

# ENGAGE CHINA Priorities White Paper

## **Financial Services Industry Objectives:**

The Engage China coalition<sup>1</sup> believes the Strategic and Economic Dialogue, announced by President Hu Jintao and President Barack Obama on April 1<sup>st</sup>, is an important framework for promoting financial services reform and modernization in China. The Dialogue will provide a critical high-level framework within which U.S. and Chinese policymakers can raise and discuss issues in a coordinated and focused manner. We believe continuation of such regular, high-level discussions is critical to ensuring a thriving, more mature, and better balanced bilateral relationship that serves the mutual economic interests of both nations and their people. Importantly, this Dialogue is the key forum for discussing the market access and national treatment issues that face foreign financial services firms in China. We also respectfully urge the Administration to raise financial services in other appropriate forums, such as the JEC, JCCT, and WTO TRM process.

We discuss below a number of areas for financial markets reform and modernization that will provide the platform for China's ability to shift future growth to domestic demand, reduce precautionary savings, and provide the funding needed to shift to a more services-oriented economy. Continued reform and modernization that is characterized by open markets is an essential element of the State Council's decision to develop Shanghai as an international financial center. This, in turn, will positively impact China's development, job creation and the achievement of other national priorities.

## ***Cross-Cutting Issues***

While each sector of the U.S. financial services industry faces its own specific market access and national treatment barriers in China, all financial services firms confront common challenges including restrictions on foreign ownership and a lack of regulatory transparency. We are strongly of the view that China should meaningfully address these important issues in keeping with its efforts to reform and modernize its financial system and in support of its broader economic objectives. We believe the increased profile of China's economy and capital markets in the global marketplace – underscored by its Financial Stability Board membership – should lead to a corresponding reduction and elimination of discriminatory barriers to foreign firms.

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<sup>1</sup> **ENGAGE CHINA** is a coalition of eleven financial services trade associations united in our view that active cooperation with China remains the most constructive means of ensuring that the citizens of both nations mutually benefit from the growing bilateral economic relationship. Coalition members are American Bankers Association, American Council of Life Insurers, American Insurance Association, Bankers' Association for Trade & Finance, The Council of Insurance Agents & Brokers, The Financial Services Forum, The Financial Services Roundtable, The Futures Industry Association, Investment Company Institute, Property and Casualty Insurers Association of America, and the Securities Industry and Financial Markets Association.

The current financial crisis and the global economic downturn have only further highlighted the degree to which the U.S. and Chinese economies are interconnected. As the world's first and third largest economies, the implications of the U.S.-China relationship extend beyond the borders of both countries and will play a large and critical role in the global economic recovery. While current circumstances can complicate the relationship, we believe that they also offer a unique opportunity for the U.S. and China to build a more balanced, sustainable, and mutually beneficial relationship.

Engage China members are strongly of the view that continued reform and modernization of China's underdeveloped financial sector is critical to China achieving its own economic goals of maintaining high rates of growth and job creation, and promoting greater internal demand by cultivating a more services-based, consumer-driven economy. As financial reform and modernization discussions continue within the United States, similar progress within China will lead to more integrated financial systems that will benefit both economies.

In anticipation of the Dialogue, we respectfully request the U.S. government advocate for the following cross-cutting objectives in addition to the sector specific priorities detailed in this paper and its annexes:

- 1) Remove equity limits on ownership in the financial services sector We recognize that the U.S.-China relationship is ongoing and appreciate the strong advocacy of the U.S. government on this issue. Strong, consistent advocacy that targets ongoing liberalization, allowing full freedom of corporate form – including 100 percent ownership – must be maintained in the relationship and beyond.
- 2) Improve regulatory and procedural 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, and to have sufficient opportunity to review and comment on proposed rules. Final rules and regulations should be clearly articulated and easily understood and should reflect the input of all stakeholders.
- 3) Further expand the QFII program Enacted in December of 2002, the Qualified Foreign Institutional Investor (QFII) Act permits qualified foreign institutional investors to invest in the securities of Chinese companies. Implementing a Strategic Economic Dialogue (SED) II commitment, China raised the quota for QFIIs from US\$ 10 billion to US\$ 30 billion and, as part of its SED IV commitments, China has agreed to reduce the initial “lock-up” period for investments of certain QFIIs from one year to three months. We welcome these important steps in the direction of greater integration with the global capital markets. Still, QFII requirements remain onerous with the effect of substantially limiting the utility of the program as well as the universe of investors that can take

advantage of it (discussed in more detail in the attached securities annex). We urge China to continue the process of making its securities markets more attractive to investment through the rapid liberalization of current QFII restrictions on an agreed transition schedule. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would result in greater foreign investment in China's securities markets, add to the depth and breadth of trading in those markets, and result in increased capital available to Chinese issuers.

