ENGAGE CHINA COALITION Policy Priorities White Paper

Financial Services Industry Objectives:

The Engage China coalition[1] believes the Strategic and Economic Dialogue (S&ED), initiated following an announcement by President Barack Obama and former Chinese President Hu Jintao on April 1, 2009, is an important framework for promoting financial services reform and modernization in China. The Dialogue provides an important, high-level framework within which U.S. and Chinese policymakers can raise and discuss issues in a coordinated and focused manner. Such regular, high-level discussions are critical to ensuring a thriving, more mature, and better balanced bilateral relationship that serves the mutual economic interests of both nations and their people. In order to make further progress, we also respectfully urge the Administration to raise financial services in other appropriate forums, such as the JEC, JCCT, U.S.-China BIT negotiations, and WTO TRM process.

Importantly, the S&ED is the key forum for discussing the market access and national treatment issues that face foreign financial services firms in China. The continued reduction and elimination of barriers that foreign financial services firms encounter in China is integral to the development of a modern financial system which will serve as the platform to help promote more balanced growth in China and the world economy. Indeed, Haruhiko Kuroda, President of the Asian Development Bank, wrote that, "In developing economies, the adequate provision of services – particularly transportation, telecommunications, logistics and financial services – is a prerequisite to ensure and sustain economic growth.[2]"

Engage China is strongly of the view that the deliberate pace of global financial regulatory reform and the Doha Round of WTO negotiations should not preclude China

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[1] **ENGAGE CHINA** is a coalition of 12 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, BAFT, 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.

[2] Kuroda, Haruhiko. "China and the World Economy: Growth, Restructuring, Cooperation." Asian Development Bank China Development Forum 2010. March 21, 2010.

from taking further steps to open its financial markets and should not encourage it to introduce new discriminatory measures. Regulatory reform and financial liberalization are two distinct tracks – discussion of financial sector reforms should not preclude China's ability to permit foreign financial services firms to fully participate. Moreover, we note that the market access and national treatment reforms in China's financial markets for which Engage China advocates will not prevent China's regulatory authorities from taking measures for prudential reasons, such as the protection of investors or to ensure the integrity and stability of the financial system.

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, financial services firms confront common challenges, including restrictions on foreign ownership, scope of business, 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.

As the world's two 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.

Engage China members are very encouraged by the Obama Administration's ongoing efforts to negotiate a Bilateral Investment Treaty (BIT) between the U.S. and China. Announced at the 2014 S&ED, a high-quality BIT will be an important tool for achieving financial reforms in China. The successful conclusion of a treaty will strengthen the bilateral investment climate and provide important investment protections for U.S. investors. Perhaps more importantly, a BIT offers a unique opportunity to address important market access impediments and equity cap limitations the industry currently faces when operating in China. A high-standard BIT could also reduce the preferential treatment enjoyed by Chinese state-owned financial services providers, to build a competitive environment that benefits its consumers.

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 foreign 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. We encourage Chinese regulators to monitor reforms and engage in international regulatory cooperative efforts with the aim of improving cross-border and global coordination of rules. Conflicting rules and regulations can lead to significant market fragmentation, disruption and hinder the growth and development of capital markets.

   Although China committed at S&ED III to "reaffirm [the] prior SEP (sic) outcomes on transparency," in practice transparency remains insufficient. AmCham China in Beijing found in its recent Business Climate Survey that inconsistent regulatory interpretation continues to be among the top challenges facing U.S. firms in China[3]. We also note that the European Union Chamber of Commerce in China's Position Paper 2014/2015 showed similar findings, noting the lack of transparency and consultation in the rulemaking process,[4] and that rule of law and transparent policy making continue to be cited by the European Union Chamber's members as China's key need for economic development problems

[3] AmCham 2015 China Business Climate Survey, February 11, 2015
[4] European Business in China Position Paper 2014/2015, September 9, 2014

affecting business[5] In the highly regulated financial services sector, transparency-related challenges effectively work to reduce and impede market access.

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. China has gradually raised the quota for QFIIs from the initial US$ 10 billion to US$ 69.7 billion and, in fulfillment of its S&ED commitments, China has reduced the initial "lock-up" period for investments of certain QFIIs from one year to three months. These steps will reduce restrictions on the free flow of capital and increase opportunities for U.S. pension and mutual funds and other investment management firms. 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. Regulations for QFII participation in Chinese stock index futures markets should be completed to enable QFII institutions access to this important tool for enhancing the risk-return characteristics of their securities portfolios.

