Statement of the Honorable Donald L. Evans
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Introduction

Chairman Frank, and Ranking Member Bachus, thank you for the opportunity to participate in this important hearing regarding U.S. interests in reform and modernization of China's financial services sector.

I am here as Chief Executive Officer of the Financial Services Forum. The Forum is an association comprising the chief executive officers of 20 of the largest and most diversified financial institutions with business operations in the United States. The Forum works to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 1.5 million people and hold combined assets of more than $12 trillion.

Importance of China to the U.S. and Global Economies

The 20 member CEOs of the Financial Services Forum meet twice a year, our most recent meeting occurring this past April. At each meeting, we conduct a survey regarding our members outlook on the U.S. and global economies. The answers we collected are of special value because, as the CEOs of 20 of the world's largest financial institutions, our members enjoy a unique vantage point on the U.S. and global economies.

As part of the survey, we ask our CEOs to rate a number of factors, including technological innovation, improved education, freer and more open trade, and growth in a number of regions around the world, to reflect their likely contribution to global economic growth over the next decade. The CEOs are asked to assign a number between 1 and 5 to each rated factor, with "1" being "not important" and "5" being "the most important." Our CEOs have consistently rated growth in China as the single most important source of growth for the global economy, assigning a rating of 4.7 out of 5 in our most recent survey.

The rate of China's expansion and the impact of its integration into the global trading system are unprecedented in the history of the world's economy – with profound implications for U.S. economic growth and job creation. Since China's joined the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest. How this critical relationship is managed is sure to be one of the most important factors determining the growth and stability of the global economy in the 21st century.

Critical Importance of Financial Sector Reform in China

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 sector 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, efficient, and sophisticated financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend. It is the "force multiplier" for progress and development, amplifying and extending the underlying strengths of a growing economy.

Almost immediately after assuming leadership at the 16th Chinese Communist Party Congress in 2002, President Hu Jintao and Premier Wen Jiabao sought to distinguish themselves as the "putting-people-first administration." They also articulated the notion of a "scientific viewpoint of development," by which economic growth is to be balanced with social priorities such as a more equitable distribution of income, poverty reduction, education, improved medical care, and environmental protection.[1] Such adjustments were necessary, according to the new leadership, to establish a more sustainable course for China's long-term economic growth and to achieve a more "harmonious" – which is to say, a more equitable and stable – society.

These priorities became the framework of China's 11th Five-Year Plan[2], which broadens China's development policy beyond simply promoting rapid economic growth to include a clear emphasis on "common prosperity" – that is, an effort to extend westward the economic gains enjoyed principally in China's east coast urban areas. The Five-Year Plan seeks to address the twin problems of an economy perceived as being too dependent on external demand and the social consequences of the widening wealth gap by: 1) maintaining high rates of growth and job creation; 2) encouraging a structural shift from industry to services; 3) promoting the development of domestic consumer demand; 4) reducing poverty; and, 5) ensuring a more equitable distribution of opportunity and prosperity.

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[1] See Wen Jiabao, closing speech at the Specialized Research Course for Province-Level Cadres on Establishing and Implementing a Scientific Developmentalist Viewpoint," February 21, 2004.

[2] The Five-Year Plan, the 11th since 1953, was approved by the fifth plenary session of the 16th Communist Party Central Committee in October of 2005 and ratified by the National People's Congress this past spring.

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals. Financial sector reform is also a prerequisite to meaningfully addressing issues that have complicated the U.S.-China economic relationship, particularly greater currency flexibility and reducing trade imbalances.

Achieving China's Economic Priorities

- *Maintaining High Rates of Growth and Job Creation*: Maintaining exceptional rates of economic growth and job creation in China increasingly depends on an effective system for mobilizing investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world. 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.

- *Shifting from a Manufacturing-for-Export to a Services-Based Economy*: Facilitating China's desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available.

- *Activating the Chinese Consumer*: Chinese households historically save as much as a third 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, 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 insurance intermediary services – that will eliminate the need for such "precautionary savings" and facilitate consumption.

