

SECTION 3: GOVERNANCE AND ACCOUNTABILITY IN CHINA'S FINANCIAL SYSTEM

Introduction

This section provides an overview of China's financial system, covering strains in the state banking system; the growth of the shadow banking sector and access to credit; market access issues and operational challenges for foreign financial services firms; and governance, transparency and accountability problems in China's financial sector. It is based on witness testimonies from the Commission's March 7, 2013, hearing; information from the Commission's fact-finding trips to China, Japan, and Taiwan; and additional staff research.

China's Banking System and Access to Credit and Capital

China's 12th Five-Year Plan (2011–2015) calls for less dependence on exports and state-funded infrastructure projects and more domestic consumption to support China's economy. This shift from government-led to private-led growth necessarily requires that Chinese families and private sector businesses have sufficient access to credit and capital. Private small- to medium-sized enterprises (SMEs) already contribute 60 percent of gross domestic product (GDP) and 80 percent of urban employment, according to some estimates.^{1,2} Yet bank lending, the traditional source of credit for entrepreneurs and startups in most countries, is largely inaccessible to Chinese individuals and SMEs, because China's financial system is dominated by large, state-owned banks that mainly service government-directed projects and state-owned enterprises. A shadow banking system of unofficial credit has sprung up to fill the gaps left by the big banks' lending practices, but it is largely unregulated, and the proliferation of shadow banking activity poses threats to the country's financial stability.*

Chinese State Banks

Chinese banks hold a unique position. "In China, banks are everything," said Carl Walter, former chief operating officer of JP Morgan China and co-author of *Red Capitalism*, at a March 7 hearing of the Commission.³ The banks provide the loans and underwrite the bonds that fund government investments in infrastruc-

*A shadow banking system is comprised of the unregulated or loosely regulated lending institutions outside the more familiar model of depository commercial banks. The shadow banking system may include loans from insurance companies, private equity firms, hedge funds, money market funds, venture capital firms, microlending, crowd sourcing, off-balance sheet lending by commercial banks, and even loan sharking.

ture and fixed assets, which have been “the major force driving China’s economic growth to near double-digit levels over the past twenty years,”⁴ he said. Banks in China are even more important to the national economy than are banks in Europe or North America, where alternative sources of financing through equity and bond markets are available even to small startups. In China, banks provide over 75 percent of the nation’s capital, according to the Financial Services Forum’s John Dearie, a Commission witness. By contrast, in most developed economies, banks are a source of less than 20 percent of capital, and in other emerging economies, banks typically provide about 50 percent of total capital.⁵

China’s financial sector is dominated by five massive, state-owned commercial banks—the Bank of China; the Industrial and Commercial Bank of China; the China Construction Bank; the Agricultural Bank of China; and, to a lesser extent, the Bank of Communications. Though they are categorized as commercial lenders, they function more as an arm of the government. The Commercial Bank Law of 1994 commercialized the operations of these banks by transforming them into retail deposit and lending institutions. The country has a network of other commercial banks, both state owned and semiprivate, which includes ten secondary shareholding commercial banks (the government holds a majority of shares in most of these), a number of city commercial banks (originally founded on the basis of urban credit cooperatives), village and township banks (the primary shareholders of which are often city commercial banks), and rural credit cooperatives.*⁶ However, as Lynette Ong of the University of Toronto explained in her testimony, the five big, state-controlled commercial banks comprise the heart of the banking system, collectively accounting for about 50 percent of all deposits and loans.⁷ In 2011, total assets of commercial banking institutions were valued at renminbi (RMB) 113.29 trillion (\$16.54 trillion), with the biggest four banks alone holding nearly 60 percent of those assets.⁸

Three policy banks were established in 1994 to take over government-directed spending functions like financing of major development projects, which were previously the purview of the newly commercialized state banks. These state-owned policy banks are the Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China.†⁹ The Chinese Communist Party (CCP) and central government treat the policy banks as “basic utilities” that provide capital to the state sector of the economy.¹⁰ The borrowers are almost exclusively state sector entities undertaking state-directed development projects, such as the construction of dams, highways, and airports. The People’s Bank of China (PBOC), China’s central bank, sets credit quotas for the big

*The major, second-tier shareholding commercial banks include the Bank of Communications, China CITIC Bank, China Everbright Bank, Hua Xia Bank, China Minsheng Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, and Industrial Bank.

†The three policy banks—the Export-Import Bank, the Agricultural Development Bank, and the China Development Bank—were respectively charged with promoting exports, assisting with food production, and financing infrastructure projects. In the last decade, the policy banks, particularly the Export-Import Bank, have expanded their undertakings. The Export-Import Bank provides development aid and preferential loans to foreign clients purchasing certain goods and services from China and distributes government-backed loans to foreign nations. Since 2007, it has had a formal, market-oriented division.

