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Increasing Market Access for U.S. Financial Firms in China:

Update on Progress of the Strategic & Economic Dialogue

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China has partially liberalized foreign access to its domestic financial services industry, including banking, insurance, securities, and asset management, since its accession to the World Trade Organization (WTO) in 2001. Nonetheless US and other foreign firms have been disappointed that they have not been able to expand their financial service business activities in China more rapidly. This disappointment in my judgment stems from three factors. First, in the bilateral negotiations for China's entry into the WTO the United States did not press very hard for market opening in financial services. China, by and large, has complied with its WTO commitments in banking, insurance, securities, and asset management but foreign firms have gained only a marginal presence in China's domestic financial services market. Second, both US and Chinese negotiators are constrained in their ability to make reciprocal concessions so further market opening measures flowing from the U.S.-China Strategic & Economic Dialogue and its predecessor, the U.S.-China Strategic Economic Dialogue, has been painfully slow. Third, the US argument that China would benefit from further unilateral opening of its market to US and other foreign financial services firms is far less compelling today than it was prior to 2008.

Banking

Prior to China's entry into the WTO, China's central bank limited the number of cities in which foreign banks could operate and severely restricted the ability of foreign banks to provide local currency services. Foreign branch banks were permitted to operate in China as early as 1981, shortly after economic reforms began. But these institutions effectively were limited to providing foreign currency banking services to foreign-invested companies, foreign embassies, and individual foreign citizens. In the late 1990s foreign banks operating in Pudong and in Shenzhen were allowed to conduct domestic currency business, but this liberalization was subject to a number of constraints. The result was that domestic currency lending by foreign banks at the end of 1999 accounted for only 0.07 percent of the volume of domestic currency credit extended by domestic Chinese financial institutions.[1]

Under the terms of China's entry into the WTO most of these restrictions were eased or eliminated. Geographic restrictions on where foreign banks can operate were lifted by 2005 as were numerical limits on the number of foreign banks operating in China. By 2006 foreign banks were subject to national treatment, meaning that they could offer the same range of domestic currency services to domestic firms and individuals as domestic banks.

As a result of China's implementation of its WTO commitments, the number of foreign banking institutions operating in China grew significantly from 177 in 1999, on the eve of China's entry into the WTO, to 387 institutions by the end of 2011.[2] But as, shown in table 1, the foreign bank share of the total assets of China's banking system, which was 1.5 percent in 1999, has grown extremely slowly, reaching only 2.0 percent by the end of 2011.

Table 1: Foreign Bank Presence in China

		Foreign Bank Assets	
	Number of Institutions	Amount	Percent of Total Banking System
Unit	Number	RMB Bn	Percent
1999	177	263	1.53
2000	191	285	1.70
2001	190	373	2.10
2002	180	324	1.50
2003	192	416	1.50
2004	188	582	1.84
2005	207	716	1.91
2006	224	928	2.11
2007	274	1,253	2.38
2008	311	1,345	2.16
2009	338	1,349	1.71
2010	360	1,742	1.85
2011	387	2,154	1.93

The limited role of foreign financial institutions in China is the result of several factors. First, most foreign banks operating in China have limited aspirations, focusing primarily on investment and corporate banking. Only a handful of foreign banks aspire to develop a substantial branch network that

[1] Nicholas R. Lardy, *Integrating China into the Global Economy* (Brookings Institution Press, 2002), p. 70

[2] The total at year-end 2011 includes 94 foreign branch banks and 37 locally incorporated banks with 245 branches.

would allow them to compete in the retail banking market. HSBC, for example, has opened about 110 branches and sub-branches. Bank of East Asia, its nearest foreign competitor, has more than 90 banking offices.

Second, regulatory changes initiated since China joined the WTO have increased the cost to foreign banks of providing domestic currency services. Originally, virtually all foreign banks operated in China as branches, meaning that there was no requirement for separate capital to support their operations in China. But beginning in 2006 China began to require foreign banks that wished to offer domestic currency services to incorporate as subsidiaries, meaning that the parent bank had to supply capital to the subsidiary to support its lending and other banking services. Requiring foreign banks to operate as subsidiaries rather than branches is a common practice in both emerging markets and in developed economies. But the new requirement increased the cost of doing business in China, thus reducing foreign bank profits.

