I don't know. I haven't heard that as being one part of the competitive advantage that U.S. companies have. They definitely do have a competitive advantage over Chinese companies, but I haven't heard that as one.

CHAIRMAN REINSCH: What is their competitive advantage over Chinese companies?

MR. SIMCHAK: They have much more sophisticated products. They have a better pricing system. Sometimes they have more marketability based upon their international notability, and in general just better products and more sophisticated products.

CHAIRMAN REINSCH: Okay. Let me turn that around then and ask Mr. Dearie and Mr. Saulski how from the other side have we taken a credibility hit as a result of the financial crisis? And how are the financial products and institutions that we offer there less credible and less attractive than they were previously?

MR. DEARIE: Well, as I was trying to touch on in the previous answer, there's no question that we did take a credibility hit in the minds of the Chinese. I think a large part of that credibility gap has been made up by the policy response. In fact, they've told us that. And we've detected a very clear change of attitude and posture on the other side of the table when we go over there to talk with them.

There's a much greater openness to our input, particularly following, I must say, the "China 2030" report by the World Bank. By the way, the Chinese have a very high regard for the World Bank, and we know from the World Bank, which was not widely publicized at the time, the Chinese asked the World Bank to do that report. In other words, it was done at the Chinese request. It was also done in partnership with--I can't remember the name of it--it's the Chinese Research Development--

CHAIRMAN REINSCH: Yes, NDRC?

MR. DEARIE: Right. A very highly regarded and very highly connected think tank in China, and its conclusions with regard to the financial sector and its impact on future economic growth were absolutely unequivocal and positively frightening.

So they get that this is a major problem. And there was a very discernable change in the rhetoric from Wen Jiabao all the way down through the financial regulators following that report about their openness to accelerated financial reform. So we're hopeful that we can pick back up and continue to make progress.

MR. SAULSKI: I would just like to mirror the same comment. Yes, I think specifically right after or in the height of the financial crisis, from the different contacts I had with our Chinese counterparts, there is no doubt that we took a significant rhetorical hit, to say the least. I think for those who were already predisposed for keeping out foreign financial service providers, it was a perfect rhetorical tool for them to bludgeon us with.

That being said, as has been mentioned, I think over the past couple of years, we've seen less of that rhetoric being used against us. I think part of it is that there really isn't an alternative. This World Bank report has shown the need for financial reform. Although the reformists within the Chinese government have maybe came out with a black eye because their master was found wanting, the other side, the non-reformists, those who want to maintain the status quo, don't have any real productive suggestions to work on. So they're coming back towards the idea of reform.

CHAIRMAN REINSCH: Thank you.

HEARING CO-CHAIR GOODWIN: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: Mr. Simchak, you said that you have access to two percent of the market. Who has the other 98 percent?

MR. SIMCHAK: That would be Chinese-owned companies.

HEARING CO-CHAIR CLEVELAND: Chinese state-owned enterprises?

MR. SIMCHAK: In large part, yeah, absolutely.

HEARING CO-CHAIR CLEVELAND: All right. And they're offering life insurance, car insurance, sort of a basic line of products or what is it?

MR. SIMCHAK: They offer all types of products of insurance that are available in China.

HEARING CO-CHAIR CLEVELAND: I think you mentioned, and actually you may have all mentioned BIT negotiations. I think you said explicitly at the end of your testimony that it would be useful to proceed on that front. What would the value be to American companies to conclude a BIT agreement?

MR. SIMCHAK: On the state-owned enterprise front, you're referring to my comment that we hope that state-owned enterprises will be addressed in a BIT. As I think everyone in the Commission is very much aware, when a private company competes with a state-owned enterprise, particularly one that receives favorable treatment from the government, it inherently is an anti-competitive marketplace. So that, of course, is a major issue in China, not just for insurance, for a lot of different sectors, and may be even worse for some other sectors than insurance.

And so if there were SOE provisions, state-owned enterprise provisions, in a BIT negotiation that were successful, that would be very helpful.