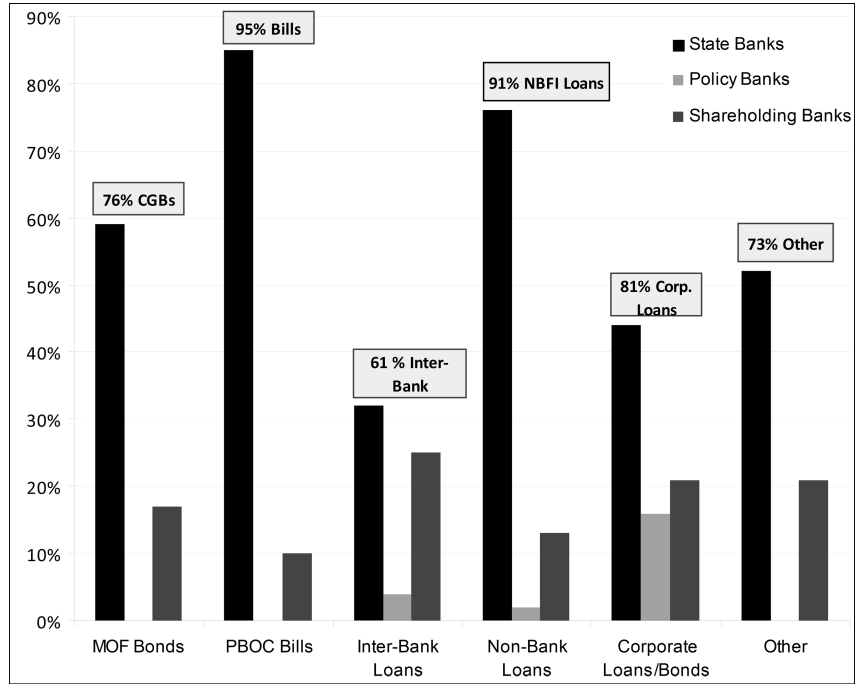
five commercial banks, and PBOC data confirm that loans made by these banks have also historically gone overwhelmingly to the state sector.¹¹

A 2013 Brookings Institution report outlines broad rationales behind the big five commercial banks' lending bias, a combination of government directives requiring them to loan to the state sector and a greater sense of confidence on their own part in the credit risks presented by state-owned enterprises (SOEs). State sector borrowers often have "strong business positions, resulting from monopolistic or oligopolistic power, superior business models or other factors;" and it seems relatively unlikely that the government will allow a large, state-owned enterprise to default on its loans.¹² On the other hand, private sector businesses are typically small, possess fewer assets that can serve as collateral, and do not enjoy the implicit backing of the government. As a result, the private sector enjoys almost no assistance from China's largest commercial lending institutions. According to an estimate by Citic Securities Co., only 3 percent of China's SMEs are able to get loans from these banks. Other estimates are even lower.¹³

The policy banks and the big commercial banks are all regulated by the China Banking Regulatory Commission. The policy banks are funded primarily by selling bonds to the big commercial banks, and all are ultimately guaranteed by the Chinese government.¹⁴ The incestuous relationship between the government; the large, state-owned policy banks; and their state-owned commercial cousins provides borrowers a considerable benefit: artificially low interest rates. PBOC sets low interest rates for depositors as well as for borrowers. Rates are approved by the State Council and the CCP's Leading Group on Finance and Banking. By controlling rates rather than allowing the market to determine them, the government ensures that the mainly state sector borrowers are able to access inexpensive capital, which in turn encourages them to borrow. The banks' depositors, meanwhile, are paid very low rates, sometimes below the rate of inflation, to help hold down the rates charged to borrowers. Thus, the state-owned corporate sector receives a subsidy from the bank's depositors (Chinese households) in the form of low interest rates. Renminbi (RMB) 36.7 trillion (\$6 trillion) of household savings are deposited into the state-owned commercial banks and receive a savings rate of only about 3 percent. Although this is higher than the average savings rate in the United States, the repressive impact on Chinese household savings is compounded by the fact that there are virtually no viable alternatives for the average Chinese person that offer higher yields.^{15,16}

Figure 1 demonstrates the outsized holdings of the large, state-owned commercial banks. Figure 2 shows shares of loans and deposits accounted for by various types of financial institutions in China, also underscoring the dominance of the five key state-owned commercial banks in China's financial system.

