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TESTIMONY OF NORMAN R. SORENSEN

ON BEHALF OF

The American Council of Life Insurers

BEFORE A HEARING OF THE

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

ON

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

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American Council of Life Insurers
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Thank you, Chairman Frank, Ranking Member Bachus, and members of the Committee, for the opportunity to testify today on U.S. Interests in Reform of China's Financial Services Sector.

I am Norman Sorensen, President and CEO of Principal International, Inc. a wholly owned subsidiary of the Principal Financial Group. I testify before you in my current role as Chairman of the International Committee of the American Council of Life Insurers, and in my capacity as the President of Principal International.

The American Council of Life Insurers (ACLI) is a unified voice for the United States life insurance and reinsurance, pension and retirement security industries. Its nearly 373 member companies account for more than 93 percent of total industry assets and life insurance premiums in the United States and are the leading providers of financial and retirement security products covering individual and group markets. Member companies are present in every major market globally, including key emerging markets. ACLI member companies are represented and invested throughout China's major cities and provinces.

The Principal Financial Group is an Iowa-based financial services company focused on retirement benefits and asset management, both here in the United States and overseas. As the nation's 401(k) leader we have a particular interest in providing long term savings for employers, employees, and individuals which will benefit them during their retirement years.[1] A focus on pension products has served us well as we have accumulated over $250 billion in assets under management from 16 million customers, serviced by our 15,100 employees (9,396 staff in Iowa) in 11 countries, including in China where we established an asset management company – the China Construction Bank (CCB) Principal Asset Management Co. – in 2005.

Our venture is becoming another success story in our family of companies and a testimonial to the promise of China's market. Our partner – CCB – is the third largest bank in China and was ranked 11th out of the top 1,000 global banks by The Banker Magazine with respect to capital adequacy. As of June 30, 2006, the bank has 14,250 bank branches, 300,000 employees and over US$667 billion in total assets. We rolled out four mutual funds since November of 2005 with the most recent retail mutual fund accumulating US$1.25billion (RMB 10 billion) in subscriptions in a single day. The joint venture has also earned awards for most innovative fund and also awards for sales distribution excellence. The Principal has integrated some of its own staff and processes into the fund company in an effort to develop worldwide best practices within the Chinese asset management industry. We have become one of the major asset management players in China (20 out of 60), but there is much yet to achieve, and we hope that regulatory changes in China will make that possible.

This is my fourth opportunity since 2000 to provide testimony to both U.S. Senate and House committees in support of our growing economic relationship with China. I provided testimony on May 11th, 2000 before the Committee on Banking and Financial Services of the U.S. House of Representatives on the subject of granting Permanent Normal Trade Relationship (PNTR) status to China, which culminated in China being allowed to join the World Trade Organization. I was further honored to be able to provide testimony on May 17th, 2005 before the Sub-committee on Trade of the Committee on Ways and Means of the U.S. House of Representatives on the subject of liberalization of financial services trade with China, and opening China's financial markets to U.S.

[1] The Principal ranks number one in plans among companies that provide both administrative and investment services – 2006 Spectrem Group analysis of fully-bundled 401(k) providers.

companies. Most recently, I appeared before the Senate Finance Committee on March 27, 2007 to provide testimony on opportunities and challenges in the U.S.-China Economic Relationship, with emphasis on China's burgeoning enterprise annuity and pension system.

Engagement with China

With the recently concluded second session of the U.S.-China Strategic Economic Dialogue (SED) on May 23 as backdrop, I am here once again to underscore the importance to our industry of continued purposeful, sustained, and constructive engagement with China on economic and broader financial services issues, to highlight progress in our industry, and to seek your continued support as we address remaining challenges.