HEARING CO-CHAIR CLEVELAND: So it's sort of a broad--

MR. SIMCHAK: Yeah, absolutely. The BIT negotiations are very ambitious. The negotiators at USTR, I think, are some of the best, most dedicated negotiators in the world. So I think that it would be good for them to address state-owned enterprises in that negotiation.

HEARING CO-CHAIR CLEVELAND: Also overworked and underpaid.

Mr. Saulski, you and others, I think actually Dr. Walter talked about the Qualified Foreign Institutional Investor program. I'm interested in how that works; how are the companies selected? And they, I gather, apply for permission. What's the importance of participating in that mechanism? And what's the profit or the result?

MR. SAULSKI: Sure. Taking the last part of your question first, the advantage of participating in that program is that you can invest in the Chinese stock markets directly. My written testimony goes in a little bit more detail. The Chinese stock market, as many of you probably are aware, is divided into A shares and B shares, B shares being shares that foreigners can own directly, but only accounting for 0.7%of the actual market cap of the stock market. And that has pretty much been a moribund pointless market.

As for the A share market, foreigners cannot invest directly except for certain designated institutional investors. In 2002, the CSRC created the Qualified Institutional Foreign Investor program, or QFII program, that allows certain designated institutional investors to directly invest in the A share market, as well as now the bond market.

What happens is SAFE, the China State Administration of Foreign Exchange, sets a quota, and they have to get the certification through the CSRC, and obtain a quota from SAFE. Then once they've received that, they're allowed to invest that quota in the A share markets. That quota for individual firms I think has recently been moved up to one billion per firm. I think it was 850 million prior.

And that goes to into total aggregate of now 80 billion that's allowed for the foreign QFIIs.

HEARING CO-CHAIR CLEVELAND: And how are they selected?

MR. SAULSKI: Well, they apply, and I'm not--I don't believe there is anything nefarious in this instance. They look at what this firm is, their quality, their experience as institutional investors. I actually haven't thought really too much about it. If one were to look at the list of QFIIs, it would be the, you know, all of the major financial firms that you would expect.

HEARING CO-CHAIR CLEVELAND: And are they the same financial firms that support the underwriting of Chinese IPOs overseas?

MR. SAULSKI: Well, not necessarily because sometimes they might be under perhaps the same bank holding company. But obviously the QFIIs are principally investment funds, whereas those who do the underwriting would be a broker dealer underwriter. So there may be cases where they're within the same network or family of companies. I don't believe there would be a significant conflict of interest there, but it's an interesting question.

HEARING CO-CHAIR CLEVELAND: I wasn't looking for complicated.

MR. SAULSKI: Okay.

HEARING CO-CHAIR CLEVELAND: I was just trying to figure out whom. There are companies that are allowed to do business, and a billion dollars isn't inconsequential in terms of your opportunity to invest in what is a growing market. I'm just wondering who they are? I mean are we talking about the Goldman Sachs family? Or are we talking about--

MR. SAULSKI: Well, this is like the Fidelity's.

HEARING CO-CHAIR CLEVELAND: Okay.

MR. SAULSKI: So this is where if you're investing in Fidelity emerging market funds, it's very likely--I don't invest in Fidelity so I'm just picking them out of the air--but it's probably likely that if you look down, they maybe will claim to be investing a portion of their shares in emerging markets, including China. That would probably be because of their QFII status, though they may also be investing some of that as a way of diversification in those U.S.-listed Chinese companies that come here through, let's say, the British Virgin Islands or the Cayman Islands, et cetera.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

HEARING CO-CHAIR GOODWIN: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, Chairman.

Let me go back to Commissioner Slane's question earlier: why would foreign investors want to move into and participate in greater numbers in China? So we can't quite imagine howand yet all of you have said there's been progress--each of youmentioned achievements.

How would you characterize the progress here in 2013, not going forward, but what have we achieved so far? What growth or what improvement has there been?

MR. SAULSKI: If I can take that first only because I would like to distinguish between two distinct categories. The first would be the financial service providers, which I think are represented on either side of this table. The other would be the investors, obviously a broader class, which could be anything from our grandparents investing through their retirement funds, or other products, including maybe those directed at China, to large institutional investors, and even day traders. I think those two groups, the financial service providers and the investors, are distinct in what they are looking for in China.