Figure 1: Chinese Bank Holdings of Financial Assets, Fiscal Year 2010



* CGB—Chinese Government Bonds; MOF—Ministry of Finance; NBFIs—Nonbank financial institution; PBOC—People’s Bank of China.

Source: U.S.-China Economic and Security Review Commission, *Hearing on Corporate Accountability, Access to Credit, and Access to Markets in China’s Financial System: Rules and their Ramifications for U.S. Investors*, written testimony of Carl Walter, March 7, 2013.

Figure 2: Chinese Financial Institutions by Size of Loans and Deposits, 2010

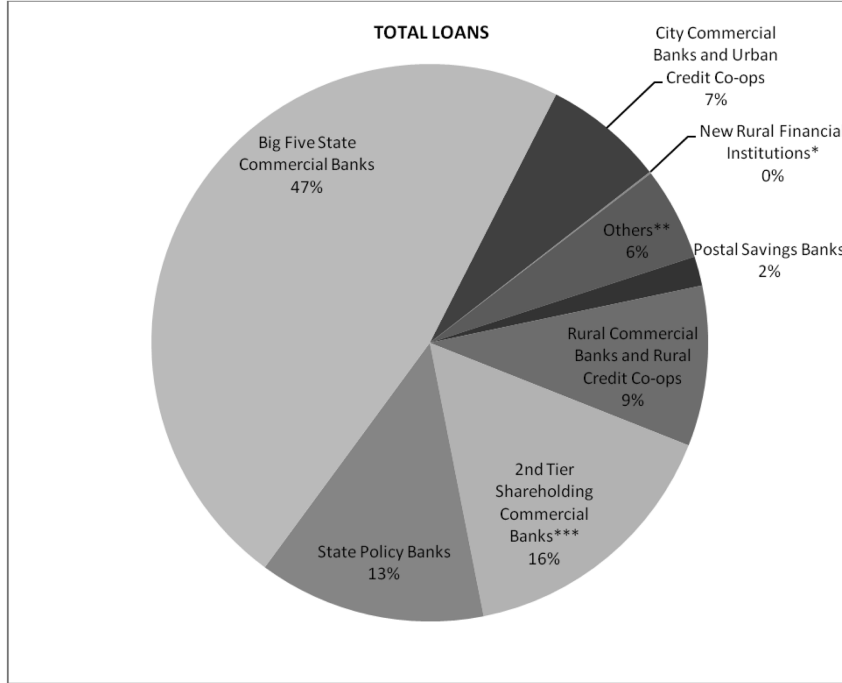
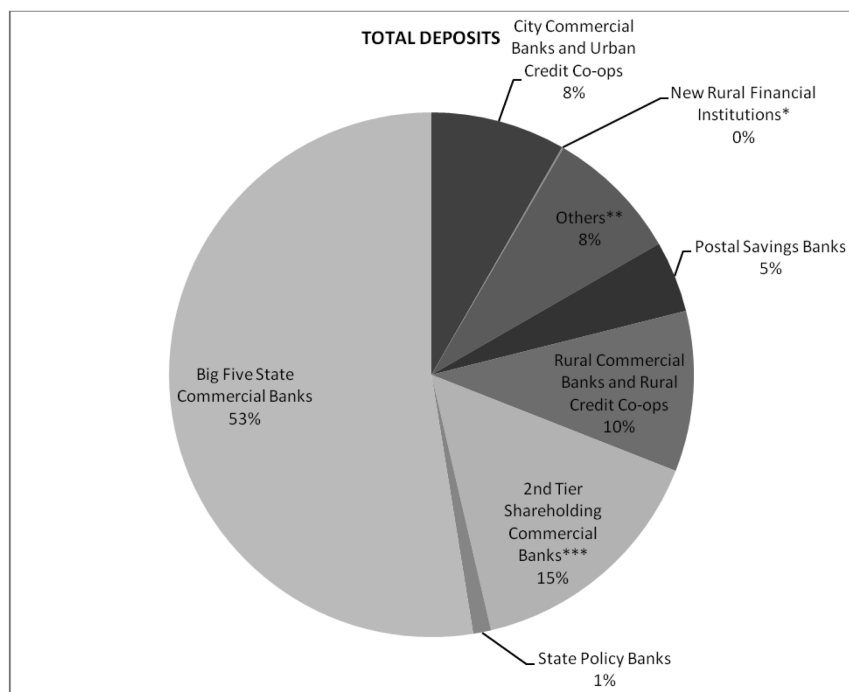


Figure 2: Chinese Financial Institutions by Size of Loans and Deposits, 2010—Continued



*New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.

