

**WRITTEN STATEMENT OF THE
SECURITIES INDUSTRY AND FINANCIAL
MARKETS ASSOCIATION**

TESTIMONY BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

**“U.S. INTERESTS IN REFORM OF CHINA’S
FINANCIAL SERVICES SECTOR”**

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**Before the Committee on Financial Services
United States House of Representatives**

**Hearing on U.S. Interests in Reform of
China's Financial Services Sector**

June 6, 2007

Mr. Chairman, and Members of the Committee:

The Securities Industry and Financial Markets Association¹ is pleased to submit this testimony on China's capital markets and the benefits for U.S. financial services firms and both the U.S. and Chinese economies of opening China's financial markets. Our testimony will focus on the goals and objectives of the U.S. securities industry in our growing relationship with China's economy. As such, this testimony delves into some key issues related to China's capital markets. This hearing is especially timely and provides us with an opportunity to outline progress made to date on expanding opportunities in China for non-Chinese financial services firms as well as areas for continued attention.

SIFMA has long supported more open, fair and transparent markets, and has strongly advocated liberalization in U.S. multilateral and bilateral trade in financial services. The economic benefits of financial services sector liberalization reverberate throughout the world in the form of higher growth and greater opportunities. Financial services liberalization leads to new entrants, innovative products and services, and capital markets with greater depth and efficiency.

In the global economy, openness and fairness are essential to ensuring that markets operate efficiently so that capital can move seamlessly across borders and investors can easily and quickly buy and sell securities anywhere, while businesses can access capital at the lowest cost. The international financial system has been a major contributing factor in the marked increase in living standards of those countries that participate in it.

¹ The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

China's WTO accession commitments for financial services, and more specifically for the securities industry, demonstrated a reluctance to open this sector fully to foreign competition. China's reluctance to open its securities markets fully to foreign investment has stymied the interest of foreign securities firms, and has slowed the pace of reforms in China's capital markets. Since China's accession to the WTO, nearly \$24 billion has been committed to China's financial services sector, and according to SIFMA estimates less than \$600 million of this total has found its way to China's securities firms. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

We also wish to take this opportunity to commend the U.S. Treasury Department for its continuing work and active engagement in seeking open and fair markets for securities firms in China. Through the formation of the U.S.-China Strategic Economic Dialogue ("SED"), and the establishment of a Treasury Financial Attaché in Beijing, Treasury has put in place the framework for continued and active advocacy on behalf of the U.S. financial services sector.

Expanding Business Opportunities for U.S. Financial Services Firms

Many of SIFMA's leading member-firms have identified China as the largest single emerging market opportunity in the next few decades, with some measures indicating that China will be the world's largest economy within the next 40 years.² To achieve this, China will need an enormous supply of capital and a market that can efficiently allocate savings. Analysts predict that over the next five years China will need to invest more than \$1.5 trillion in improvements to physical infrastructure. Moreover, as China's economy continues to move from planned to market-based, decisions on capital allocation will become increasingly complex, and it will be ever more important to have efficient capital markets to ensure capital is allocated to where it is needed and will be used most efficiently.

At the same time, China will accelerate its ambitious reform program even while its nascent pension system begins to address the needs of a huge and rapidly aging population. In 2005, 7.6 percent of China's population was over 65; by 2025 that number is projected to reach roughly 14 percent. The country's infrastructure, privatization, and social welfare demands will require an increasingly more efficient and sophisticated deployment of capital.