Basically, the industries are looking for greater profits through expanding into additional markets, whereas investors, hopefully, if they're being rational, are looking for diversification and trying to capture the gains from this growth story that's coming out of China.

COMMISSIONER TOBIN: So do you see achievement there or progress?

MR. SAULSKI: It's one of those glass half empty/half full kinds of things. I think everybody in this panel mentioned that there has definitely been progress over the last number of years, particularly since World Trade Organization accession by China. Allowing for financial service providers to come in and to sell insurance or the banks, particularly, have developed a pretty strong foothold, but there is much to be improved on.

As my statements mention, China is of the G-20 countries the most restrictive on foreign access for financial service providers, but there is hope that there will be improvement there. As for the investor, that is mixed--the question is, well, but we are in a period where investors have been hurt globally, including here in the U.S., over the last couple of years from downturns in the market. So many people have lost money in China. Many people have lost money here in the U.S. But they have the opportunity hopefully for the diversification that they seek.

MR. DEARIE: If I could just quickly add.

COMMISSIONER TOBIN: Please.

MR. DEARIE: Why would anyone want to put up with all of these headaches and uncertainty and everything? I think the simple answer is there is not now, nor has there ever been in human history, a market like China. You're talking about a fifth of the world's population that is coming online, and it's growing at ten or 12 percent. Of course, not now. It's down to around seven percent. But over the last 25 or 30 years, it's been growing at ten percent or better a year. There's never been a market like that in the history of the world.

So it's incredibly attractive as a business matter, as a commercial matter, not just for financial firms, but for U.S. producers, service providers, manufacturers, farmers, et cetera. The problem is that after you get there you find out it's really hard to do business there and make money. I think we're seeing a lot of that now, and you're seeing folks unwind investments. They're being a lot more cautious.

But, again, I think it has to be acknowledged that if you look back to 1979 and what's been accomplished since then, it's absolutely unbelievable. Now, having said that, it's too slow. So as Mr. Saulski says, it's sort of a glass half full or glass half empty type of thing, but China is and remains a remarkable opportunity.

COMMISSIONER TOBIN: And any comments comparative to other BRIC countries?

MR. DEARIE: In certain ways, I think that China has done better. In other ways, I think they haven't. I've listed a number of the specific areas of progress in my written testimony as well as specific areas of where we need to focus in terms of improvements going forward. So hopefully that will be helpful.

COMMISSIONER TOBIN: Thank you.

HEARING CO-CHAIR GOODWIN: I'll jump in, Mr. Simchak. I'd like to ask you about the Tort Liability Law of 2010. First, I think it's refreshing that a representative of the insurance industry is talking about advancing understanding of a tort liability law in the abstract.

But my question is how is it being applied? Do litigants trust it to seek redress for injuries? But then I suppose, more importantly, you suggest in your testimony that Chinese companies are not yet purchasing products liability insurance or insurance for other exposures. So my question is who's footing the bill? Who's paying it? Are those judgments being collected?

MR. SIMCHAK: I think that this was a large reform of their tort system. There's a general lack of understanding about it, and so you're right. People aren't buying the insurance. Companies aren't necessarily buying the liability insurance or other types of insurance that they probably should have to cover their liability.

But as for who is paying it now, I suppose if there was a judgment and they weren't insured, then whoever the judgment was against would have to pay it. I'm not sure that there are as many suits being brought. I don't know. I can't claim to have a lot of experience or expertise in China's liability legal system, but that would be my guess.

HEARING CO-CHAIR GOODWIN: Sure. Well, I think it's particularly interesting when you talk about state-owned enterprises. If they're getting dinged for judgments, to the extent as this process and this law matures and gets enhanced and developed by case law or through the proceedings themselves, what happens when essentially arms of the government start getting hit with liability judgments? What sort of incentives does that put in place for the law itself and for the development of the insurance market and everything else?