The Chinese government should expedite authorization of foreign insurance companies, which are subsidiaries of large well-established foreign insurers with extensive investment experience, as QFIIs and should confirm that a portion of pension assets, of foreign-invested insurance companies regardless of size may be invested in the same assets classes in both China and overseas in the same manner as their domestically-invested competitors may be invested (up to 30% of pension assets may be invested in equities, hybrids and investment-linked insurance products and up to 15% may be invested overseas) to further diversify their risk.

3) 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

[5] European Chamber Business Confidence Survey 2014, May 29, 2014

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 VII, the scheduling of this Dialogue should be announced and China should reiterate and then implement its commitment to make all qualified financial services firms, including foreign-invested firms, 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.

While China now provides tax-deferred treatment for annuity contributions, the incentive to contribute will be enhanced by raising the low current income base upon whose tax deferrals may be claimed. Foreign participation in the EA industry should be allowed provided the foreign firm can bring in international practices that can benefit the industry. Regardless of the relevant ministry to approve the application on foreign participation, they all should apply the same standards.

Futures and exchange traded derivatives

The experience of the financial crisis has demonstrated the transparency and robustness of the centralized clearing and settlement model of exchange-traded derivatives. These markets 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. The CSRC has issued regulations authorizing QFII funds to use stock index futures to hedge their equity portfolios. This is a positive step, but unfortunately the new rules cannot be fully implemented until the SAFE and PBOC take further action to allow the QFIIs to track futures. 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. The public consultation undertaken by the CSRC in early 2015 to facilitate international participation in Chinese futures markets is a positive step. We welcome a roadmap that would result in providing well-capitalized and well-managed foreign institutions the right to own a majority stake in a Chinese futures brokerage firm. Further, we encourage the introduction of certain rules and laws (including close-out netting legislation, contractual novation and finality of settlement and payments) to allow for effective risk management and facilitate the effective operation of central counterparties. Consistent with global best practices, China should become open to outside participation in their futures market, given that a diversity of market participants promotes market depth, liquidity, and flexibility in the event of market shocks. In addition, China should relax rules restricting Chinese firms and individuals from accessing futures and options markets outside China, given that listed derivatives have proven themselves to be efficient and low-cost instruments for achieving portfolio diversification and for managing market risk. Currently a significant number of state-owned enterprises are permitted to access international commodity futures markets. The authorities should expand the range of markets that the SOEs can access and extend the opportunity to access foreign futures and options markets to a wider range of Chinese companies.

Insurance

In August of 2014, the State Council issued a document that called for more growth, innovation and openness in the insurance sector. Yet, progress toward achieving those goals has been slow and even halting. Further, as Chinese financial services wish to expand outside China it becomes even more reasonable to argue that China should open up its market to a much greater degree.

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[6] and exemption of representative offices, which are not allowed to engage in business, from enterprise income taxation.

Other issues that should be addressed include: further expansion of the products available for marketing and sale through Internet; regulatory cooperation between CIRC and CSRC on portfolio diversification – corporate bond market growth; recognition of operational experience and expertise in lieu of executive training requirements; opening of the political risk insurance market; removal of burdensome registration and collateral requirements for offshore reinsurers; and realization of a non-discriminatory insurance asset management regime through the issuance of license 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. The Interim Provisions on the Regulation of IAMCs continue to require that all IAMCs have at least two shareholders, with the result that foreign-invested life insurers must partner with a second company to establish an IAMC. Even if a second shareholder can be found, this reduces a 50% foreign shareholder in the insurer to a minority shareholding in the IAMC. This rule applies even though the Company Law now allows one founding shareholder.

CIRC's 2009 Notice on Strengthening the Construction of Asset Management Capability allowed 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.

While we recognize that CIRC has instituted some reforms, such as allowing foreign-invested insurers to partner with licensed mutual fund companies under the Temporary Measures on the Establishment of Investment Management of Insurance Funds (2012), additional actions which we would like the U.S. government to discuss with China's government 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.

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[6] 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

Doing so 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.

The most pressing concern for U.S. life insurance companies operating in China is market access. Currently foreign firms are unable to submit multiple applications for provincial branch approval. The branch geographical limit has continued to be a barrier for direct business development for foreign insurers. The ability to expand geographically, capitalize on different channels of distribution, and diversify risk portfolios are basic, fundamentally important insurance principles.