To meet these demands, China will need to modernize its capital markets more rapidly. Currently, banks intermediate nearly three-quarters of all capital in the Chinese economy. For China to meet its financing needs, increase the products and services available to investors, provide companies with new funding options, and enhance financial stability it will need to transition to a financial system less dependent on bank lending and more

² Goldman Sachs' Global Economics Weekly, Issue 03/34, 1st October 2003.

focused on capital markets financing. China's first modern stock market only opened in 1990. Between 1998 and 2000, market capitalization more than doubled from \$231 billion to \$581 billion; by the end of 2006, market capitalization rose to more than \$917 billion. In less than two decades China's stock market stands as the largest in the emerging market world.³ However, the need for China to further develop its capital markets is illustrated when compared to other developing markets. A McKinsey & Company study found that in 2005, equity market capitalization, excluding non-tradable, state-owned shares, was 17 percent of GDP. This is the smallest market capitalization to GDP ratio in emerging Asia, where the ratio averages 70 percent.⁴

The government of the Peoples Republic of China (PRC) has acknowledged the need to reform the securities industry and has stated that it wants foreign investors and foreign firms to participate. China's domestic capital markets will benefit from the entry of U.S. securities firms and their technology, capital, innovation and best practices. As local firms prepare for this increased competition, they will adopt new technologies and improve the quality of products and services they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist the exchange of goods and services.

Importantly, increased competition will create incentives and opportunities for niche players to enter the market and provide financial services on a regional basis, offer expertise in specific product areas, and produce new and innovative products that respond to consumer demands for risk management and retirement products, for example.

As China's capital markets develop, Chinese firms will be able to raise more capital at lower costs to grow their businesses and create more products, services, and jobs. Since financial markets are inextricably linked to increased investment and economic growth, it is estimated that financial sector reforms could boost China's GDP annually by up to \$321 billion.⁵ To put that number in perspective, as of 2005, only 20 countries have total GDP that exceeds \$321 billion.⁶

China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will, by necessity, be funded through foreign sources, and this opportunity has generated substantial interest by the U.S. securities industry. Indeed, despite difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have participated in China's international securities offerings.

³ However, according to McKinsey Global Institute, once these figures are adjusted for nontradable shares, China's stock market capitalization as a percent of GDP is among the world's smallest, about 17 percent. Corporate debt issuance lags too, with issuance equal to about only 1 percent of GDP. "How Financial System Reform Could Benefit China," 2006 Special Edition: Serving the New Chinese Consumer, *The McKinsey Quarterly*.

⁴ Similarly, corporate bond issues by non-financial companies amounted to between 2 and 3 percent of GDP, compared with a typical 50 percent in other emerging Asian markets.

⁵ Putting China's Capital to Work: The Value of Financial System Reform, May 2006, McKinsey & Company.

⁶ World Bank, World Development Indicators database, World Bank, 23 April 2007.

U.S.-China Strategic Economic Dialogue

SIFMA is an enthusiastic supporter of the Strategic Economic Dialogue (SED) and we commend Treasury Secretary Paulson, Ambassador Holmer, their Treasury colleagues, and the Administration, for this important undertaking. Our view is that the SED has the potential to play a key role in advancing the US-China economic relationship. The SED provides a forum where—with a single, unified voice—the Administration can underscore the importance to China of an open, fair and transparent market for financial services. Consequently, SIFMA has urged the Administration to engage in a results-oriented discussion that leads to the reduction and elimination of barriers that continue to obstruct global financial services firms in China. Eliminating burdensome barriers to entry will benefit the economies of both nations. While we detail our agenda for reform below, we believe there are a number of steps the Chinese should take in the short-term that will help it to reach its stated economic goals and reinforce the political sustainability of the SED.

First, China should lift the de facto moratorium on foreign securities firm joint ventures that has been in place since December 2005. Importantly, removal of the moratorium will bring China back into compliance with its WTO commitments. We are pleased that during the May 22-23, 2007 SED meeting, China took a critical first step towards this goal by lifting the moratorium imposed on foreign investment in Chinese securities firms. It is important to note, however, that the moratorium is to be lifted sometime in the second half of 2007, rather than by a specific date.

Second, China should put in place a precise and transparent roadmap, on an agreed to timetable, that would result in providing foreign securities firms with the right to own 100 percent of a PRC financial services firm and the ability to engage in a full range of securities activities. No progress was made on this issue during the recent SED.⁷

China's WTO Commitments For Foreign Securities Firms

China's 2001 World Trade Organization (WTO) entry commitments in the securities and asset management sectors marked the country's first step toward liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures (JVs) in which foreign ownership is capped at 33 percent—although as more fully described below the scope of securities activities in which these joint ventures can participate is limited. China's WTO commitments also limit foreign participation in China's asset management sector to ownership of no more than 49 percent of domestic fund management firms.