** Others consist of nonbank finance companies and overseas banks.

*** The government owns a majority of shares in most of the second-tier shareholding commercial banks.

Source: U.S.-China Economic and Security Review Commission, *Hearing on Corporate Accountability, Access to Credit, and Access to Markets in China's Financial System: Rules and their Ramifications for U.S. Investors*, written testimony of Lynette Ong, March 7, 2013.

The Stock and Bond Markets

Shareholder rights are limited in China, and many publicly traded firms are majority owned by the government. “Lacking the ability to influence business choices and dividend levels, or to sell the firm as a whole, shareowners place less reliance on underlying firm value and focus more on likely stock price movements in the short run.”¹⁷ As a result, Chinese markets are dominated by volatile speculative trading, and are often compared to casinos. The two Mainland stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, have undergone significant development in recent years but are not comparable to the U.S. or European stock exchanges in scale, importance, or regulation and still largely exclude private Chinese enterprise. The Hong Kong exchange is the sixth-largest exchange globally and the most popular destination for Chinese companies seeking to list outside the Mainland, but it has a backlog of Chinese firms waiting for approval to list.¹⁸

Like the state banks, China's stock markets most reliably generate capital for the state sector.¹⁹ The Chinese government uses the domestic stock markets "to create oligopolies and monopolies—the so-called national champions—run by high-ranking political appointees," said Dr. Walter.²⁰ As with bank interest rates, the equity market system for initial public offerings (IPOs) is controlled by the government. The government "literally sets the prices of new shares based on how much funding it needs to raise, then directs other government-controlled entities to invest."²¹

Equity markets "fail to serve as a venue for capital-raising by the private entrepreneurial companies critical for the innovation and job creation that will be necessary for China's long-term economic health," Georgetown University law professor Paul Saulski told the Commission.²² An IPO is "fundamentally a bank loan from a state-controlled bank, not the result of a business owner selling a stake in his company to outside investors seeking the highest return on their capital, as we think of in the West," wrote Dr. Walter.²³

Compared to the banks, the stock markets play a less important financial role.²⁴ Chinese equity financing raised a record \$123 billion on domestic and foreign exchanges in prerecession 2007. Far larger was the \$530 billion in new loans extended by Chinese banks that year and the \$581 billion in total debt issues in the bond market.²⁵ Current imbalances are even more striking. Total debt issuance in the bond market was approximately \$1.2 trillion in 2011.²⁶ Total new loans extended by Chinese banks in 2012 were approximately \$1.1 trillion.²⁷ Meanwhile, IPO approvals ground to a virtual halt in 2012 as a result of new China Securities Regulatory Commission policies, underscoring the fact that "IPOs in China remain not a function of market dynamics, but of political and institutional policies that can change both completely and suddenly."²⁸

One means of diversifying credit risk away from the banking system is to encourage companies to raise funds by issuing bonds. China's leadership seems to have recognized the potential utility of a strong bond market and has made rapid headway in developing one. The Chinese bond market is now the world's fourth largest in terms of value. At approximately \$3.41 trillion (RMB 20.9 trillion), its size is surpassed only by the United States, Japan, and France.²⁹ It is also increasingly diverse and includes both public and private debt. But while China's bond market possesses the superficial appearance of a modern bond market, most of the bonds issued and traded are actually issued by other banks rather than corporations. The corporate bond sector was valued at only RMB 548 billion (\$89.7 billion), or less than 3 percent of the Chinese bond market's total value, as of December 2012.³⁰ China also has yet to develop a properly functioning municipal bond market, and it is only beginning to develop a market for high-yield bonds, both of which are important for attracting investment capital. In addition, Beijing restricts foreigners from investing in the bond markets.³¹

Strains on the Banking System

Because lending by the state-owned banks is based on government policy decisions rather than commercial considerations, it is

not surprising that the banks have accumulated large numbers of nonperforming loans from lending to poorly run or poorly chosen projects undertaken by SOEs.³² Chinese banks appear to be undergoing a resurgence of the self-inflicted bad debt crisis that troubled them in the late 1990s and early 2000s.³³