Third, there are still a number of administrative hurdles to create a subsidiary bank in China. A bank must operate a representative office for three years before applying for a banking license. Once a license is granted and a subsidiary created, it must operate for three years before it can apply for a license to provide full domestic currency services, and the operation must have been profitable for two consecutive years. Nonetheless banks that are pursuing a retail strategy and seek to expand their geographic footprint have been able to open a significant number of branches. This group includes not only HSBC and Bank of East Asia but also Standard Chartered Bank, Hang Seng Bank, Citibank, and DBS Bank.

The fourth factor limiting the expansion of foreign banks in China is price controls. In banking the key prices are interest rates, and in China the central bank sets benchmark interest rates for both deposits and loans for a variety of tenors. While the central bank has increased the flexibility that banks have to set deposit and lending rates above and below these benchmark rates, there remains a fixed upper limit on deposit rates and a lower limit on lending rates. These limits restrict the ability of foreign banks to exercise their presumably better capability to assess the creditworthiness of potential borrowers. In a liberalized interest rate environment foreign banks presumably would be able to offer lower rates to better borrowers. This, in turn, would allow them to offer higher rates to depositors than their domestic competitors. Less efficient domestic banks would have to devote a larger share of their interest income to the writing off of non-performing loans made to poor credit risks and thus would not be able to offer competitive interest rates to depositors. Thus in a liberalized interest rate environment foreign banks would be able to attract a growing volume of deposits that they could use to fund an expanding loan portfolio and thereby increase their market share at the expense of domestic banks. But existing interest rate controls limit the ability of foreign banks to take advantage of their superior risk pricing ability and thus foreign banks have not been able to significantly expand their market share over the past decade.

Insurance

Prior to accession to the WTO, China also severely limited the access of foreign firms to the domestic insurance market. The first license to a foreign insurance company was granted in 1992 but it was only for a single line of business, life insurance, and limited to a single city, Shanghai. By the end of the decade China had licensed only a handful of foreign companies to sell a limited range of insurance products in only three cities. As a result, in 1999 foreign insurance companies accounted for less than two percent of all insurance company assets and only 1.3 percent of all insurance premium income.[3]

Under the terms of its accession to the WTO China was required to gradually phase out many of these restrictions. For example, all geographic restrictions on the operation of foreign insurance companies were lifted by 2005. However, China retained the right to limit foreign participation in the life insurance industry to joint ventures and caps the foreign ownership share at 50 percent. The China Insurance Regulatory Commission continues to subject new branch applications to a lengthy review process and refuses to consider multiple branch applications at the same time, limiting the ability of foreign firms to expand geographically within China.

Foreign insurance firms were able to grow their share of the life insurance market after China's accession to the WTO, reaching a peak of 8.9 percent in 2005. By 2010, however, this share had fallen to 5.6 percent, only slightly ahead of their share prior to China's WTO accession. The foreign share of the property and casualty market also rose slightly in the mid-2000s but by 2010 had fallen to 1.1 percent, strikingly below their share prior to China's entry into the WTO.[4] This presumably is because until February 2012 China has not allowed foreign firms to enter the Mandatory Third-Party Liability auto insurance business. Since China's car market has surpassed in size that of the United States, auto insurance now accounts for more than two-thirds of the property and casualty insurance market. Thus foreign firms were excluded from an increasingly important segment of the insurance market.

Securities and fund management

Prior to China's entry into the WTO, foreign participation in China's securities market was limited to a single joint venture in which an American firm held a 37.5 percent interest. China's WTO commitments opened the securities and fund management sectors to foreign firms only marginally. Most important participation in the Chinese market was restricted to the form of joint ventures, limited to 33 percent and 49 percent in the case of securities and fund management firms, respectively. The Chinese government, in the most recent Strategic & Economic Dialogue, agreed to raise the foreign ownership cap in securities firms to 49 percent, and more importantly, to reduce the waiting time before these firms can apply for licenses with a broader business scope. It remains to be seen whether these steps will be sufficient to erode the dominance of the securities market in China by indigenous firms.

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[3] Nicholas R. Lardy, *Integrating China into the Global Economy*, p. 71.

[4] American Chamber of Commerce in China, *2011 White Paper*, p. 107.