In sum, a more modern, open, and competitive financial system would greatly enhance the productive capacity and stability of the Chinese economy and facilitate the achievement of China's economic goals, as described in the 11th Five-Year Plan. Indeed, research conducted by

McKinsey indicates that genuine reform of its financial system would expand China's economic output by as much as 17 percent, or an additional $320 billion a year.[3]

Meaningfully Addressing Issues with the United States

A more effective and efficient financial sector in China is also a prerequisite to successfully addressing issues that have complicated the U.S.-China economic relationship, particularly further currency reform and meaningfully reducing the trade imbalance.

- *Market-determined exchange rate*: A Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.

- *Reduction of trade deficit*: Reorienting the financial habits of China's population from precautionary savings to a better balance between savings and consumption – while progressively bringing more than a billion Chinese into the global economy – is the most powerful remedy to the U.S.-China trade imbalance. Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

Status of Financial Sector Reform in China

In addition to working to meet its WTO commitments, China has also taken important steps to liberalize its financial sector and improve financial regulation. For example:

- The financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm.

[3] See "Putting China's Capital to Work: The Value of Financial System Reform," by Diana Farrell, Susan Lund, and Fabrice Morin, The McKinsey Global Institute, May 2006.

- Meaningful steps have been taken to eliminate state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending.

- The China Banking Regulatory Commission (CBRC) was established in April of 2003 to oversee all banks in China, investigate illegal banking operations, and punish violations of law.

- Interbank, equity, and foreign exchange markets have been established and important progress made toward implementing monetary policy through market mechanisms rather than by government fiat.

Despite these achievements, China's financial sector still faces serious challenges:

- Non-commercial lending to state-owned enterprises continues, although on a diminishing scale.

- The stock of nonperforming loans on banks' balance sheets remains high.

- Banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate.

- Prudential supervision and regulation of the financial sector is opaque, applied inconsistently, and lags behind international best practices.

- China's equity and bond markets remain small and underdeveloped.

With these problems in mind, efforts to build on the progress achieved to date should focus on:

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the 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.

  Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. The China Securities Regulatory Commission (CSRC) continues to limit foreign ownership of Chinese securities firms to 33 percent and foreign ownership of Chinese asset management companies to 49 percent. Worse, since December of 2005 has imposed a de facto moratorium on foreign investments in Chinese securities firms. The moratorium is inconsistent with the letter, and certainly the spirit, of China's WTO commitments. Foreign life insurance companies remain limited to 50 percent ownership in joint ventures and all foreign insurers are limited to 25 percent equity ownership of existing domestic companies.

While these 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. Most 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. For these reasons, the United States and other WTO members have urged China to relax these limitations.

China also continues to restrict access by foreign credit card companies. Banks in China are permitted to issue a credit card with a foreign logo only if the card is co-branded with the logo of China Union Pay (CUP), an entity created by the People's Bank of China (PBOC) and owned by participating Chinese banks. In addition, all yuan-denominated transactions must be processed through CUP's network, while the network of the foreign credit card company is used only to process foreign currency transactions.

- Non-discriminatory treatment with regard to licensing, corporate form, and permitted products and services.

- Non-discriminatory treatment with regard to regulation and supervision.

- Regulatory and procedural transparency.

- Attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

- Priority issues from the Transitional Review Mechanism that remain unresolved.[4]

For a more detailed discussion of the U.S. financial services industry's priorities in China, please see the Appendix.

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[4] China's WTO accession included the Transitional Review Mechanism (TRM) as a means for ongoing review of China's compliance with its obligations, and to provide those elements of the Chinese government supportive of further economic reform with information and evidence to urge full compliance with China's WTO commitments.

The Importance of a Market-Determined Yuan

With the importance and status of financial sector reform in China as a backdrop, let me focus for a few minutes on the importance of a market-determined Chinese yuan. In recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for the United States and especially for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have begun to bear fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by about 8 percent since July of 2005.

This is important progress – but, clearly, much more progress is needed. Given the importance of a market-determined yuan to the economic objectives of both countries, the United States should continue to press China to redouble its reform efforts and accelerate movement toward a freely floating yuan.