At the outset, I want to make clear that our industry views outcomes of the recently concluded second session of the U.S.-China Strategic Economic Dialogue as solid and meaningful steps in a longer term process. The SED is an ongoing process of dialogue that offers an unprecedented opportunity to pursue a frank exchange on the most important financial and broader economic issues facing both countries. This second session is also only the second time in the history of normalized relations that both countries have marshaled in one venue such a high powered group of economic leaders from both countries, including six U.S. cabinet level agencies, and more than a dozen Chinese ministries and commissions. No effort of this sort can resolve all issues in one or two sessions nor should we expect it to. Progress during this session in the area of insurance and other areas germane to our industry was evident, including:

- The China Insurance Regulatory Commission (CIRC) has pledged to complete its review of outstanding branch-to-subsidiary license conversion applications by August 1, 2007 and to institute a policy of completing all future license applications within 60 days of their filing;
- China has also agreed to have by the time of the third SED a streamlined licensing process for financial services firms seeking to provide enterprise annuity services; and,
- China's announcement to expand the Qualified Domestic Institutional Investor and Qualified Foreign Institutional Investor programs, which facilitate China's integration with international capital markets.

We will be working vigorously during the next few months and in the lead up to the next session of the SED to ensure that China's commitments in insurance result in meaningful outcomes for our industry, including licensing procedures to support these and other areas of greatest concern to our members. Expansion of the QDII and QFII programs will encourage China's greater participation in capital markets and open up broader avenues for asset investment, a critical link for fund management and related companies.

ACLI works regularly with the Office of the United States Trade Representative and the U.S. Departments of Commerce and Treasury to advance these and a wide variety of other industry interests and to engage Chinese counterparts regularly on China's commitments on insurance in its WTO Protocol of Accession. We appreciate the support we received throughout the entire SED process of consultations and look forward to working together constructively with the Administration and Congress to forge ahead with our ambitious agenda in China for the third session of the SED in December 2007 and beyond.

The SED provided our industry an opportunity to heighten the level of focus and attention on two fronts: one, the need for China to redouble efforts to comply with its WTO commitments on

insurance, reinsurance, and pension products; and two, the importance for China's reform agenda and our industry to hasten liberalization of financial services markets, including removing equity limits in key industries and, in our industry, establish a "one stop shop," managed and coordinated within one government agency, which can approve licenses for providing enterprise annuity/pension related products/services in the market. On this latter objective, we will be working in the SED process through December to make licensing of enterprise annuities for U.S. companies much easier so that our industry can participate more fully in China's retirement and securities market and offer the products, services and expertise that China needs.

China's Insurance and Pension Markets

ACLI has over 30 U.S. and global member companies with operations or representative offices in China. China is considered underserved but rapidly developing, both in terms of business model (distribution, products) and in terms of regulation and tax policy, because of the vast population, high savings, sustained growth rates, and demographics (rapidly aging population).

China is the world's 11th largest insurance market by total premium volume (8th by life insurance), up from 16th in 2000, with premium volumes of almost $68 billion in 2006 - life premiums accounted for the lion's share at $48 billion, a near threefold increase since 2001. Although ranked in the top ten globally, China's life market is under-penetrated -- 38% of households have life insurance and spend on average $35 yearly, accounting for 2.5% of GDP (far below developed countries). As China's burgeoning middle class grows (already considered to be the world's largest), incomes grow, and consumptions patterns change, average yearly per capita expenditures on life insurance will surge – predictions are that China will rank among the world's largest life insurance markets by 2020. As of 2006, the total number of insurers in China had increased to 83 - 35 were non-life insurance companies, 43 were life companies, five were professional reinsurers. Of the total number, 41 were foreign insurers.

In the area of life insurance, China's WTO commitments phased in over five years (2001-2006), enabled our members and other foreign life insurers to choose their partners, invest up to 50% in an equity joint venture, expand geographically throughout China, and enjoy the possibility of underwriting individual, group, health, and pension/annuity policies. Twenty-two life joint ventures and one wholly owned entity account for approximately 6% of the total life market - market shares approach 10% and higher in the cities of Shanghai, Beijing, Guangzhou, and Shenzhen.