MR. SIMCHAK: I haven't heard of any cases that directly impact the insurance sector. I haven't heard of the insurance aspects of those cases involving state enterprises. I have read in the news, just as anybody else could, about issues of state-owned enterprises having liability. So certainly it's an area of concern for any insurance company that is insuring liability.

HEARING CO-CHAIR GOODWIN: Sure. Thank you.

Second round. Commissioner Fiedler.

COMMISSIONER FIEDLER: One quick question just because I don't know. What is the highest rate on a savings deposit paid by a Chinese bank?

MR. DEARIE: The interest rates in China have only begun to be liberalized beginning in the middle of last year in terms of both the rates that they will pay on savings deposits and the rates that they can charge on lending. That has been led by Governor Zhou of the People's Bank of China, which is part of the reason why it's so significant that an exception was made for him to stay in that position. He's a true reformer.

COMMISSIONER FIEDLER: What is the rate?

MR. DEARIE: It's very, very low.

COMMISSIONER FIEDLER: It's nominal, right?

MR. DEARIE: It's nominal. It's absolutely nominal.

COMMISSIONER FIEDLER: Okay. So I think I figured out how to make money in the short run and collapse the Chinese government at the same time.

MR. DEARIE: Excellent.

COMMISSIONER FIEDLER: If they allow retail banking, if they allow Citibank to have more than 50 branches, and you can take deposits, any reasonable bank would pay people more interest. We just heard all morning that individuals' savings is what's feeding the Ponzi scheme. If you could pay more interest, everybody would come to your bank, and the Ponzi scheme would collapse.

In the short run, I would lend my money to the shadow banking system because they can charge higher interests. The spread between what I'm charging them and what they're making, I'd take in a bag and take it to my pal or go somewhere else. The insurance industry insures the 300 families against regime change. Okay, you're going to lose your money in the end --no wonder they won't let the banks into China because you will pay more interest.

The economics are clearly there, and the number of people with money saving at the rate of 50 percent of their incomes. They would deposit it in your bank tomorrow morning and, therefore, their system would collapse. You can have all the negotiations you want. Until they change that system, you're not going to get access for retail banking.

MR. SAULSKI: My only comment would be, of course--

COMMISSIONER FIEDLER: That's where most banks make their money, by the way, retail banking.

MR. SAULSKI: Of course. But my comment would be that irrespective of the nationality of the bank, they are subject to China's set interest rate. So even if they were to allow Citibank to have 500,000 more branches--

COMMISSIONER FIEDLER: Which goes to my earlier question, why do you want to be there in the first place if you can't charge any more money or you can't pay any more--

MR. SAULSKI: But just like the Chinese banks, then they can turn around and loan it at just a little bit--they make a spread and they go home with their--

COMMISSIONER FIEDLER: What you're talking about is you want entry into an unreal financial system. I'm trying to understand why.

MR. DEARIE: Well, sir, if I could just jump in. If the WTO did not exist, if the Strategic Economic Dialogue did not exist, and other avenues of bilateral negotiation in terms of opening up China's financial sector in all kinds of ways, including deposit rates and things like that, I think the interest in being in China would be lower than it is now.

Certainly U.S. firms know that their participation in China only makes sense in the context of further structural progress. Structural progress is being pursued in bilateral and multilateral fora like the WTO, such as the U.S.-China Strategic Economic Dialogue. That's why those dialogues are so important because they are extracting the commitments from China to China more of a predictable and profitable opportunity for U.S. firms.

COMMISSIONER FIEDLER: It sounds good in the theories of engagement, but we have had all kinds of commitments from China in WTO that we have catalogued many times that they have not lived up to in the last 12 years.

MR. DEARIE: Well, I agree that they-- as I said at the very beginning, even if it can be argued that China is compliant with the letter of its WTO commitments, I would argue, and I think Engage China would argue, that it's complying with the spirit of WTO.

COMMISSIONER FIEDLER: But my earlier--

MR. DEARIE: Having said that, I also think it's true if you look back to 1979 when all of this really began, and you look at what's been accomplished, it is remarkable. But progress with China is always incremental, it's always frustrating, but progress happens.