In 1999, the key Chinese state-owned commercial banks held roughly RMB 2.5 trillion in nonperforming loans, or 31 percent of China's annual GDP at the time. Bad loans accounted for 39 percent of Chinese banks' loans.*³⁴ China's central government created four asset management companies to bail out the banks by disposing of their loans. The government's recapitalization of the big banks between 1999 and 2005 removed RMB 3 trillion (\$400 billion) in bad loans, or 25 percent of total loans, from bank balance sheets in order to compensate for the missed loan repayments from mismanaged and unprofitable state sector projects.^{35,36} The banks' nonperforming loans were generally bought at full value by the asset management companies, paid for with ten-year bonds backed by the Ministry of Finance and loans issued to the asset management companies by China's central bank.³⁷ The central government also launched a variety of other initiatives aimed at curbing the big banks' substandard lending and maintaining asset quality. By the end of 2008, the nonperforming loan ratios of commercial banks had dropped to 2.4 percent of the total.^{38,39}

With the Chinese government's response to the global financial crisis, however, the strain of nonperforming loans has returned. Although financial statements provided by international auditing companies show the banks' current nonperforming loan ratios at less than 1 percent, this figure only covers loans that are on the balance sheets, and it strains credulity in light of the banks' central role in carrying out the government's stimulus response to the global economic crisis.⁴⁰ In November 2008, the central government announced a \$652 billion (in current dollars) stimulus, the equivalent of 12.5 percent of China's GDP that year, and directed the banks to fund the bulk of it by granting loans for infrastructure projects.⁴¹ According to analysis by KPMG, a multinational accounting firm, "Banks extended RMB 9.6 trillion worth of new loans" in 2009, "more than twice the total lending in 2008," and RMB 8.0 trillion in 2010.⁴² As the Chinese economy responded, the banks kept boosting their lending. The International Monetary Fund (IMF) estimates that Beijing has relied on the big banks to issue at least \$3.8 trillion (RMB 23.4 trillion) in new loans since 2008 to help offset the impact of the global economic crisis on the Chinese economy. Dr. Walter estimated that the unofficial shortfall "could be anywhere from \$1 trillion (RMB 6.2 trillion) to \$2.3 trillion (RMB 14.2 trillion) against bank capital of \$400 billion."⁴³ As one financial journalist noted, "Either the Chinese government has become extremely skilled at lending in a very short time, and Chi-

*By comparison, Spanish banks' bad loan ratio reached a record high of 12 percent in 2013 as a result of the recession there. The average nonperforming loan ratio for all U.S. banks between 1999 and 2009 was 1.67 percent, according to the Federal Reserve, and is currently 3.16 percent. At the height of the financial crisis, the average nonperforming loan ratio for all U.S. banks was nearly 6 percent. "Banking Brief for Pennsylvania, New Jersey and Delaware," *Philadelphia Fed*, First Quarter 2011. <http://www.philadelphiafed.org/research-and-data/publications/banking-brief/2011/BB1Q2011.pdf>; Charles Penty & Emma Ross-Thomas, "Spanish Banks' Bad Loans Ratio Climbs to Record 12.1%," *Bloomberg*, October 8, 2013. <http://www.bloomberg.com/news/2013-10-18/spanish-banks-bad-loans-ratio-climbs-to-record-12-1-.html>.

nese borrowers have become even better at repaying, or the numbers are too good to be true.”⁴⁴ Meanwhile, there are questions about whether the asset management companies (AMC) could be used to aid another bank recapitalization. Though at least two of them claim to be profitable today, other evidence strongly suggests that they are still holding a significant amount of the debt they took on in 1999. According to one unnamed financial expert who spoke to *The Economist*, they “seem to be virtual holding-tanks where the debt doesn’t stay and doesn’t depart either.” There is speculation that they are insolvent.*⁴⁵

The lending binge has raised fears of impending inflation and ushered in a clampdown on lending in 2012 and 2013, “with harsh quotas that have made credit available only to those SOEs least likely to default.”⁴⁶ For example, bank lending to local government financing vehicles has been curtailed.† Local government financing vehicles are companies set up by local governments to facilitate borrowing from state banks, which allows them to spend beyond the limits of their budgets. There are currently more than 10,000 local government financing vehicles in China. These hidden and unregulated companies have been “the unseen hand powering China’s investment-led economic growth over the past decade.”⁴⁷ Bank lending to local government financing vehicles rose from “RMB 1.7 trillion in outstanding loans at the beginning of 2008 to nearly RMB 5 trillion just two years later.”⁴⁸ In December 2012, outstanding loans to local government financing vehicles reached an estimated RMB 9.2 trillion (\$1.4 trillion). The China Banking Regulatory Commission and the Chinese Ministry of Finance began instituting limits on future issuances, first barring local governments from using public assets as loan guarantees on behalf of their financing vehicles and then announcing that new loans extended to local government financing vehicles must be covered by existing cash flows and that the projects they are used for must generate returns.⁴⁹ Approximately one-third of the outstanding loans to local government financing vehicles are scheduled to come due in the next three years, and “there are well documented concerns that many of the underlying projects offer insufficient cash generating ability to service the incumbent debt.”⁵⁰ To avoid potential defaults, banks have begun extending maturities for local governments.⁵¹