The current trajectory of China's insurance market contrasts sharply with its earlier history. From 1949 to 1988, the People's Insurance Company of China (PICC) was the sole insurance provider in China. From 1988 to 1996, 18 new shareholder owned insurance companies were established, including 9 domestic companies and 9 foreign insurance companies, including AIG which was the first foreign insurer to establish a branch. Foreign life companies could not pick their partners until after China's accession to the WTO in 2001. Most insurers concentrated their businesses in Shanghai and Guangzhou. The People's Bank of China (PBOC) was China's sole insurance regulator until the CIRC was established in 1998. The United States has been regulating insurance at the state level for more than 150 years.

While China has come a long way in opening up its life insurance market over this period, China is only beginning to appreciate the critical role that enterprise annuities needs to play in providing retirement security to Chinese households. Up until last year, there was no formal supplementary retirement savings program in China despite the fact that it began dismantling its "cradle to grave" social safety net beginning in the 1980s. Pensions are largely unfunded, under-funded or non-existent for scores of citizens.

To address the pension gap, Chinese regulators started in the spring of 2005 to establish an enterprise annuity system - the Enterprise Annuity Pension System (EA) - as a second pillar individual account, defined contribution retirement program (similar to our 401(k)). Conservatively, our estimates indicate 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. While a number of foreign firms have been licensed to provide custodial, trustee, management, and related services for pension assets, no American firm has been licensed to underwrite pension products directly.

Participating in the type of growth noted above is paramount for firms in worldwide life insurance and retirement benefits leadership positions. It is equally important for China's economic leadership, regulators and industry to view our greater involvement and participation as win-win for the economy, consumers, and capital markets generally. Circumstances in play, which were highlighted consistently throughout the SED, make this imperative - China's high savings (40%) are driven by the need to provide for family security in the absence of an adequate social safety net, especially retirement benefits. China's "aging" society heightens the need to save, however existing return on savings (as low as 2.5%) undercut the full potential of saving assets. Accelerating the growth of private consumption (i.e., decreasing precautionary savings) requires the strengthening of the social security system, the introduction of better, higher yield products, and capital markets more generally.

<u>ACLI's Record of Engagement With China – An Industry Leader</u>

Clearly, our industry desires much greater participation in China's phenomenal growth and China needs to accelerate its reform agenda – ACLI has worked vigorously through the SED and in other venues for a number of years to support these goals.

We have been the principal industry driver of four U.S.-China government-to-government insurance dialogues since 2002, established under the Joint Committee on Commerce and Trade (JCCT). In addition to the main government interlocutors – USTR and China's Insurance Regulatory Commission – ACLI, the American Insurance Association, the National Association of Insurance Commissioners, the American Chamber of Commerce in China, the Insurance Association of China, and representatives of major insurers from both countries participated in these deliberations. These efforts resulted in 2003 in a dramatic reduction in paid-in-capital – from $180 million to $60 million – required to qualify for and sustain an insurance venture in China. They also enabled our industry to re-focus attention on areas where we believe China has fallen short in its WTO commitments.

Governor Keating, ACLI President and CEO, traveled to China in the latter part of 2006 and in the beginning of 2007 to provide impetus and support for the SED, build coalitions with our Chinese counterparts, and reach out to a broad group of Chinese economic and financial officials. Our visit in

January of 2007, in which I also participated, included meetings with an unprecedented number of Ministers, Vice Ministers, and other senior officials representing all of China's economic and financial services agencies. We have concluded an MOU with China's largest industry group the Insurance Association of China, a first in our industry.

In April of this year, I co-chaired the ACLI-Beijing University Roundtable Forum on "Livelihood Protection and Harmonious Society: Perspectives from Insurance, Social Security and Economic Reform," held at Beijing University's Center for Insurance and Social Security Research. The event, which included representatives of all of China's key insurance and pension related regulatory bodies, including the CIRC's Chairman Wu Dingfu, industry leaders, American and foreign insurers, and leading academics, was unparalleled in scope, focus and attendance. ACLI supported this event through its non-profit foundation and will continue to work with Beijing University and other partners in China to offer additional programs that support global best practices regulation.