COMMISSIONER FIEDLER: But basically on a banking level, my point was that with Banking Economics 101, there are no favorable factors. You would need not just an access agreement, not just an ownership percentage agreement, not just this, that. You would need a panoply of things, circumstances to exist to make it profitable to operate a bank, a straightforward, simple, traditional, non-CDO financial, you know, instrument bank, the old kind of bank that we used to have that lent people money to build things.

I don't see where the SED does it. There has to be a willingness on the part of the Chinese government to dismantle what we heard this morning. In order to do that, what you're actually arguing for is dismantling of the system. So it's a systemic problem as opposed to a sort of arcane little banking problem.

That's why the rule of law question I didn't think was specious at all. You have an earthquake in Yunnan, and you pay on all the shabby houses. Okay. So I just don't see why or how you're going to succeed. That's all.

Thank you.

HEARING CO-CHAIR CLEVELAND: In somebody's testimony this morning or perhaps something that I read, it was noted that there were 153 million depositors in the Industrial and Commercial Bank of China, which is ten million more than the entire population of Russia, and I would ask you all whether or not the prospect of 153 million depositors who husband at least half their income isn't part of the motivation, notwithstanding the rule of law and the other challenges? Isn't it still that potential market opportunity that drives your interest?

MR. SIMCHAK: Yeah. For insurance, it wouldn't--well, unless it's life insurance, it wouldn't be depositors; it would be purchasers.

HEARING CO-CHAIR CLEVELAND: Right. But depositors in the bank. It's the prospect of that--

MR. SIMCHAK: Of course. Of course.

HEARING CO-CHAIR CLEVELAND: Yes.

MR. SIMCHAK: It's the potential of the market. That's absolutely why an insurance company or a bank would want to be in China.

HEARING CO-CHAIR CLEVELAND: Okay. So you're in it for the long haul--

MR. SIMCHAK: That's right, and I think that's the approach that U.S. insurers are taking when they get into China. They all recognize that it's going to be unprofitable for some time. It normally is when you enter any market, but the hope is in the long term by being there now and by gaining the experience in the market will let you be profitable later, and that you're going to be able to access that enormous potential of an insurance market.

HEARING CO-CHAIR CLEVELAND: And do you see differentiation in treatment between U.S. investment and corporate interests and how the British, the French, the Italians, the Indonesians are treated? I mean is this just a systemic problem or uniquely ours?

MR. SIMCHAK: All foreign-owned insurers in China go through the same regulatory process, which is through the International Affairs Department of CIRC, the regulator, which is different from the regulatory process that domestic insurers go through.

So it's uniform across the board. Because of the structure of some other countries' insurance markets, they're able to be more profitable than U.S. insurers. But that's largely because their insurers that are operating in China are operating as captive insurers of a larger company. So, in other words, there will be an insurer that services only one company. That company has a subsidiary or other operation in China so they automatically insure all that risk because of the way that company is structured.

HEARING CO-CHAIR CLEVELAND: Mr. Dearie.

MR. DEARIE: I don't think that there is any evidence that the United States is being singled out. I think for all of the reasons that we're talking about in terms of the hesitations on the part of the Chinese to open up control of the financial sector to foreign influence, banks and other financial institutions from other countries experience exactly the same problems that U.S. firms experience in terms of trying to do business in China.

HEARING CO-CHAIR CLEVELAND: Thank you.

Commissioner Slane, you had a question--

COMMISSIONER SLANE: Just a couple of quick questions. Mr. Dearie, have your banks that you're representing expressed an interest to make commercial loans to Chinese small- and-medium-size non-state-owned entities?

MR. DEARIE: Very much so. In fact, that's where the action is.

COMMISSIONER SLANE: And is it surprising to you that the Chinese haven't embraced this since this is the driver of jobs for them?

MR. DEARIE: Well, this gets back to your point or somebody's point about are they capable of identifying and being in their own self-interests? It continues to be frustrating and sort of incomprehensible to many of us in a lot of ways why progress has not been faster because it seems to us it's so obviously in their interests. Why would they not allow it?

Especially because, for example, they are, for social stability reasons, very worried, as I'm sure you've read, about social unrest. I've read that there are as many as a hundred, 150 incidents of social unrest in China everyday. And most of that is happening in the central and western interior that is not well served.