In recent years, statistics from the Chinese Government reveal a significant slowdown in number of provincial licenses approved:

2013: 5 provincial licenses
2012: 6 provincial licenses
2011: 29 provincial licenses
2010: 19 provincial licenses
2009: 10 provincial licenses

Another important issue includes a lack or regulatory transparency and routine regulatory procedures. CIRC is charged with a dual mission: to both regulate the industry and develop China's domestic industry. A central tenet of good regulatory practice is that regulators must be independent and impartial. The social objectives and regulatory objectives of CIRC create an enormous potential for conflicts of interest. As the International Monetary Fund (IMF) and World Bank's 2012 Financial Sector Assessment Program (FSAP) report for China pointed out, "the range of commercial and social objectives almost inevitably will lead to conflicts with the supervisory objectives."

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 2.2% 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. Meanwhile, health insurance continues to be off-limits for foreign insurers despite the wealth of experience that they offer.

With RMB 720.338 billion (U.S. $116.296 billion) of premiums written in 2014 at a 25% compound annual growth rate since 1980, the China non-life insurance market is the world's largest. Non-life insurance premiums are 1% of GDP, about a fifth of the U.S. level. China life insurance premiums written in 2014 totaled RMB 1.090 trillion and have increased at a 17.55% compound annual growth rate since 1999. Life insurance premiums constituted 1.71% of GDP in 2014. 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. Insurance industry depth (premium income ÷ GDP), combining both property and life insurance, is less than 3% of GDP, far below the target of 5% set by the State Council in 2014 in the so-called New Ten Opinions.

Although insurance premiums have expanded at an annual growth rate of 25% over the past two decades, non-life insurance's contribution to GDP in 2014 was 1.13%. The entire insurance sector makes up only 5.58% of China's total financial assets and is dwarfed by the banking and securities sectors. The State Council has already overseen fundamental reform of the latter two 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.

<u>Securities</u>
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 and ownership percentage.*
- *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.*

Sales Channels

China in 2011 and again in 2014 restricted the number of insurers whose products can be sold through bancassuance at bank outlets, and barred the presence of insurance personnel in the bank outlets. This has an anti-competitive impact on smaller insurers, including foreign-invested insurers.

Discussion Points:

- *CBRC and CIRC should lift the cap on the number of insurers per bank outlet and allow insurance company personnel to be present on the premises to provide information to customers.*

Health Insurance

Issue licenses to foreign health insurers.

Discussion Points:

- *China has expanded health insurance throughout the country in recognition of the needs of its citizens and to reduce the government's financial burden. CIRC should license foreign health insurers to avail the country of their vast experience.*

Group-Wide Master Property Insurance Policies

While CIRC allows master policies, a separate policy is required for each subsidiary in a group. This is inefficient and discriminates against foreign-invested insurers who are far less likely to have a broad geographic base in China because of the residual effects of slow branch approvals.

Discussion Points:

- *Allow group-wide master property insurance policies.*

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 2013, the Ministry of Finance, MOHRSS and the State Administration of Taxation issued the Notice on Issues Concerning Individual Income Tax on Enterprise Annuities and Occupational Annuities. This is a positive step but we believe that the low income base on which the deferrals apply will limit its popularity and incentive to save. We further believe that the Measures should be extended to individual annuities.*

- *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

- China in 2007 issued the Temporary Measures on the Management of the Offshore Investment of Insurance Funds, subsequently augmented by their 2012 Implementing Rules, which specify relevant CIRC requirements to allow insurance companies in China ("Measures on Overseas Investments with Insurance Funds"), including foreign-invested insurers, to invest a certain portion of their assets overseas, including by creation of Qualified Domestic Institutional Investor (QDII) funds.
- 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 through their investment managers 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 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. The Interim Provisions on the Regulation of IAMCs continue to require that all IAMCs have at least two shareholders, with the result that foreign-invested life insurers must practice with a second company to establish an IAMC. Even if a second shareholder can be found, this reduces a 50% foreign shareholder in the insurer to a minority shareholding in the IAMC. This rule applies even though the Company Law now allows one founding shareholder.

- CIRC's 2009 Notice on Strengthening the Construction of Assets Management Capability allowed 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.
- 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.

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.*
- *Doing this would avoid conflict of interest of solely outsourcing assets exclusively to domestic insurance asset management companies that also are competitors in the market.*

<u>Management Training Requirements</u>

- CIRC's 2008 regulations, recently augmented by the annual 2015 Training Plan for Insurance Company Senior Management Personnel, outline ongoing training requirements for senior executives of insurance companies to receive CIRC-approved training.
- The regulations are over-inclusive and do not recognize international qualifications.