By directing the banks to extend so much cheap credit to local government financing vehicles and SOEs for state sector projects

*The four asset management companies established to dispose of the banks’ nonperforming loans are Orient AMC (which serviced the Bank of China), Great Wall AMC (which serviced the Agricultural Bank of China), Huarong AMC (which serviced the Industrial and Commercial Bank of China), and Cinda AMC (which serviced the China Construction Bank). It is not entirely clear how much the asset management companies have recovered, but in 2009 the ten-year bonds were extended an additional ten years to assist in continued recovery, indicating that the 1999 bank bailout is very much an ongoing job. As of December 2012, Orient AMC had reportedly disposed of \$37 billion of these nonperforming assets and recovered \$8 billion, achieving a cash recovery ratio of 21.90 percent. Both Huarong and Cinda claim to be making profits, but their claims are not verified.

†Local governments are not permitted to borrow directly from state banks and also are generally not permitted to issue municipal bonds under the 1995 People’s Republic of China algorithm law (Chapter 4, Article 28). Thus, in order to fund the infrastructure and development projects that the central government encouraged, local governments have used state-owned resources and assets, especially land, as collateral to set up local government financing vehicles that meet basic asset and cash flow lending requirements and then borrowed from the state banks through the local government financing vehicles.

unlikely to generate revenue in the short term, the central government has encouraged SOEs and local governments to hold too much debt, increasing the likelihood that the banks will require another government bailout or restructuring due to an accumulation of nonperforming loans and a sudden drop in profits.⁵² Despite the high ratio of outstanding bad loans to capital, however, the stability of the banks may be relatively assured in the near term because the banks are undergirded by the central government and the central bank. Dr. Walter describes the backstops in the financial system as a shell game with three shells: the government itself, the banks, and the SOEs. “You can move these bad loans anywhere you want,” he says, to ensure that the banks remain solvent.⁵³ But the central government’s effort to rein in risky bank loans has fueled a boom in unofficial credit that presents more complex problems for authorities. As the challenges of obtaining bank credit have mounted, local governments and private sector businesses have increasingly relied on alternative, less regulated, and less transparent financing channels to fund investment projects.⁵⁴ This explosion of unofficial credit complicates existing challenges for the government’s efforts to rebalance the economy and maintain financial stability.

Strains on Rural Credit Cooperatives—The Big State Banks of the Countryside

Rural credit cooperatives are locality-based credit institutions important to banking and credit in rural China. Although they account for only 10 percent of total deposits and loans nationwide, 80 percent of rural deposits and loans are made using rural credit cooperatives. They are the primary providers of credit to rural households and the primary holders of rural household savings.⁵⁵ As of 2010, the rural credit cooperative system included 2,646 rural credit cooperative county unions, 223 rural cooperative banks, and 85 rural commercial banks.⁵⁶ Rural credit cooperatives have historically been “first and foremost accountable to the party, rather than to depositors or shareholders,” and they are frequently urged to support local government enterprises and projects.⁵⁷ Since 2003, the rural credit cooperatives have been managed by provincial credit unions that report to provincial governments, but local party leaders also continue to influence loan allocations and decisions.⁵⁸

The financial performance and asset quality of rural credit cooperatives vary, but Dr. Ong notes in written testimony to the Commission that rural credit cooperatives are a longstanding weak link in China’s fiscal system, because they are perpetually “saddled with mountains of bad loans.”⁵⁹ In 2007, the PBOC provided RMB 168 billion in debt-for-bonds swaps and RMB 830 million in earmarked loans to assist rural credit cooperatives in disposing of bad assets and writing off historical losses.⁶⁰ The stability of rural credit cooperatives improved after their bailout but, like the state-owned banks, they heavily supported the 2008–2009 stimulus programs and are likely experiencing deteriorating asset values.