But even as we continue to press China on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, it should be noted that the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation is for China to achieve a more sustainable model of continued economic growth, and for its population of 1.3 billion – a fifth of the world's population – to begin consuming at higher levels. Both goals require reform of China's financial sector.

Conclusion

Mr. Chairman, 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 import it – that is, by opening 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, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

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 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.

Thank you very much for the opportunity to appear at this important hearing.

Appendix

U.S. Financial Industry Priorities in China

Banking

Raise Current Investment Caps – Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Such caps are a significant obstacle to China's achievement of a more balanced, resilient, and stable economy. Creating the millions of new jobs that China will need each year requires maintaining exceptional rates of economic growth, which in turn will increasingly depend on an effective system for mobilizing and allocating investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate.

The result is that investment capital continues to be misallocated, to the detriment of China's economy and people. State-owned enterprises, though contributing only a quarter of China's GDP, receive more than a third of bank credit and account for nearly all equity and bond issues. Private enterprises – the most productive of China's economy and the engine of future growth and job creation – account for only 27 percent of bank loan balances.

Greater access for foreign banking institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the competition brought by foreign institutions would accelerate the adoption of such techniques and methodologies by domestic financial institutions

Grant non-discriminatory treatment with regard to licensing, corporate form, regulation, and permitted products and services: While China imposes no explicit limits on the number of licenses provided to foreign banks and remaining geographic and customer restrictions were phased out as of December 2006, regulations continue to require three years of operation and two continuous years of profitability before foreign bank branches are permitted to carry out local currency business. China also imposes substantial asset and capital requirements. To establish a subsidiary in China, a foreign bank must have total assets of more than US$10 billion and the subsidiary must maintain minimum capital of 1 billion yuan (US$129.2 million); to establish a branch, foreign banks must have total assets of more than US$20 billion and each branch must maintain minimum operating capital of about $50 million. Such capitalization requirements have the effect of making subsidiaries significantly more economical than branches – limiting the extent to which foreign banks can penetrate the Chinese market.

The efficient deployment of the capital and other resources of foreign financial institutions in China requires the flexibility to determine which particular corporate reform – whether a wholly-owned subsidiary, branch, representative office, joint venture, or majority equity investment in an existing Chinese company – is most appropriate economically and within the broader strategic parameters of the foreign institution. Restrictions on operational form can discourage foreign financial institutions from initiating business activities in China, despite finding the market attractive, which will not serve the interests of the Chinese consumer.

Chinese authorities have also been slow to act on foreign banks' applications and continue to permit foreign banks to open only one branch every 12 months. In addition, a portion of foreign banks' branch capital must be deposited in Chinese banks, and foreign banks remain subject to minimum interest rate rules when borrowing from Chinese banks. Most problematic, the 75 percent loan-to-deposit cap discriminates against foreign banks because their small number of branches – made worse by a slow approval process – limits foreign banks' deposit base.

<u>Improve regulatory and procedural transparency</u>: Related to the issue of non-discriminatory regulatory treatment, China must also continue to make progress regarding the critical issue of regulatory and supervisory transparency. Fair and transparent regulation plays an integral role in the development of deep and liquid capital markets that attract market participants, increase efficiency, and spur economic growth and job creation. Transparency generally means that the public and industry participants have the opportunity to participate in the rule-making process, to access information about proposed rules, to question and understand the rationale behind draft rules, to have sufficient opportunity to review and comment on proposed rules, and that final rules and regulations be clearly articulated and easily understood.

Unfortunately, regulatory ambiguity continues in China and administrative procedures and the rule-making process continue to be inconsistent and unnecessarily opaque. New regulatory guidelines are too often promulgated without notice or consultation with the industry. Even when industry consultation has been sought, the response period has often been insufficient. While China has agreed to publish the laws and regulations governing financial services as its WTO accession protocol requires, it has not committed to all of the essential elements of modern regulatory transparency, including advance notice of new rules or rule changes, public comment, and the right to judicial review.

Securities

<u>Greater Market Access</u>

China's 2001 WTO accession commitments in the securities sector were an important first step towards liberalizing its capital markets. These commitments permit foreign securities firms to participate in the securities business in China – but only through minority-owned joint ventures with permitted ownership levels in such ventures capped at just 33 percent. China has made no further commitments in the securities sector for further increases in foreign ownership in the Doha Round. Moreover, China has a placed a *de facto* moratorium on securities firm joint ventures.