⁷ That being said, Tu Guangshao, vice chairman of the China Securities Regulatory Commission, was quoted by state media as saying China will raise the ceiling for foreign investment banks' stake holdings in domestic brokerages and joint ventures before the year-end. Reuters, Shanghai, Wednesday, May 30, 2007.

These WTO commitments make no provision for further increases in foreign ownership in either securities or asset management firms. Instead, the commitments suggest that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future. Indeed, China remains as one of the few markets of interest to the securities industry where majority ownership is not permitted.

China's WTO commitments in the securities sector also limit these minority owned JVs to underwriting the A shares of Chinese corporations, and to underwriting and trading government and corporate debt, B shares and H shares. The fundamental ability to trade in A shares was not conferred on these minority JVs. (A shares are Renminbi (RMB)-denominated shares limited to domestic investors, foreign financial firms with qualified foreign institutional investor (QFII) status, and foreign strategic investors. B shares are foreign-currency denominated shares listed on PRC exchanges and are open to both domestic and foreign investors. H shares are shares of PRC companies listed in Hong Kong.)

Though foreign industry involvement can improve many aspects of the securities industry, we would urge China to move forward in two distinct, but reinforcing, areas to modernize and strengthen its capital markets. First, improvements in market access would improve the ability of foreign securities firms to compete in a fair manner with local firms. Second, steps in market reform would better regulate the industry and increase transparency.

However, there remain significant market access barriers. SIFMA strongly urges China to make the following additional commitments, in the context of the ongoing WTO financial services discussions, in other trade forums, or government-to-government discussions:

1) Permit Full Ownership and the Right to Choose Corporate Form

China should put in place a precise and transparent roadmap, on an agreed to timetable, that would result in providing foreign securities firms with the right to own 100 percent of a PRC financial services firm, including the ability to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and all classes of equity, hybrid mortgage products, derivatives trading, and asset management. We do note, however, that one of the results of the recent SED was that the Chinese will announce before the next SED meeting that foreign securities firms will be permitted to expand their operations in China to include brokerage, propriety trading and fund management.

The right to enter a market and establish a wholly owned presence in a form of the firm's own choosing is relatively common in today's global markets. Currently, foreign investors can enter China's securities markets in two ways: by establishing a new JV with a Chinese partner or by taking a stake in an existing brokerage, the path that a number of foreign securities firms have chosen. Because in most cases the negotiations that result in a JV or a foreign stake are opaque, however, potential entrants have little available in the way of guidance on how to arrange such JVs. Similarly, foreign asset management firms should be permitted to manage money for Chinese investors, both retail and institutional, as

well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

2) Liberalization of Qualified Foreign Institutional Investors (QFII) Standards

China's decision to permit foreign investment in A shares through QFIIs beginning in 2003 was a landmark step in the development and liberalization of China's capital markets. More recently, PRC authorities have taken steps to increase the number of QFIIs and the amount invested by QFIIs.⁸ Nevertheless, a few QFII requirements are onerous and have substantially limited the utility of the program, as well as the number of investors that can take advantage of it.

Along with the QFII program, China has recently taken steps to allow certain large foreign investors to purchase shares in domestic companies. These new rules will allow foreign investors to buy stock in Chinese companies that have completed the share-reform program (exchange of nontradable shares to common A shares). Foreign investors that meet certain government standards can buy existing shares or purchase new shares that might be issued. But requirements that an investor purchase at least 10 percent of the company, and hold the stake for at least three years, could limit the desirability of the program.

China would make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would almost certainly result in greater foreign investment in China's securities markets, deepen and broaden trading in those markets, and increase capital availability to Chinese issuers.