When you think about China and the economic miracle of China, you're really only talking about 400 million people. There is another billion people in the central and western interior who haven't participated. That's the great potential that all of the Western providers and manufacturers are looking at, like, my God, just look at the size of this potential market. China's state-owned banks are not actively involved in the central and western interior with a lot of the small and medium-sized businesses. I think that's why you're seeing the growth and development of the shadow banking system.

These trusts that you heard of earlier this morning and our institutions have said to the Chinese, look, you know, we understand why you may not want to raise the ownership or investment caps in the Big Five state-owned banks. How about raising the ownership caps in the smaller regional banks? We've got the capital and the willingness to go into the central and western interior; it's in your interests to do that. To the extent that area starts to develop, it deals with the problems of social instability and unrest and the widening wealth gap. It's like banging on a wall. We have not been able to convince them to do it.

COMMISSIONER SLANE: Mr. Simchak, are there any Chinese casualty insurance companies doing business in the United States?

MR. SIMCHAK: No.

COMMISSIONER SLANE: Thank you, Chairman.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

VICE CHAIRMAN SHEA: Thank you. Thank you all for your testimony.

VICE CHAIRMAN SHEA: You say you have been banging your head, and not getting as much success as you want. Your approach seems to be more engagement, more dialogue, and more high-level discussion. Have you given thought to any other potential economic or diplomatic tools to achieve the objectives that you're seeking beyond more talk?

MR. DEARIE: Well, we think the WTO and certainly the Strategic Economic Dialogue is very important, but your question is great. It gives me the opportunity to say this, and I think this is a very specific answer to your question. When the Strategic Economic Dialogue was originally stood up, before it was the Strategic and Economic Dialogue, it was focused specifically on financial reform and modernization.

Moreover, it was twice a year. Now it may not be immediately obvious why the difference between once a year and twice a year is so important. But if you've ever had to run a really big series of meetings, having to do it twice a year is a hell of a lot more work than doing it once.

And this is not a political statement; it's just a statement of fact, and I understand why they did this. When the Obama administration came into office, they broadened the Strategic Economic Dialogue to the Strategic and Economic Dialogue and put a whole lot more issues on the table including environmental, military, strategic, et cetera.

Moreover, they cut the number of meetings in half from two to one. That had the effect of, number one, taking financial progress or faster reform, including greater forum participation, out of the center of the table and putting it way over here.

In fact, for a couple of years, it fell completely off the table. Part of the reason why that happened is we had the intervening financial crisis. Talking about greater foreign participation was not exactly a productive conversation there for awhile. But as a specific answer to your question, we're of the view that given the central importance of financial reform, we see it as really the key to many of the outstanding economic issues, problems that define the bilateral relationship.

We think it's very important to do two things: to double the number of meetings a year, restore it back to two from one; and to restore the central focus of financial reform to the Strategic and Economic Dialogue as it was originally stood up.

VICE CHAIRMAN SHEA: Thank you.

MR. SAULSKI: If I can just add my own opinion, as someone who has to prepare all the briefings for those meetings and attend them. Sometimes they generate so much paper that you can't get a decision made because you're just in the process of getting ready for the meetings. Actually I think the outcomes of the S&EDs have been advanced by cutting it down to once a year.

HEARING CO-CHAIR CLEVELAND: It begs the question, and it came up in an earlier hearing, that a witness--I can't recall who at this point--testified that it's not just cutting them in half. It is the lack of focus. The Chinese come in each and every time with a very clear agenda, knowing what they want to accomplish, in what domains, and who their key counterparts are to achieve that.

Do you feel that we go into these discussions with a clear agenda, knowing exactly what we want to accomplish on a finite set of issues and walk away successfully?

MR. DEARIE: Well, this is not unique to the Strategic and Economic Dialogue. This is true I think of any sort of summit. The meeting is baked in between the meetings.

HEARING CO-CHAIR CLEVELAND: Right.

MR. DEARIE: And then everybody shows up and sort of goes through it. Now that's not entirely fair. There are things that happen that are unexpected. There's always a value of sitting down across the table to be sure.