- Permit 100% ownership, and right to establish in corporate form of choice: China should lift the de facto moratorium on securities firm joint ventures. Foreign firms are unlikely to invest without the ability to control their investment, either through a wholly-owned entity or another ownership form of choice. Firms also should have the right to establish without geographical limitation.

- Permit same scope of business: Foreign minority-owned joint ventures are limited to underwriting the A shares of Chinese corporations, and to underwriting and trading government debt, corporate debt, B shares and H shares. The fundamental right to *trade* A shares, the most liquid domestic market, was not conferred on these foreign joint ventures, which compromises their underwriting business. Foreign entities are also restricted in many cases from trading renminbi and renminbi-linked products with foreign and domestic enterprises in China. Without the ability to trade renminbi, any progress otherwise made in expanding the permitted activities of foreign securities firms will be difficult to realize competitively.

Regulation

- Permit Derivatives Transactions: Subject to reasonable prudential requirements, foreign or domestic securities firms should be permitted directly to engage in the development and distribution of derivative products and services, without requiring a banking license.

- Change Assessment of Capitalization Requirements: Rather than establishing a capital requirement based upon a technical assessment of the risk of the business to be entered, China has promulgated a fixed minimum capital requirement of RMB 500 million ($U.S. 50 million) for securities and asset management firms wishing to participate in joint ventures permitted under China's WTO commitments. This dissuades smaller foreign entrants, reducing the overall attractiveness of the joint venture vehicle and discouraging foreign direct investment. A capital assessment system that took into account a firm's overall risk and consolidated capital would reward firms who invest in stronger risk management systems and shore up their balance sheets appropriately for their business mix.

- Promote Regulatory Transparency: Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract market participants, increase efficiency and spur economic growth and job creation. In general the practice of transparency means that the public and industry participants have the opportunity to participate in the rule-making process, to access information about proposed rules, to question and understand the rationale behind draft rules and sufficient opportunity to review and comment on them, and that the resultant rules and regulations be clearly stated and easily understood.

- Improve Qualified Foreign Institutional Investors (QFII) Program: Reforming the QFII program could encourage more investors for Chinese stock markets. Limits on the types (size) of investors, the length and size of quotas, and difficulties with remitting profit are key barriers to more participation.

- Support A Qualified Domestic Institutional Investor (QDII) Program: Implementing the QDII program would help familiarize Chinese domestic investors with international best corporate and broking practices and give them access to top quality research.

Insurance and Insurance Brokerage

Ownership (#1 insurance issue)

- Ensure that foreign insurers are guaranteed the freedom to choose their desired form of juridical form of establishment (branch, subsidiary, or joint venture).

- Remove equity limitations on foreign life insurers - currently capped at 50%; allow equity ownership up to and including 100%.

- Provide national treatment for foreign invested insurers, allowing them to purchase or sell ownership stakes on commercial basis between joint venture contract partners, consistent with most favored nation principals.

Discussion Points:

- ➢ There is no statutory restriction that foreign life insurance companies be limited to 50% ownership, and the Government of China has discretionary power to authorize up to 100%.

- ➢ There are legitimate prudential reasons why Chinese insurance regulators could need to allow an equity increase by a foreign JV partner above 51% and up to 100% (such as financial difficulty of the Chinese partner) in the interests of policyholders and the stability of the Chinese insurance market.

- ➢ All parties in managing insurance companies should be committed to the financial vitality of the company and the best interests of policyholders. Both foreign and Chinese partners should have the right to purchase or sell their interests consistent with the interests of their stakeholders and the contractual terms of the joint venture.

- ➢ It is not in anyone's interest to require ongoing company ownership by partners who are no longer committed to the enterprise, and who are dedicating their resources to other businesses.

Branches, Subsidiaries

- Allow foreign insurers to submit multiple applications for branch approval, and if approved, grant them concurrently, which is consistent with branch approvals for domestic insurers.