3) Implement a QDII program

China is in the process of launching its long-awaited qualified domestic institutional investor (QDII) program to promote Chinese investment in foreign stocks and bonds. The People's Bank of China (PBOC) announced the launch of the program in April 2006, and the PBOC, the China Banking Regulatory Commission, and the State Administration of Foreign Exchange released interim measures that permit qualified commercial banks to pool RMB from domestic institutions and individuals and convert them into foreign exchange for investment overseas in fixed-income securities. Other implementation rules will eventually expand the program to qualified mainland insurance companies, fund management firms, and securities brokerages to convert RMB into foreign currency, raise funds in RMB or foreign currency, and invest in overseas securities. Such a program

⁸ China will raise the quota for Qualified Foreign Institutional Investors from \$10 billion to \$30 billion, SED Financial Sector Reform Fact Sheet, May 23, 2007.

will further liberalize China's capital accounts. It may also help familiarize Chinese domestic investors with international corporate and brokerage practices and give them access to top-quality research under conditions that would respect officials' concerns about currency flows. China recently lifted restrictions prohibiting Chinese banks from buying foreign equities, and will allow banks to invest up to 50 percent of the QDII funds in overseas stocks. Previously, QDII banks were restricted to buying bonds, money-market products and fixed-income derivatives.⁹

4) Promote Regulatory Transparency

A transparent industry is generally one in which the public and industry participants have the opportunity to be involved in the rulemaking process, access information about proposed rules, question and understand the rationale behind draft rules, and have sufficient opportunity to review and comment on them. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract participants, increase efficiency, and spur economic growth and job creation. The absence of transparency in the implementation of laws and regulations can seriously impede the ability of firms to compete fairly and often distorts the market. Though China's securities regulator, the China Securities Regulatory Commission (CSRC), has improved its policies on prior consultation and has presented many proposed regulations for public comment, much progress is still needed. Short comment periods are insufficient to review complex new regulations, particularly those intended to affect foreign firms whose ability to comment is hampered by distance and language.

SIFMA has published a paper (attached as an Appendix) that serves as a blueprint for a transparent regulatory regime. The paper underscores the key guiding principles of fair and transparent regulations as follows: 1) rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified; 2) regulation should be enforced in a fair and non-discriminatory manner; 3) regulations should be clear and understandable; 4) all regulations should be publicly available at all times; and 5) regulators should issue and make available to the public final regulatory actions and the basis for those actions.

⁹ QDII's will still be prohibited from, "...no investment in commodities-based derivative products, hedge funds and debt securities with credit ratings below BBB as assigned by an international credit rating agency." Notice of the Adjustments to the Offshore Investment Scope of Overseas Wealth Management Business of Commercial Banks on behalf of Their Clients (promulgated on May 10, 2007), <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20070511425E7E3A4547640AFFE563AD79AEB000>.

5) Liberalize Derivatives Regulation

Interim derivative rules, which took effect in March 2004, have prohibited securities firms from creating and distributing derivative products. The inability of securities firms to engage in these activities hampers the development of these markets. Foreign firms hope that China's newly revised Securities Law will lead the State Council to formulate measures on the issuance and trading of derivatives.

Continued liberalization of China's capital markets has clear benefits for China and the global economy. Long-established U.S. policy seeks to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost. Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital—institutional investors or individual savers—receive better returns on their investments.

The most reliable and expedient way for China to meet its massive capital demand is to access the larger pools of capital available in the global markets. Foreign securities firms can contribute to the development of China's financial markets by sharing their expertise on the infrastructure needed to effectively serve a sophisticated and globally oriented client base. Foreign players can also provide new financial products and services that meet the changing needs of Chinese investors, demonstrate the benefits of high corporate governance standards, and consult on legal issues that must be addressed to help domestic equity and capital markets flourish. Ultimately, the modernization of China's financial system, especially its capital markets, will benefit both China and the world.

Finally, open, fair markets help to increase living standards. We look forward to working with the Congress and the Administration to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums. A coordinated U.S. government effort, including all relevant agencies, will be critical in helping U.S. securities firms to gain full access to these crucial markets.

We appreciate the opportunity to present this statement today and we look forward to working constructively with this committee on issues related to the global financial markets in the future.