But my point is that when you know that there's a meeting coming up --the Chinese are very results oriented--there is a set of expectations and an expectation of new commitments and an expectation of demonstrated progress that is part of every meeting's agenda.

If you cut that in half, you slow down that progress and expectations of new commitments by half, by 50 percent. So I respectfully disagree with my colleague. We're of the view that it's very important to have more frequent meetings. We think that twice a year is probably enough. These are a lot of topics to get your arms around, but once a year is not enough, in our view.

HEARING CO-CHAIR CLEVELAND: We in OMB used to disdainfully refer to those results as deliverables.

MR. DEARIE: Right.

HEARING CO-CHAIR CLEVELAND: And they always came at a huge price that we had to figure out how to pay, but--

MR. SAULSKI: Do you mind if I hit your question about having the right interlocutor?

HEARING CO-CHAIR CLEVELAND: Sure.

MR. SAULSKI: I think one of the biggest advantages for moving to the SED and then later the S&ED, was our previous economic track discussions happened at the JEC, the U.S.-China Joint Economic Committee, between the U.S. and China.

The problem was that was set up back in the 1970s when we first started to engage with China again, and there was a misunderstanding of China's political establishment and structure. It had the Secretary of Treasury negotiating with the Minister of Finance, which would seem right, but his true counterpart is the Vice Premier for economic issues on the State Council.

That was the big advancement in setting up the SED and then the S&ED. We now are on the economic side and on the strategic side ensuring that these meetings are occurring between the proper parties who can make a decision.

And, again, these discussions are going throughout the year. This kind of let's get together and have deliverables only happens once a year.

HEARING CO-CHAIR CLEVELAND: Mr. Simchak, do you have anything to add?

MR. SIMCHAK: Absolutely. I think that in my testimony, my concluding point was that the best path forward is to redouble our efforts through these dialogues. It's the U.S.-China BIT negotiations. It's the S&ED. It's also the JCCT, the Joint Commission on Commerce and Trade, which includes, under that umbrella, the Insurance Dialogue. So those are all three very important forums in which we can push U.S. economic interests, and in the S&ED, the strategic interests. But I absolutely think that those are the best path forward, and it gives our negotiators at Commerce and USTR and Treasury the ability to do what they do best.

HEARING CO-CHAIR CLEVELAND: Okay. Just to broaden it, do you see any utility in the G-20 forum for any of these issues being pursued, or is this exclusively bilateral?

MR. SAULSKI: I also teach a course on international financial regulation, and the G-20 process is something that we cover in my class extensively. The G-20 focuses on--currently and over the last couple of years-- issues of financial stability and financial architecture, regulation, et cetera.

So issues about access and openness of economies are something that is not addressed there, and I doubt it would be a forum in which those issues would be taken up. I think that we are probably better off in the bilateral context and through the World Trade Organization.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

MR. SIMCHAK: One final opportunity or forum that I might mention is negotiations that have been launched in Geneva, not part of the WTO, but at the WTO delegations, called the International Services Agreement. China is not part of those negotiations, but China is watching it very closely. Those negotiations will probably set the standard for services trade for decades to come. It's been some time since the GATT's, and this is our chance to set a new standard.

China is watching it very closely. Who knows? Maybe they'll join at some point in the future.

HEARING CO-CHAIR CLEVELAND: They haven't joined because?

MR. SIMCHAK: Their official objection at the moment is that there shouldn't be a plurilateral agreement, and that we should redouble our efforts in a multilateral context being the Doha Round. In my opinion, the

Doha Round is dormant, to put it nicely, and probably isn't going to see a lot of progress. So the next best option is this plurilateral International Services Agreement that Ambassador Punke is pursuing in Geneva.

HEARING CO-CHAIR CLEVELAND: Thank you. Anybody else? Thank you very much. Appreciate your testimony.

I leave more worried than I arrived today but at least better informed, and thank you to the staff, Anna and Paul, and everyone else, you did a terrific job. The memos and materials were excellent. So thank you.

We stand adjourned.