Building upon its commitments in SED IV, the Chinese government should expedite authorization of foreign invested insurance companies as qualified foreign institutional investors and should confirm that pension assets may be partially invested overseas (30 percent of the assets immediately increasing to 60 percent within two years) to further diversify their risk.

- 4) Further expand the QDII program China's Qualified Domestic Institutional Investor (QDII) program, initiated in May of 2006, allows approved financial institutions in China to make overseas portfolio investments in foreign currencies, both for themselves and on behalf of clients. The program has been slow to gather momentum, due to limited knowledge of the program, a lack of understanding on the part of potential investors regarding overseas investing, and comparatively low returns associated with the original permitted investments. Although we are encouraged by changes to China's QDII program that permit certain QDIIs to invest in the equity markets of some countries, including the U.S., we encourage China to further liberalize restrictions on foreign investments held in domestic portfolios of Chinese investors.

We believe that the U.S. government should regard the successful implementation of China's previous financial services commitments as an integral part of the Dialogue.

***Industry-Specific Priority Issues to Include in the S&ED***

We summarize below key sectoral objectives for asset management, banking, enterprise annuity, futures, insurance, and securities. More detail is provided in the annexes that accompany this document.

To continue the relevance of the Dialogue as a demonstration of the good faith bilateral economic relationship, there should be an opportunity to announce progress of ongoing financial services issues included under the JEC, JCCT, and WTO TRM process, including industry specific issues that have not been resolved after prolonged discussion in the other forums.

### Asset Management

Priorities for the U.S. mutual fund and asset management industry include (1) raising the ceiling on foreign ownership of Chinese asset management firms; (2) liberalizing the rules on foreign investment in Chinese markets (the QFII program); and (3) liberalizing local portfolio content restrictions for Chinese investors (the QDII program).

### Banking

China should make further progress on providing true national treatment, treating foreign banks no differently than domestic banks with regard to licensing, corporate form, regulation, and permitted products and services.

### Enterprise Annuities (EA)

In the SED V jointly agreed outcomes, the U.S. and China committed to conduct a technical dialogue on best practices tax incentives to promote defined contribution pension products in China to build private savings in support of the social safety net.

As a deliverable for S&ED I, the scheduling of this Dialogue should be announced and China should restate its commitment that all qualified financial services firms, including foreign invested firms, are eligible for licensing to provide these products, including enterprise annuity and group annuity products.

Additionally, China agreed to have, by the time of the SED III, a streamlined licensing process for financial services firms (including foreign invested) seeking to provide EA services. A time specific, step-by-step roadmap is urgently needed. To operationalize this, the Chinese government should utilize the existing framework of licensing today, but consolidate the licensing process into MOHRSS on a time-specific basis (60 days) and include all three operating permits (trustee, recordkeeping, asset management). MOHRSS would be the licensing regulator. CBRC, CSRC and CIRC would be gatekeepers for their industries, but would not issue EA licenses.

### Futures

The experience of the past year demonstrated that the transparency and centralized clearing and settlement of exchange-traded derivatives provided crucial risk management tools in an environment in which many markets had become illiquid. A diversified exchange-traded derivatives market, including stock index and interest rate futures and options, would deepen cash equity and fixed income markets in China and add much-needed risk management tools to the Chinese marketplace. As new futures markets are introduced, both QFII and QDII programs should accommodate the new instruments in a manner that appropriately addresses the unique characteristic of these risk-management markets. A roadmap should be put in place that would result in providing well-capitalized and well-managed foreign institutions the right to own a majority stake in a Chinese futures firm. Consistent with global best practices, China should become open to outside participation on the one hand, and on the other, relax rules restricting Chinese firms and individuals from accessing markets outside China.

## Insurance

As an extension of the China/U.S. Defined Contribution Tax Dialogue, the scope should be expanded to include another session on “related tax issues” such as treatment of distribution expenses<sup>2</sup>.

Approval of concurrent as opposed to consecutive branching for foreign invested insurers; providing national treatment for foreign invested insurers seeking sub-branch approvals directly from regional CIRC; regulatory cooperation between CIRC and CBRC on portfolio diversification – corporate bond market growth; opening of the third-party mandatory auto liability market to foreign insurers; recognition of operational experience and expertise in lieu of executive training requirements; opening of the political risk insurance market; and realization of a non-discriminatory insurance asset management regime through announcement of approvals for U.S. companies.