- Approve existing non-life company applications for conversion of their branches to subsidiaries and ensure that future applications are considered and acted on in a transparent and timely fashion consistent with international norms and practices.

Discussion Points:

- ➢ Both of these issues have been raised in the JCCT, the JEC and the annual TRM.
- ➢ The Government of China is on record as agreeing with the US requests on both concurrent branching and conversion, and stating that their laws and regulations provide for such treatment.
- ➢ On conversion several U.S, companies have had applications pending for approaching two years, where as Chinese regulations promise decisions within sixty days.
- ➢ Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

<u>Enterprise Annuities</u> (#1 pension issue)

- Establish "one stop shop," managed and coordinated within one government agency, which can approve licenses for providing EA related products/services in the market – master trust plan bundle: trustee; record keeper; asset manager and custodian.
- End the moratorium on EA licensing (last batch of licenses were awarded in August 2005) and allow applicants to submit EA related applications at will.
- Allow foreign equity ownership in EA related ventures up to (at least) 50%; and, participation up to 100% consistent with broader goals for financial services market access (see above).

Discussion Points:

- ➢ The enterprise annuity framework is already in place, and all relevant Chinese regulatory agencies (MOLSS, CBRC, CSRC and CIRC) are on record as supporting the increase in plan sponsors and participants.
- ➢ Current Chinese statute allows for bundled licensing for three of the four licensing elements (asset manager, trustee and record keeper) only requiring removal of the prohibition on licensing of "custodians" by insurers and asset managers.
- ➢ A public announcement that the Government of China will process applications bundling these three elements would allow the Government of China to proceed with an effective first step towards the "one stop license" within the scope of their current discretion.

- The Government of China recently announced the creation of an inter-agency committee to develop unified national tax incentive policies for both employer and employee contributions to EA.

- Adoption of best practices tax incentives for EA along with a simplified licensing process is the best way for the Government of China to build private savings in support of the social safety net.

<u>Investment of Assets</u>

- Credit global insurers' international operating experience and capital to fulfill current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit. An announcement by Chinese leadership of an intention to credit global experience and capital would be a strong first step, but would need monitoring to guarantee CIRC implementation.

<u>Political Risk Insurance</u>

- Allow foreign insurers to underwrite political risk insurance in China and approve all outstanding applications to do so.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

<u>Reinsurance</u>

- Confirm that foreign reinsurance and insurance companies are allowed to conduct cross border reinsurance with Chinese direct insurers or re-insurers on the same basis as reinsurance companies admitted in China.

Discussion Points:

- Achieving a commitment for resolution of these issues is necessary as the base elements of any outcome acceptable to industry, but represents low hanging fruit.

Insurance Background - Lexicon

Acquired Rights

Industry would like to confirm that foreign insurance companies operating in China at the time of WTO accession may continue to operate and expand their existing structure without modification of juridical form, under the conditions that existed, and pursuant to the approvals granted, prior to the recently issued regulations and implementing rules on administration of foreign insurance companies. This should include operations, financial structure, capital and mode of establishment. Similarly, non-life companies already established in China (whether as a branch or otherwise) should also be able to open additional branches and sub-branches, whether or not they re-establish as a subsidiary (see below).

Equity Ownership

Currently, foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies. Consistent with rights enjoyed by domestic insurers and all other financial service institutions in China, foreign insurers should be allowed to invest up to 100% in their operations in China. Foreign non-life providers can own up to 100%. AIG, which owns 100% of its life and non-life operations, and a number of life companies (Manulife and Allianz among them) were allowed to grand-father arrangements held prior to WTO accession. ACLI is currently investigating reports that Allianz has been allowed to buy up from its original 51% stake to 100% - if so, this would unprecedented and potentially allow for further increases in equity caps among insurers.

