

Is China's Financial System as Open as America's ?

Though great progress has been made in opening China's financial sector to foreign participation since China's accession to the WTO in 2001, significant barriers to entry – legal, regulatory, and procedural – remain.

Banking

Foreign banks can enter China by establishing wholly-owned subsidiaries or branches, or by investing in a local partner – although investment in Chinese banks is severely limited. Single foreign investors can only acquire up to 20 percent of a Chinese bank, while aggregate foreign ownership in the sector cannot exceed 25 percent. A Chinese bank in the United States faces no such restrictions, and may operate in the juridical form (branch, agency, representative office, or subsidiary) of its choice.

In both the United States and China, bank licensing criteria are prudential in nature – although in China a number of “non-prudential” regulatory barriers complicate and slow foreign participation. For example, 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 million); to establish a branch, foreign banks must have total assets of more than US\$20 billion and each branch must maintain operating capital of \$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.

In the United States, financial strength is taken into account by Federal and state regulators when evaluating a licensing request, but assets and capital are generally not the sole or even most important factor.¹ In 1991, licensing criteria in the United States were significantly tightened after U.S. and British regulators uncovered a massive, cross-border scheme involving money laundering and fraud by Pakistan's Bank of Credit and Commerce International (BCCI). Congress responded by enacting the Foreign Bank Supervision Enhancement Act, which requires the Federal Reserve to evaluate the quality and scope of the home country supervision of an applicant bank – specifically whether the applicant is subject to “comprehensive, consolidated supervision.” Given China's weak supervisory practices, the requirement effectively barred Chinese banks from opening branch offices in the United States. Some banks did win approval to open representative offices, but such operations typically employ only a few people and cannot engage in such key banking activities as lending. Improvements in China's bank supervision framework over the past 10 years have expanded the possibility of greater access to the U.S. market for Chinese banks.

Securities

Foreign firms may establish securities operations in China by way of joint-ventures in which foreign ownership is limited to just 33 percent. Foreign securities firm joint ventures are also limited in the types of activities in which they can engage –

¹ State criteria vary. Illinois, for example, grants foreign banks' offices the same rights and privileges given to a state bank, but assets must exceed liabilities by \$1 million on a date within 120 days prior of the application.

underwriting domestic company (A) shares, foreign currency (B) shares, and Hong Kong (H) registered shares, as well as corporate and government debt, and trading in all these securities, except A shares. Chinese securities firms wishing to establish in the United States face no such restrictions – after complying with securities laws, any foreign securities firm is permitted to establish a broker-dealer and engage in the full range of securities activities. Even more troubling, in December of 2005, Chinese authorities imposed a de facto moratorium on new foreign joint-ventures, which remains in effect.

China's current WTO commitments also limit foreign participation in the Chinese asset management sector to joint-ventures, in which foreign ownership is limited to 49 percent. In addition, non-transparent licensing procedures make the application for joint ventures extremely burdensome and slow. China's WTO commitments in the securities and asset management sectors make no provision for further increases in foreign ownership.

Insurance

China's five-year phase-in of its WTO commitments in insurance enabled foreign life, property and casualty, reinsurance, and brokerage firms unprecedented access to what is now the 11th largest insurance market in the world. Twenty-two life insurance joint ventures and one wholly owned subsidiary account for approximately 6 percent of the total life insurance market, with higher market shares in larger cities in China. A variety of foreign

firms have also invested in China's largest insurance companies, including Ping An, China Pacific Insurance, Taikang and Xinhua.

Unlike in the United States, however, foreign investors in China may not invest more than 24.9 percent in Chinese insurance companies. In addition, foreign life companies entering the market may only establish a 50/50 limited liability equity joint venture with a local partner and may not increase equity ownership beyond 50 percent.

By contrast, the United States is one of the most open insurance markets in the world with no equity ownership limitations. As of year-end 2005, 1,119 life insurance companies operated in the United States, earning annual premium income of \$535.9 billion – 9.9 percent of which were foreign-owned. Moreover, all insurance-related laws and regulations in the United States are made available for public comment prior to their issuance, are published after their enactment, and are subject to independent judicial review. China's regulatory process, by contrast, while improved since joining the WTO, remains opaque, generally not subject to judicial review, and is frequently cited as yet another source of difficulty for foreign firms.