Finally, ACLI has been a strong supporter of inclusion of technical assistance on pension regulation and policy between the U.S. Department of Labor and China's Ministry of Labor and Social Security, which we believe has the potential to significantly broaden government-to-government work in the area of enterprise annuities, other defined contribution programs, and tax reform.

Our Agenda on Life Insurance and Pensions – the Glass is Half Full

We remain committed to ongoing engagement and dialogue with our Chinese counterparts and have confidence that the process started by the SED, ongoing bilateral discussions in the U.S.-China Joint Commission on Commerce and Trade (JCCT), multilateral discussions in Geneva under the WTO related TRM process, and other efforts can help our industry address and resolve longstanding issues of concern to our members. These include:

- Approval of concurrent as opposed to consecutive branching for foreign invested insurers;
- Approval of foreign non-life insurers to convert branches to subsidiaries – full rectification pending China's SED II pledge to review all existing applications by August 1;
- Approval of new products, such as political risk insurance;
- Credit for global operational experience and assets for seasoning requirements for insurers seeking asset management licenses;

The SED also provided the impetus to focus attention on two areas where we believe China can make progress in support of its broader economic reforms and the development of our industry. These include:

- Removal of equity limits on ownership in the financial services sector; and,
- Establishing a "one stop shop" for the review and approval of pension licenses under its Enterprise Annuity system.

Branch Approvals Foreign insurers repeatedly report that they are told by CIRC 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 We appreciate CIRC commitment to act on existing applications from insurers to convert their Chinese operations from branches to subsidiaries and to act on all other applications within sixty days. 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 foreign companies (Japanese) that have been granted subsidiary conversion approvals effectively have an unfair advantage over U.S. firms, none of which have received approval, because they are unable to move ahead to expand their Chinese operations.

CIRC should also 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.

Political Risk Insurance American non-life insurance companies have been unable to gain 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. 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.

Investment of Assets

Overseas Utilization of Insurance Foreign Exchange Funds. Existing regulations 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 credit global insurer's 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. Existing regulations indicate that 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 insurer's 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.

Required Outsourcing. 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).

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%.

Enterprise Annuities. The Principal Financial Group and ACLI welcome the creation of the Enterprise Annuity Pension system and China's decision in the SED to streamline the application process for financial institutions. The regulations currently prevent one company from providing a comprehensive package of services (custodian, administration, asset management, and trustee). We will be working vigorously in the SED process through December 2007 to clarify the regulatory framework to authorize single provider plans under a single license. This 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 additional momentum is needed 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.

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.

In a recent global retirement benefits study, Principal Financial Group found that only 15% of Chinese respondents have tried to figure out how much money they will need to have saved by the time they retire so that they can live comfortably in retirement. Perhaps this poor planning is because almost half expect financial support from their families when they retire and almost a quarter expect to live with their children or relatives. Another reason may be that Chinese households receive advice about financial and retirement planning from magazines and newspapers

(33%), television and radio (28%), or friends and relatives (17%), rather than banks (3%) or insurance or pension companies (2%) or other recognized sources of expertise.

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 services regulators such as China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), and the 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 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.

Conclusion

Taken together, progress in these areas has the potential to greatly increase American participation in China's effort to mend its social safety net and grow its financial service industry assets to new heights. Progress in this session in the SED is promising; much more remains to be done in the lead up to the third SED and beyond. The ACLI, The Principal and all other ACLI member companies, along with many other U.S. life insurance and financial services companies, see great promise in China's life insurance and retirement security markets. We believe that working constructively to resolve issues noted above and to take additional bold steps, such as removing equity caps and significantly expanding foreign participation in China's enterprise annuity system, represent a fortuitous win–win opportunity for the U.S. and China – one which we should all work to expand.