Discussion Points:

- *Requirements should apply only 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.*

<u>Innovative Products</u>

- The insurance industry continues to be concerned that CIRC is considering regulations that may limit the 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. Unit-link products serve as equity investments with insurance products to provide higher returns to customers thereby meeting customer needs.*
- *Unit-link products are sold around the globe. By limiting such products, CIRC would be sending a signal of limiting innovation in the market.*
- *Foreign-invested insurers have effective distribution/good sales practices which they 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 without limiting the market and consumer choice.*

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.
- CIRC has since 2012 allowed insurers (the largest purchasers of corporate bonds) to invest in non-guaranteed bonds due to credit risk concerns.

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 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 only 10 percent rather than 15 percent.
- The rules thus simplify procedures by combining treatment of commissions, processing fees and surrenders in the same document. Although the rules double the percentage cap for both property insurance companies and life insurance companies, the rules widened the difference between property insurance companies and personal insurance companies 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 provision 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 of the 5-year carry-forward period. Under the earlier 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 the new rules consequently discourage long-term life policies which CIRC otherwise 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 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 Domestic Institutional Investment

- Expanding upon the scope of SED commitments on QDII, China has stated that foreign-invested insurance companies will be included among the financial institutions benefiting from these liberalizations. Unfortunately, the February 27, 2015 list of QDII licenses indicates that only a handful of the licenses issued to insurance companies have gone to foreign-invested insurers.

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

Dismantle the monopoly on political risk insurance and license foreign insurers to underwrite political risk insurance in China without discrimination as to eligibility for risk subsidies.

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.*

Market Openness

The Chinese insurance market is not really "open." A foreign insurance company must be in continuous existence for at least 20 years to establish a representative office and at least 30 years, including at least 2 years maintaining a representative office, to qualify for a license, without regard for acquisitions and restructurings that do not affect the basic business. Even after more than a decade of effort by foreign non-life insurers, which has been met with delay and multiple regulatory obstacles, foreign-invested non-life insurance companies write only 2.2 percent of the market. The expansion of foreign-invested life insurers has been greatly slowed by earlier branch approval requirements and restrictions on products sold through the Internet, and they write only 5.8% of the market. Foreign reinsurers are threatened by registration and collateral requirements that will impose costly and customize burdens. Foreign health insurers and annuities providers are still excluded from the market.

Despite China's commitment to transparency of regulation, such transparency is often honored in the breach or only after the regulations have been all but finalized. To take just one recent example, the Measures on the Administration of Pension Guaranty Management Business were published in draft form for public comment on December 24, 2014 with a December 31 deadline for submission of comments, just seven days later during the holiday period. Of greater consequence, the immensely significant C-ROSS equivalent to Solvency 2 was released on February 2, 2015 after approval on January 13, 2015 without having undergone a public comment period.

Meanwhile, no foreign-invested annuity provider or health insurer has been licensed to operate in China, even in the Shanghai Pilot Free Trade Zone despite China's commitment at S&ED V "to open up further to foreign investment in services, including through the establishment of the Shanghai Free Trade Zone pilot."

Discussion Points:

- *Reduce the 20- and 30-year continuous existence seasoning requirements in favor of an evaluation system based on technical capability and financial condition. Follow CBRC precedent and eliminate the 2-year representative office requirement.*
- *Dispense with costly and unnecessary offshore reinsurer registration requirements that will discourage offshore cessions and concentrate risk in China*
- *Remove the de facto bans on licensing of foreign-invested annuity providers and health insurers*

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. During the Fourth Meeting of the S&ED, China committed to allow foreign investors to take up to 49 percent equity stakes in domestic securities joint ventures, going beyond China's WTO commitment of 33 percent.

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, (as was evidenced when the increase from 33 to 49 percent was not accompanied by significant growth in foreign 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[7], and expanding the QFII quota from $10 billion to $30 billion. During the recent Fourth Meeting of the S&ED, China committed to increase the total dollar amount that foreigners can invest in China's stock and bond markets under its QFII program from $30 to $80 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.

[7] 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 Annex

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. Although China has instituted certain programs such as QFII, RQFII and the Shanghai-Hong Kong Stock Connect program that provide foreign investors with limited access to the Chinese securities market, overall China continues to greatly restrict outside investment in its securities markets. Further, foreign investors that do receive the limited licenses and investment quotas under these programs 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 taken certain actions in the area, more must be done to make the Chinese securities markets more accessible.

Local Portfolio Content

China should further liberalize restrictions on foreign investments held in the domestic portfolios of Chinese investors. Despite some liberalization in the original QDII program, the restrictions are still quite stringent. Even considering the recent announcement of a new QDII 2 program that would allow investors in the Shanghai Free Trade Zone to participate in outward investment, 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.