In December 2005, CIRC issued the Regulations on the Administration of Insurance Funds which mandate that insurers not qualifying for an Insurance Asset Management Company License (Seasoning Requirement of 8 years operations in China and 10 billion RMB) must outsource their asset management (on-balance and off-balance sheet funds) to an Insurance Asset Management Company (IAMC). CIRC’s official rationale is that an IAMC has better internal controls and investment capabilities for improving insurers’ risk management and returns.

In early 2009 CIRC issued revised guidance on the Regulations on the Administration of Insurance Funds allowing optional investment by insurers in new asset classes but with the requirement that companies have specifically set numbers of approved investment management staff physically in China and employed by the statutory entity wishing to access the additional investment options. Currently, insurance companies are required to outsource most new channels of investment to IAMCs (asset management companies set up by insurance companies) if certain standards are not met, e.g., number of investment staff.

Possible solutions which we would like the U.S. government to discuss with the government of China include: recognizing the global, or greater Chinese (Hong Kong) experience, capital and organizational resources for all seasoning or staffing requirements for IMAC or other investment requirements, and; allowing foreign-invested insurers to work with licensed mutual fund companies (several have foreign partners) to leverage their extensive experience and global best practices on fund management.

Doing this would both avoid conflict of interest of solely outsourcing assets exclusively to domestic IAMCs that are also competitors in the market; and promote competition, efficiency and improved service by allowing choice of qualified asset managers.

National treatment for foreign insurance brokerage to allow them the same scope of business activities as domestic firms, e.g., claims handling, risk management services and

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<sup>2</sup> Ministry of Finance and SAT Notice Concerning the Policy for Before-Tax Deduction of Processing Fees and Commission Expenses by Enterprises, Caishui [2009] No. 29

consulting, handling of application processes and placement services, and reinsurance brokerage. Allow foreign insurance brokers to provide client services for small commercial business, group life and health business and affinity programs.

The most pressing concern for U.S. non-life insurance companies operating in China is market access. Other important issues include a lack of regulatory transparency and routine regulatory procedures that assure meaningful foreign insurer input and the inability to write political risk and mandatory third party auto liability insurance.

Despite the symbolic promise of China's accession to the World Trade Organization (WTO) in 2001 that raised expectations of market-opening in financial services, foreign insurers still hold only a 1.2% share of the non-life market. While the State Council has spearheaded reform of the banking and securities sectors, CIRC, China's insurance regulator, continues to hinder foreign carriers' access. CIRC has severely limited the geographic expansion of foreign (including U.S.) insurers.

With U.S. \$34.4 billion of premiums written in 2008 and a 22% compound annual growth rate, the China non-life insurance market will surpass Korea's this year to become the world's 10<sup>th</sup> largest. Non-life insurance premium as a percentage of GDP is roughly 1%, about a fifth of the U.S. level. Given this low level of overall insurance penetration, potential for growth in China's addressable market is already strong and will expand further as the Chinese economy matures.

Although insurance premiums have expanded at an annual growth rate of 20% over the past two decades, non-life insurance's contribution to GDP in 2008 was 0.75%. The entire insurance sector makes up only 5.2% of China's total financial assets and is dwarfed by the banking and securities sectors. The State Council has already overseen fundamental reform of these sectors but insurance reform has lagged. Insurance liberalization would improve the efficiency of China's financial system, in turn aiding economic growth. Further, China's continued economic expansion hinges on specialization and productivity improvements that require specialized and innovative insurance products that its state-owned insurers cannot adequately provide.

In this regard, China requires, for example, participation of experienced foreign non-life insurers to mitigate domestic liability exposures (e.g., environmental liability, Directors & Officers liability), mitigate exposures in foreign markets (e.g., product liability, political risk liability), and enable growth in national priority areas such as life sciences and high technology.

Engage China coalition member companies have been active in China for more than a decade. We strongly supported China's accession to the WTO and are committed to playing an increasingly important role in development of China's insurance sector. An open Chinese insurance market benefits not only coalition companies, but the people of China.

If non-life insurers are to play an optimal role in financial sector reform and continued Chinese economic growth, CIRC must remove restrictions hindering foreign insurers' access and accelerate its approval process for their geographic expansion.