Although the central government is not technically under any formal obligation to ensure the stability of the rural credit cooperatives, much like the big, state commercial banks, they are treated as if they are too big to fail. Most likely this is due to the risk of

social unrest in the event of a rural financial collapse.⁶¹ Because rural credit cooperatives are locality specific, the collapse of a rural credit cooperative would be less likely to cause cross-regional economic panic and bank runs than would the collapse of one of the big state banks, but rumors of a collapse in one region could potentially incite panic and runs in another.⁶²

Shadow Banking

The “shadow banking system” can broadly be defined as lending that falls outside of the official banking system.*⁶³ It can involve both traditional and nontraditional institutions and is best understood not in terms of the institutions engaged in the system but in terms of the activities that they undertake.⁶⁴ It encompasses a “broad range of bank-like activities (often using uninsured, short-term funding) that are lightly scrutinized and only sometimes backed by private sector sources of liquidity.”⁶⁵ Since shadow banking activity occurs outside of formal banking channels, it does not appear on bank balance sheets and is far less transparent than official lending activity. Chinese shadow banking products include entrusted loans (loans made by a third party to a borrower where a bank or other financial institution serves as the intermediary), investment trusts, wealth management products, credit guarantees, trusts, money market products, and various types of microloans.⁶⁶

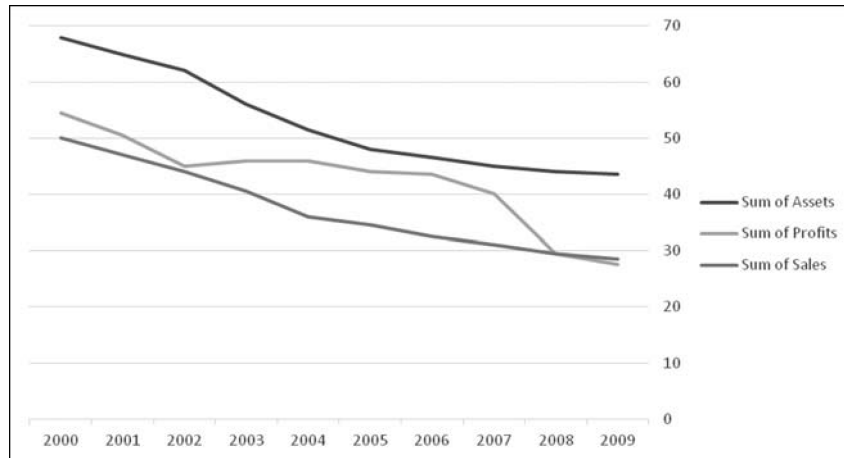
Since shadow banking is dominated by lending to higher-risk borrowers, it is frequently characterized by high fees and high interest rates.⁶⁷ Loans are often arranged by middlemen who are paid a fee, and borrowers sometimes pay interest as high as 70 percent or more per year.⁶⁸ Such high rates are charged despite the fact that the legal maximum interest rate is currently 23 percent and by law cannot exceed four times the benchmark lending rate, currently 6 percent for one-year loans.⁶⁹ Commission witness Regina Abrami, Wharton’s director of the Global Program at the Lauder Institute of International Studies and Management, points out that some non-bank-based financing in China, in the form of private money houses, pawnshops, and revolving credit associations, dates back centuries. This financing has long served much as it does today “to aid the economic transactions of firms and individuals who might not otherwise be able to obtain funding or resolve short-term liquidity crises.”⁷⁰ Chinese demand for shadow banking is largely driven by the growth of China’s private sector, a sector with limited access to official bank credit; and the Chinese government’s tolerance of shadow banking in recent years has been tied to the reality that the private sector is the increasingly dominant source of the nation’s employment. In 1980, the state sector accounted for 76.2 percent of urban employment. But by 2012, official Chinese sources attributed 80 percent of urban employment and at least 60 percent of China’s GDP to the private sector.⁷¹

*The term “shadow banking” refers to “the whole alphabet soup of levered up non-bank investment conduits, vehicles and structures” that are either unregulated or less regulated than conventional bank loans. In the prefinancial crisis U.S. context, this meant money market funds, asset-backed securities, leveraged derivative products, and other nonbank assets in the capital market that featured prominently in the U.S.’s subprime mortgage crisis. Paul A. McCulley, “Global Central Bank Focus: Teton Reflections” (PIMCO, September 2007).

According to written testimony prepared for the Commission by *Bloomberg Businessweek*'s Sheridan Prasso, 97 percent of China's 42 million privately owned SMEs are unable to obtain officially sanctioned loans from the big state banks.⁷² According to the official Xinhua news agency, 19 percent of all bank lending went to small businesses in 2011, and KPMG estimates that the size of SME lending in the banking sector may now account for as much as 25 percent of total bank lending, but "these figures are distorted by the lack of differentiation between state-owned and privately owned SMEs."⁷³ Certainly the majority of China's private sector is comprised of SMEs, many of them unregistered businesses, but there are no data on the percentage of SMEs with significant ties to the state.⁷⁴ Chinese businesses "fall into a bewildering variety of legal categories and their respective contributions to GDP are not reported in official statistics," but China's National Bureau of Statistics estimates that enterprises not majority owned by the state now account for at least two-thirds of the country's industrial output.⁷⁵