Branches, Subsidiaries, Capitalization Requirements

<u>Branch Approvals</u>: Foreign insurers repeatedly report that they are told by CIRC (China Insurance Regulatory Commission) officials that multiple branch applications cannot be submitted at the same time, or if submitted will not be concurrently examined and approved. Overwhelming evidence exists that indicates domestically-invested insurance companies, even new companies, have been permitted to expand aggressively through multiple consecutive or virtually consecutive branch approvals. By contrast, it appears that no foreign-invested insurance companies have received consecutive branch approvals. China undertook in its WTO accession agreement to eliminate all geographic restriction on foreign-invested life, non-life, and brokers by December 11, 2004. As for national treatment, China did not include in its WTO accession schedule any limitations regarding its obligations on form of establishment in the insurance sector. China also made commitments to allow internal branching consistent with the phase out of geographic restrictions.

Senior officials at the China Insurance Regulatory Commission have recently confirmed to USTR their commitment to allow foreign companies to establish multiple concurrent branches. We are pleased with this decision, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC staff.

Subsidiary Conversion: Despite CIRC's effective requirement that foreign-owned insurers convert their Chinese operations from branches to subsidiaries (notwithstanding China's WTO commitment to allow foreign general insurers to operate on either a branch or subsidiary basis), the regulator continues to delay approval of companies' applications for such conversion. This delay contravenes CIRC's own regulation (Baojian Fa 45, page 3, section 6) that requires its response to applications within two months. The delay - over sixteen months for some companies -- has created uncertainty and confusion in corporate planning as insurers eager to expand can only apply for permission to open new offices three months after the conversion process is approved. Those few companies that have been granted subsidiary conversion approvals effectively have an unfair advantage over all of US firms, none of which have received approval, because they are able to move ahead to expand their Chinese operations.

Capitalization Requirements: CIRC should confirm that the RMB 200 million capital requirement for initial establishment, whether as a subsidiary or a branch, includes the right to establish sub-branches without limitation on numbers, and without having to satisfy any additional capital requirements. The Chinese government has yet to provide its rationale for requiring additional capital of RMB 20 million for each additional branch, particularly given that any additional branches would still be backed by the full asset base of the admitted entity and have to comply with all CIRC solvency rules.

Enterprise Annuities

In the spring of 2005, Chinese regulators started establishing an enterprise annuity system as a second pillar individual account, defined contribution retirement program. Conservatively, industry observers estimate that within 10 years the assets under management for this program should be close to $100 billion. Within 25 years they should reach $1 trillion, which is how long it has taken the U.S. 401(k) system to reach its current $3 trillion in assets. Participating in this type of growth is paramount for firms in worldwide retirement benefits leadership positions.

"One Stop Shop": Industry welcomes China's interest in developing its EA system. However, rules and standards for the provision of EA services remain unclear and act as a significant deterrent to market access and full participation in the market. The regulations currently prevent one company from providing a comprehensive package of services (custodian, administration, asset management, and trustee). China should clarify the regulatory framework to authorize single provider plans under a single license, which would enable a "one stop shop" to improve cost effectiveness of the plans, particularly for small and medium enterprises in China. The EA pension system needs changes and this is precisely the right time to implement them. The system is in a nascent stage and changes would not unduly harm or competitively impact either domestic or foreign providers. In fact, the changes identified would help to grow the market substantially, increasing the participation of employers and employees, and decreasing the future pension debt burden on the Chinese government.

Tax Incentives: A number of provinces in China have issued policies that provide various levels of tax incentives for corporate EA contributions, while many others do not have such policies in place. On the employee side, there is no individual income tax incentive for EA contributions. We believe that tax incentives are necessary for promoting private pensions and are crucial to the healthy development of the pension market. Therefore, we recommend that the State Tax Bureau and the Ministry of Finance enact unified national tax incentive policies for both employer and employee contributions to EA.

Foreign Participation Limit: Foreign participation in the enterprise annuity market should be encouraged in the interest of introducing tested professional pension management experiences from other mature pension markets in the world to the fledgling EA market in China. As pension is included in China's WTO commitments under the section covering life insurance, we believe that foreign equity ownership in all EA service provider entities should be allowed up to (at least) the same current limit as life insurance companies (50%). This limit however should represent a floor and not a ceiling, and as part of SED and in support of building momentum for the WTO's Doha Round Negotiations, the Principal, along with ACLI, call for the Government of China removing this limitation and allowing 100% ownership, as further expressed in the ACLI SED priorities letter provided to Secretary Paulson.