### Securities

China has agreed to remove the moratorium on the entry of new foreign securities firms and resume licensing securities companies, including joint-ventures. In addition, China announced that before SED III it will allow foreign securities firms to expand their operations in China to include brokerage, propriety trading, and fund management – however, there is a 5-year seasoning period prior to any request for expanded activities. China should put in place a precise and transparent roadmap, on an agreed timetable, that would result in providing foreign securities firms with the right to own 100 percent of a Chinese financial services firm, and the ability to engage in a full range of securities activities. While some progress has been made, regulatory transparency is still in need of improvement. Such reforms will create opportunities for U.S. firms and provide new competition and expertise in the Chinese securities industry.

**Conclusion:** Taken together, progress in these areas will greatly enhance China's effort to build and improve its social safety net and bolster the health and stability of its financial service sector and broader economy. Progress achieved in past dialogues, while incremental, is promising. We believe that working to resolve the sectoral issues noted above, as well as taking additional steps to liberalize China's financial services industry – such as removing equity caps and significantly improving China's administrative transparency procedures – represents a win-win opportunity for the United States and China.

## **Banking Annex**

### **Remove Current Investment Caps and Allow Establishment in the Form of Choice**

Limits on foreign investment in Chinese banks should be removed. Participation in Chinese markets by foreign banking institutions would 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. Countries which have followed this policy have seen (a) a dramatic improvement in the efficiency and safety and soundness of their financial sector; (b) an increase in available credit; and (c) the development of deep and liquid financial markets that spur economic growth. 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 and should be removed.

Equally important, China should allow foreign banks to establish a presence in China in the corporate form of their choice. The efficient deployment of the capital and other resources of foreign financial institutions in China requires the flexibility to determine which particular corporate form – 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.

### **Provide National Treatment**

China should treat foreign banks no differently than domestic banks 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, Chinese agencies and regulations continue to treat foreign banks more restrictively than domestic banks. For example, regulations require three years of operation and two continuous years of profitability before foreign bank branches are permitted to carry out local currency business. This restriction does not apply to Chinese banks.

China also imposes substantial asset and capital requirements on foreign banks that it does not apply to domestic banks. 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 \$12 million. These capitalization requirements may also contribute to a bias in favor of subsidiaries over branches, though along with such

other factors as the desire to engage in domestic retail business, which requires a bank to incorporate locally and to participate in China's deposit insurance scheme.

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 is a single-obligor limit (10 percent of capital to single borrower group) and effectively discriminates against foreign banks because their small number of branches, made worse by a slow approval process, limits the deposit base of foreign banks.

### **Allow Foreign Payment Processors to Operate Domestically**

At the end of SED II, the Chinese agreed to allow foreign banks to offer their own brand of RMB-denominated credit and debit cards through China Union Pay ("CUP"), China's monopoly for domestic electronic payments. China should now meet its full WTO obligations in this sector by providing approval for foreign electronic payment providers to operate domestically in China. Currently, these providers are restricted to issuing co-branded credit cards with CUP, a limitation which not only violates China's WTO commitments, but also limits the growth of domestic Chinese consumption and adds to the country's financial sector instability. China should allow foreign payment processors to operate fully in China independent of CUP.

### **Adopt a Risk-Based Approach to Capital**

China should change the way it assesses the capitalization of a bank to take into account a firm's overall risk and consolidated capital, rather than using the current fixed minimum capital requirement. This change would bring China's capital requirements into alignment with global standards.

### **Improve Regulatory and Procedural Transparency**

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, and to have sufficient opportunity to review and comment on proposed rules. Final rules and regulations should be clearly articulated and easily understood and should reflect the input of the public and regulated industry.

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 public or industry. Even when public and industry consultation has been sought, the response period has often been insufficient (sometimes as little as seven days). 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. China should provide 60-day advance notice of rule changes and 60 days for public comment, consistent with U.S. and European standards for comment on rules and regulations.

## **Insurance Annex**

### **Remove Equity Restrictions on Foreign Investment in Insurance Companies**

Remove the 50% cap on foreign ownership in life insurers in China.

#### *Discussion Points:*

- *In order to protect the safety and soundness of the market, CIRC should have the authority to allow foreign partners to increase their capital.*
- *To maximize the value of their investment in the sector, Chinese JV partners should be free to sell their stake to their foreign partners as part of an orderly continuation of the company if they choose to redeploy their capital.*

### **Sub Branch Approvals – Market Access**

In support of China's commitment to address the moratorium on new licenses for regional sales offices, CIRC should amend the regulations for the three structures that perform functions comparable to regional sales offices, i.e., sub-branches, central sub-branches and departments, to allow foreign invested companies to apply directly to the local CIRC office under the same procedures as domestically-owned insurers and not through the International Department of central CIRC.

#### *Discussion Points:*

- *When the moratorium was imposed in Oct. 2008, CIRC said it was temporary and would be addressed within months of release of the revised law which came out in Feb. 2009.*
- *CIRC also committed to an open and transparent comment process as the revised regulations were considered and to apply them equally to domestic and foreign companies.*
- *Because foreign companies have been required to apply through the International Department of central CIRC for any expansion since October 2008, there is currently a tremendous backlog of sub-branch applications from foreign-invested companies.*
- *To clear this backlog CIRC should allow foreign-invested insurance companies to apply to local CIRC offices for all sub-branch categories, in exactly the same manner as domestically-owned companies.*

### **Concurrent Branch Approvals – Market Access**

In demonstration of the repeated statements by CIRC that there is no discrimination between foreign and domestically owned companies as to the application approval process for geographic branch expansion, CIRC should issue a regulatory clarification that foreign-invested insurers are able to submit multiple applications for branch approval, and if qualified, CIRC will approve them concurrently.

#### *Discussion Points:*

- *This issue has been raised in the SED, JCCT, JEC and the annual TRM since 2004, and foreign-invested companies confirm that a pattern of administrative practice which*

- precludes multiple concurrent branch application approvals remains in place as of June 2009.*
- *U.S. industry has developed documentation as to the discriminatory regulations and the patterns of discrimination as demonstrated by publicly announced branch license approvals. These documents have been shared with and verified with the industries from Canada, Europe and Japan.*
  - *The government of China is on record as agreeing with the US and other trade partners regarding concurrent branching and conversion, and stating that their laws and regulations provide for such treatment.*
  - *In demonstration of this commitment, CIRC should make a public statement that foreign-invested and domestic insurers are welcome to submit multiple applications for branch approval which, if qualified, will be approved concurrently.*

### **Enterprise Annuities**

- The establishment of a successful and efficient private pension system is critically important to China. The US government and industry organizations are prepared to cooperate with China on this important initiative to help bring world class best practices to the Chinese private pension market.
- The Chinese government should encourage U.S. financial services firms, such as insurance companies, to participate in the Enterprise Annuity market by supporting the establishment of the appropriate financial services entities in China by U.S. financial services firms and awarding EA licenses to such entities.
- The relevant Chinese government agencies should establish a transparent, clear and streamlined licensing process for financial services firms (including foreign-invested) seeking to provide EA services. Foreign firms with the requisite experience should be allowed to joint-venture with Chinese companies (insurance companies, banks, trust companies, etc.) to provide EA services in China.
- In fulfillment of China's SED IV commitment on transparency, China should end the informal moratorium on EA licensing (the last batch of licenses were awarded in November 2007) and publish the procedure for companies to apply for EA authorization on an ongoing basis.
- China should encourage a "one-stop shop" provision for EA related products/services, as this is in the best interest of plan participants.
- China should permit the setting up of EA master trust plans for the interests of small and medium enterprises.
- China tax authorities and pension-related agencies should work together for better and unified tax policies to encourage the development of the EA market.
- Foreign ownership in EA-related ventures should be allowed to rise to 100 percent.
- Restrictions on investments (such as bans on foreign investments and equity caps) should be gradually relaxed for better long-term investment growth and risk diversification.

*Discussion Points:*

- *During SED IV, the United States and China had substantive discussions on how best to work together to mitigate the economic risks associated with aging populations in both countries and to provide better social services such as health care and retirement.*
- *China, in SED II, committed to implement by SED III a streamlined licensing regime for financial services firms seeking to provide EA services.*
- *What is the U.S. government's view on the "implementation score card" of this issue?*
- *The EA framework is already in place, and all relevant Chinese regulatory agencies (MHRSS, CBRC, CSRC and CIRC) are on record as supporting the increase in plan sponsors and participants.*
- *In June 2007, the government of China announced the creation of an inter-agency committee to develop a set of unified national tax incentive policies for both employer and employee contributions to EA. What is the status of this work?*
- *In SED V jointly agreed outcomes, the U.S. and China agreed to a technical dialogue on best practices tax incentives to promote EA products in China, and the U.S. expressed a strong commitment to support the development of EA in China to build private savings in support of the social safety net.*