Master Trust Plan: The EA rules as they stand now do not allow master trust plans, hence all EA plans have to be set up as individual trusts. This makes small plans unattractive to service providers. There is a strong need on the part of medium and small size companies for such plans in order to enjoy good quality service at a lower cost. Current rules effectively shut the small companies out of the enterprise annuity market. We encourage the Ministry of Labor and Social Security (MOLSS) to work with various other Chinese regulators to allow EA service providers to offer master trusts such that the medium and small size market can also be covered.

Pension Asset Investment: EA rules stipulate that no more than 20% of EA assets can be direct equity investments and no more than 30% can be investments in equity-related investment. This significantly limits the potential for higher long term returns for pension assets. In addition, the kinds of investment options allowed for EA assets are rather limited, too. We believe that a higher percentage should be allowed in equities, and that EA service providers should be allowed a broader range of investment options. This will help ensure a higher long term return for pension assets while at the same time allowing for prudent diversification to control risks. In addition, there should be a timeline for allowing pension assets to be partially invested overseas to further diversify their risk. Adding to offshore investments is a formula that has worked well for other markets, namely Chile where 30% of the assets can be invested offshore and the expectation is within two years to increase that level to 60%. It is a natural evolution in an effort to further diversify and insulate the system from local country risks as evidenced by Mexico enhancing their offshore allocations in the last two years.

Pension Regulator: While MOLSS (Ministry of Labor and Social Security) is the main regulator for EA, a lot of collaboration is needed between MOLSS and the other financial service regulators such as China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and China Insurance Regulatory Commission (CIRC). Further, it requires a lot of work and manpower to set up and run a well-regulated private pension market in China and much more dedicated and focused resources are needed at the regulator level, without which the policy making and approval process would naturally be slow. We believe that it is vital to have a fully staffed centralized decision-making pension regulator with dedicated resources so as to ensure that the EA regulatory system remains sound and healthy.

Investment of Assets

Overseas Utilization of Insurance Foreign Exchange Funds: CIRC's *Provisional Measures on the Administration of the Overseas Utilization of Insurance Foreign Exchange Funds* establish a qualifying threshold (total assets of RMB 10 billion) for companies to be able to invest their foreign exchange capital in overseas funds or equities. ACLI members would like to know the prudential justification for this requirement. Industry is concerned that even though this limitation applies to both domestic and foreign providers, only the largest insurers, i.e., mostly domestic companies, will have the necessary assets to qualify. Many foreign-invested insurers invariably will not qualify unless CIRC recognizes the assets of the parent foreign company when determining the asset level of a foreign-invested company. To rectify this concern, CIRC should ccredit global insurers international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers;

Insurance Asset Management Restrictions: Under Article 8 of CIRC's *Interim Regulations for Insurance Assets Management Companies*, only providers that have held licenses for more than eight years are permitted to apply to establish an insurance asset management company. Although China previously stated that this limitation applies to both domestic and foreign providers, it effectively excludes all foreign companies entering the market since China's WTO accession in 2001. Industry would like CIRC to provide its prudential reasons for this restriction. To rectify this concern, CIRC should ccredit global insurers international operating experience and capital in fulfillment of current seasoning and asset threshold requirements (eight years in the market, ten billion RMB) for asset managers;

Investment Channels: From an investment perspective, excessive and often discriminatory capitalization requirements continue to act as constraints on foreign insurers' ability to compete with local established insurers on a fair and equitable basis. In December 2005, CIRC's Draft Insurance Fund Management Regulation enforces outsourcing of the asset management (on-balance and off-balance sheet funds) of small and medium insurance companies to an Insurance Asset Management Company (IAMC). The draft regulation stated that an insurance company that does not own an IAMC, must outsource all its investments in equities, corporate bonds and mutual funds to an IAMC or any professional investment institution (no specific definition was given).