**Overseas Investment of Assets**

- *In the Joint SED IV statement, China confirmed that it had recently issued regulations which specify relevant CIRC requirements to allow insurance companies in China ("Measures on Overseas Investments with Insurance Funds"), including foreign-invested companies, to invest a certain proportion of their assets overseas including creation of Qualified Domestic Institutional Investor funds.*
- *This commitment should be fulfilled by allowing foreign-invested insurers the same range of investment classes as Chinese domestic providers.*
- *The U.S. and China should report progress on this commitment by announcing the grant of Insurance Asset Management licenses to qualified foreign-invested insurers, and announcing that foreign-invested insurers will be approved by SAFE to use their parents as "Overseas Advisor" without being subject to any seasoning or asset thresholds that cannot be satisfied on the basis of international experience and global assets.*

*Discussion Points:*

- *Leveraging the global experience of foreign-invested companies will help develop products and domestic expertise if Chinese industry is to become competitive in global markets.*
- *Allow insurance companies to outsource investments to qualified fund houses or security companies, including their overseas affiliated and parent companies.*
- *Allowing foreign-invested insurers and their JV partners to create QDII funds to invest part of their assets or their customers' assets overseas through this asset class would enhance portfolio diversification.*
- *Allowing Chinese consumers to invest a portion of their assets in international and domestic non-bank assets supports the risk management diversification goal as stated by the government of China.*

## **Investment of Assets**

- In December 2005, CIRC issued the Regulations on the Administration of Insurance Funds which, if implemented, would mandate that insurers not qualifying for an Insurance Asset Management Company License (8 years operations in China and 10 billion RMB) must outsource their asset management (on-balance and off-balance sheet funds) to an Insurance Asset Management Company (IAMC).
- The Regulations stated that an insurance company that does not own an IAMC must outsource all its investments in equities, corporate bonds, derivative instruments and mutual funds to an IAMC or a professional investment institution (no specific definition was given).
- CIRC's official rationale is that an IAMC has better internal controls and investment capabilities for improving insurers' risk management and returns. ACLI and the U.S. government raised concerns with CIRC regarding potential disclosure of investment asset portfolio information to competitors and potential conflicts for the IAMC to allocate assets to its parent insurance company's portfolio or those of competing insurance companies.
- In early 2009, CIRC issued revised guidance on optional investment by insurers in new asset classes but with the requirement that companies have specifically set numbers of approved investment management staff physically in China and employed by the statutory entity wishing to access additional investment options.
- Currently, insurance companies are required to outsource most new channel investment to IAMCs (asset management companies set up by insurance companies) if certain standards are not met, e.g., number of investment staff.

### *Discussion Points:*

- *CIRC should recognize the global or greater Chinese (Hong Kong) experience, capital and organizational resources for all seasoning or staffing requirements for IAMC or other investment requirement. CIRC should focus on the desired risk management standards, rather than on the number of bodies necessary to guide each type of investment class.*
- *Leveraging the global experience of foreign-invested companies will help Chinese industry to become competitive in global markets by developing products and domestic expertise.*
- *Foreign-invested insurers also should have the option to work with mutual fund companies (several have foreign partners) to leverage their extensive experience and global best practice on fund management.*
- *Doing this would: 1) Avoid conflict of interest of solely outsourcing assets exclusively to domestic insurance asset management companies that also are competitors in the market; and 2) Promote competition, efficiency and improved service by allowing choice of qualified asset managers.*

## **Management Training Requirements**

- In 2008, CIRC released regulations which outline ongoing training requirements for senior executives of insurance companies to receive CIRC-approved training.
- The regulations are vague and do not provide clear definitions as to scope, compliance requirements or fulfillment options or equivalents.

*Discussion Points:*

- *Clear definitions and scope should be provided, which clarify the scope, compliance requirements and fulfillment options.*
- *Requirements should apply to a limited number of clearly defined and prudentially justified admitted management executives.*
- *Fulfillment options should include U.S. or other comparable professional qualifications, designations or work experience.*

**Innovative Products**

- The insurance industry is concerned that CIRC is considering a regulation that may limit sale of unit-link products.
- The regulators have conveyed that they viewed unit-link as investment products and that insurers should focus more on traditional protection products.

*Discussion Points:*

- *Unit-link products are long-term contracts meant for customers to hold onto for the long-term. Merit for unit-link products as equity investments with insurance products provide higher returns to customers thereby meeting customer needs.*
- *Unit-link products are sold around the globe. By limiting the product, CIRC is sending a signal of limiting innovation in the market.*
- *There are effective distribution/good sales practices that foreign companies have deployed in China and worldwide to support unit-link products. These practices are compatible with CIRC's 2009 Notice Advancing Insurance Applications Precautions Work which is intended to educate and protect potential customers of life or health insurance products. By adopting good distribution practices in China, this will further strengthen compliance, disclosure and effective needs assessment of products.*

**Portfolio Diversification- Corporate Bond Market Growth**

- Corporate bonds are one of the most important asset classes for insurers. In China, the corporate bond market is moving from a guaranteed (mostly by large state-owned banks) model to a market-oriented (non-guaranteed) one.
- While the CBRC has been discouraging banks from providing guarantees, CIRC has not allowed insurers (the largest purchasers of corporate bonds) to invest in non-guaranteed bonds due to credit risk concerns.
- The conflicting decisions by the banking and insurance regulators have created uncertainty in the market and hindered development of the corporate bond market.
- Although CIRC opened up investment in unguaranteed corporate bonds, the 30 percent ceiling for corporate bonds has not been lifted. Compared to government bonds, financial bonds and bank term deposits, corporate bonds match the liabilities of insurance companies better. We would propose that the 30 percent limit be revised.

*Discussion Points:*

- *While the industry takes into consideration CIRC's concerns, there is a strong need for insurers to do proper asset allocations with this asset class.*

- *The current limitation in the corporate bond market environment has further limited choices of investment vehicles for insurance companies. Fixed-income securities are the best match for insurance liabilities, especially for traditional products.*
- *We strongly encourage the regulators to provide effective guidance and regulations to promote the corporate bond market.*
- *Raise the upper limit of corporate bonds investment for insurance companies.*

### **Unfavorable Tax Rule**

- The new rules, as stated in the Ministry of Finance and SAT Notice Concerning the Policy for Before-Tax Deduction of Processing Fees and Commission Expenses by Enterprises, Caishui [2009] No. 29, allow property insurance companies to deduct processing fees and commission expenses equal to 15 percent of the difference between total premiums received in the current year and total policy surrenders in the current year. Personal insurance companies are subject to the same rule, but the cap on deductions is 10 percent rather than 15 percent.
- The new rules thus simplify procedures by combining treatment of commissions, processing fees and surrenders in the same document. Although the new rules double the percentage cap for both property insurance companies and life insurance companies, the difference between property insurance companies and personal insurance companies is widened from 3 percent (8%-5%) to 5 percent (15%-10%). Property insurance companies are also favored because they do not have surrenders which reduces the base amount to which the percentage is applied.
- Another change that adversely impacts personal insurance companies relative to property insurance companies and personal insurance companies with long-term rather than short-term products is the removal under the new rules of the 5-year carry-forward period. Under the former rules, life insurance companies could use total premiums receivable under long-term policies in calculating their deduction caps. This cap is now based only on current year income minus surrenders.
- We believe that CIRC, and the larger domestic companies, are unlikely to be pleased by the new rules which discourage the long-term life policies which CIRC favors, and disadvantage personal insurers relative to property insurers.

#### *Discussion Points:*

- *We believe that one objective should be to create parity between personal insurers and property insurers at the higher 15 percent cap.*
- *We also believe that restoration of a multi-year (5-year?) carry-over period for premiums would restore an incentive for long-term life insurance policies. ACLI is currently developing materials on comparative data on tax treatment in the United States, Canada and other jurisdictions which may be helpful in beginning a discussion on this issue.*

### **Qualified Foreign Institutional Investment**

- Expanding upon the scope of SED commitments on QFII, China has stated that foreign-invested insurance companies will be included in the financial institutions benefiting from these liberalizations.

- This commitment should be reaffirmed and results of preliminary application of the commitment should be reported.

*Discussion Points:*

- *Insurance in China, as in the U.S. and other major global markets, is an integral component of the financial services sector which should not be placed at a competitive disadvantage relative to the securities and banking sector.*

### **Political Risk Insurance**

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 this issue is necessary as a base element of any outcome acceptable to industry, but represents low-hanging fruit.*

### **Third Party Auto Liability Insurance**

When China joined the WTO, “statutory insurance” was reserved for domestic companies. China can unilaterally open this product to foreign-invested insurers simply by approving license requests.

*Discussion Points:*

- *Removal of the prohibition on licensing foreign companies to sell compulsory third party auto insurance will help China to increase availability and quality of a product which is a high policy priority for Chinese regulators.*

### **Grant National Treatment for Foreign Insurance Brokers**

National treatment for foreign insurance brokerage to allow them the same scope of business activities as domestic firms, e.g., claims handling, risk management services and consulting, handling of application process and placement services, and reinsurance brokerage. Allow foreign insurance brokers to provide client services for small commercial business, group life and health business and affinity programs.