An IAMC is a subsidiary company to be set up by insurance companies that have total assets of at least RMB10B. Currently there are nine approved IAMCs that are all formed by large domestic companies. CIRC's official rationale for the policy is that an IAMC has better internal controls and investment capabilities for improving insurers' risk management and returns. However, the proposal has met with objections from both insurers and media. Both domestic and foreign insurers do not want to outsource their investment function, which is a core business element, to their competitors. There are concerns regarding potential disclosure of investment asset portfolio information to competitors and also, most important of all, potential conflicts exist for the IAMC to allocate assets to its parent insurance company's portfolio or those of competing insurance companies. If the proposal is implemented, all small and medium-sized companies that are not able to set up their own IAMC will lose the right to manage their own assets to their competitors' IAMC. Many small and medium-sized insurers viewed this initiative as a policy favoring large domestic insurers.

In June 2006, CIRC started to implement this initiative by indicating to insurers that in order to invest in direct equities, they would have to outsource equity investments to an IAMC, and CIRC would not consider any direct equity investment applications filed by them. Meanwhile, many insurers are already preparing to apply to manage their equity investments directly. CIRC also stated that it considered most small and medium-sized companies incapable of direct equity investment because of their lack of research capabilities, the fact that there was no separation between investment departments and finance departments and absence of a third-party custodian to protect asset misappropriation risk. In fact, all of the foreign insurers' parent companies have long histories of direct equity investment overseas. They could support and invest in research and systems capabilities, and install international-standard risk management systems for direct equity investment in their China operations. Enforcing outsourcing would add uncertainty and undermine insurers' commitment on spending resources to prepare for direct equity investment, which is important to insurers' portfolio diversification and future business opportunities in pension or asset management.

Enforced outsourcing of direct equity investment is seen as the first step in CIRC's initiative to have all assets outsourced. It is possible that the Chinese regulator will impose different kinds of restrictions (such as asset-based requirements) to push small and medium-sized insurance companies to outsource their fixed income investments and other future new investments (e.g., overseas investment, infrastructure investments, securitized assets investments) to large local insurers' IAMC. To any insurance company, investment capability and control are core strategic business areas to be controlled by the insurer itself. CIRC has long cited that, overseas, many small insurers outsource their investments for the sake of economies of scale. However, this would obviously not be the case for joint venture insurers in China who have strong support from their foreign parent companies. A self-controlled investment function is critical to operating an insurance business. The less robust internal control and investment capabilities in local insurers, along with the repeated scandals in their investment functions, are of obvious concern to joint venture insurers.

Political Risk Insurance Product Approval

American non-life insurance companies have been unable to gain China Insurance Regulatory Commission (CIRC) approval to provide political risk insurance (PRI) coverage for Chinese companies. One U.S. carrier has been waiting to receive CIRC approval for its PRI product for roughly 18 months.

China Export and Credit Insurance Corporation (Sinosure), is wholly owned by the Chinese government. Currently Sinosure is the only insurer allowed to offer political risk insurance in China for non-domestic exposures. It would appear that CIRC has been delaying the approval of foreign insurers PRI products because they have been told to protect Sinosure's monopoly, even though the market badly needs the additional capacity and expertise that American companies (some of whom are global market leaders in PRI) would bring. CIRC and the Ministry of Finance (MOF) jointly administer Sinosure, with MOF the stronger and more important of the two organizations in the Chinese Government. Although CIRC does not report to MOF, it can ill afford to upset MOF as the ministry provides financial resources to CIRC.

If American companies gain approval to underwrite political risk in China, Chinese investors could access enhanced, highly sophisticated risk management practices. Numerous Chinese companies have expressed a deep interest in access to new risk transfer options. China Ex-Im Bank and China Development Bank have indicated that they are not satisfied with Sinosure's service and limited capacity.

Reinsurance

Senior officials at the China Insurance Regulatory Commission have recently confirmed to USTR their commitment to allow foreign reinsurance and insurance companies to conduct cross border reinsurance with Chinese direct insurers or reinsurers on the same basis as reinsurance companies admitted in China. Industry applauds this action, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC officials. This clarification should state that China will suspend implementation of the 2005 Regulations on Administration of Reinsurance Business, as the regulation discriminates against foreign reinsurance companies by requiring right of first refusal for 50% of each primary company's reinsurance program with domestically admitted re-insurers. CIRC should also clarify that for purposes of these measures a 100% owned insurance operation may cede to a parent or affiliate insurance company.