*Discussion Points:*

- *Insurance buyers depend on their insurance broker’s experience and expertise in managing their risks. Claims handling, risk management services, etc. are all part of that process. National treatment for foreign firms will ensure that brokers are able to offer the full range of products and services that insurance buyers require to protect themselves and their assets.*

## **Market Openness**

The Chinese insurance market is not really "open". After nearly a decade of effort by foreign non-life insurers, which has been continually met with delay and new regulatory obstacles, foreign non-life insurance companies write only 2 percent of the market and they have been permitted to operate in only a few provinces.

## **Securities Annex**

### **Market Access Issues**

China's 2001 WTO accession commitments in the securities sector were an important first step towards liberalizing its capital markets. Since China's accession to the WTO, little progress has been made on reducing and eliminating the most severe constraints that impede the ability of foreign firms to do business in China. Under China's WTO commitments, foreign securities firms can 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. Those restrictions remain.

#### Permit 100 percent ownership, and the right to establish in corporate form of choice

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. Following a 5-year seasoning period for the foreign JV, regulations now permit foreign JV's to request permission to engage in additional securities activities.

### **Regulatory Issues**

#### 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 that 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. China agreed in SED IV to publish in advance for public comment, subject to specified exceptions, all trade and economic-related administrative regulations and departmental rules that are proposed for adoption and provide a public comment period of not less than 30 days from the date of publication. It is our understanding, however, that proposed regulations (September 2008) on margin requirements only provided 14 days.

### 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. More specifically: 1) requirements that the principal amount in the QFII account remain in the account for at least one year (three years for closed-end funds) and that subsequent remittances must be approved by the State Administration of Foreign Exchange with principal withdrawal permitted only in stages; 2) requirement that investment quotas must be fully funded within a three-month period, and the unused portion of quota will expire; 3) requirement that a QFII commit at least \$50 million in a special QFII account; and 4) individual and aggregate limitations on QFII ownership which, as the market changes, may limit interest in the program. China has taken some steps to bolster this market, including reducing the lock-up period from 1 year to 3 months<sup>3</sup>, and expanding the QFII quota from \$10 billion to \$30 billion.

### 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.

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<sup>3</sup> China agreed in SED IV to reduce the lock-up period for the invested principal of QFIIs to 3 months for insurance companies, government and monetary authorities, mutual funds, pension funds, charity funds, donations funds; and open-end China funds established by QFIIs.

## **Asset Management**

The following are priorities for the U.S. mutual fund and asset management industry: (1) raising the ceiling on foreign ownership of Chinese asset management firms; (2) liberalizing the rules on foreign investment in Chinese markets; and (3) liberalizing local portfolio content restrictions for Chinese investors. These priorities are addressed below.

### **Foreign Ownership**

China should allow foreign entities to own a majority, controlling interest in Chinese asset management firms. This is a significant concern for U.S. asset management firms. The current restrictions make it difficult for U.S. asset managers to control and run their businesses as they would prefer. Many U.S. asset managers are reluctant to enter the Chinese asset management market under such conditions. Increased participation of U.S. asset managers would help introduce world-class expertise and best practices with regard to products, services, risk management, internal controls, operations and governance. In addition, competition brought by U.S. asset managers would accelerate the adoption of such techniques and methodologies by domestic firms.

### **Foreign Portfolio Investment**

China should liberalize its rules on investment by foreign investors, including U.S. mutual funds. At present, China severely restricts outside investment in its securities markets, and foreign investors that do receive the limited licenses and investment quotas have to contend with complex requirements and bureaucratic hurdles that may disproportionately affect regulated entities such as mutual funds. For example, despite the fact that mutual funds tend to be the type of long-term investor that can provide stability to an emerging market, the large minimum account size, lock-up period and repatriation restrictions uniquely impact the ability of U.S. mutual funds to invest in the Chinese securities markets. These restrictions raise significant valuation and investment content questions for mutual funds. U.S. mutual funds must value their investments at least once a business day and invest substantially all of their assets in liquid securities. In addition, the restrictions raise portfolio management and fiduciary issues. The restrictions severely limit a manager's ability to adjust fund portfolios and, further, U.S. fund managers must consider, as a fiduciary, whether such investments are appropriate and justified in light of alternatives. While the Chinese government has raised the quota on foreign portfolio investment, more must be done to make the Chinese securities markets more accessible.

### **Local Portfolio Content**

China should liberalize restrictions on foreign investments held in the domestic portfolios of Chinese investors. Despite some recent liberalization in the QDII program, the restrictions are still quite stringent. If China further loosens the restrictions, domestic mutual funds, pension funds, and other institutions would be able to pursue portfolio diversification through international investment, creating advisory and management opportunities for U.S. asset managers.