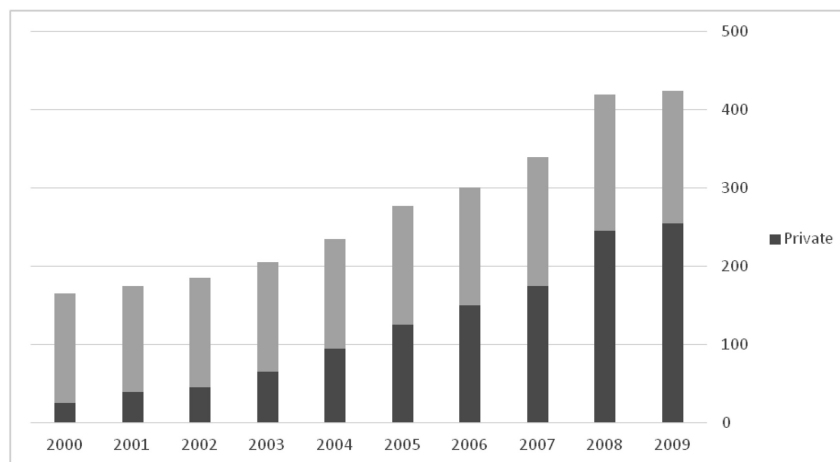
Figure 3, below, shows Chinese state-owned enterprises' declining share of industrial market. Figure 4 depicts the growing market share of private industrial enterprises with revenues exceeding RMB 5 million.

Figure 3: Chinese State-owned Enterprises' Percent Share of Industrial Assets, Sales and Profits, 2000–2009



Source: "Let a Hundred Flowers Bloom," *Economist*, March 10, 2011. <http://www.economist.com/node/18330120>, sourced from hedge fund Keywise Capital Finance.

Figure 4: Growth of Industrial Enterprises with Revenues Exceeding RMB 5 Million, 2000–2009



Source: *Economist*, “Let a Hundred Flowers Bloom,” March 10, 2011. <http://www.economist.com/node/18330120>, sourced from New York City-based research firm China Macro Finance.

Although China’s banks continue to control a significant percentage of the country’s capital, their percentage of overall lending is shrinking as the private sector grows. Commercial banks accounted for 52 percent of the country’s total financing in 2012, down from roughly 90 percent a decade ago.^{76,77} Shadow banking is filling in this gap. As a result of their limited access to official sources of credit, private sector businesses seek capital from the unofficial alternative channels in the shadow banking system. “Helping them along on the supply side,” Dr. Abrami noted, “are hundreds of millions of Chinese savers, profitable private firms, and state-owned enterprises eager to see better returns on their earnings than is possible through standard deposits within the formal banking system” or investment in the markets.⁷⁸

Successfully channeling credit to China’s productive private sector is a necessary precondition for economic rebalancing and among the biggest financial challenges facing China’s new leadership.⁷⁹ Since the government has undertaken efforts to rein in the risky bank lending that proliferated with the 2008 economic stimulus, it has permitted a boom in the shadow banking system to help maintain the country’s macroeconomic growth.⁸⁰ In addition, Chinese regulators have regarded shadow banking as “a byproduct of their attempts to unleash more market forces in the allocation of capital in China,” a useful “experiment in liberalized interest rates” and “an incubator for risk-based capital allocation and financial innovation.”^{81,82} In the meantime, the ever-tightening restrictions on access to official sources of credit have shifted more and more borrowers to shadow alternatives. Shadow banking meets important market demands, ensuring that the private sector businesses generating so many of China’s jobs are able to access credit when they need it.⁸³ The growing pool, says Dr. Abrami, has also now “moved beyond small enterprises to include larger firms, local governments

... and businesses within politically disfavored sectors, such as property development and mining,” effectively circumventing the government’s efforts to rein in lending to overdeveloped sectors.⁸⁴

No one knows with certainty the size of China’s shadow banking system but, according to Chinese Central Bank estimates and much private sector analysis, it is valued at RMB 2 trillion to 4 trillion (\$325 billion to \$630 billion), or approximately 7 percent of total lending, four times its estimated size in 2008.^{85,86} The China Banking Regulatory Commission has produced a higher estimate of RMB 7.6 trillion (\$1.2 trillion) for 2012, which is equal to 14.6 percent of China’s 2012 GDP.⁸⁷ Total off-balance-sheet banking activity in China, including “credits to property developers, local-government entities and small-and-medium size enterprises (SMEs), individuals and bridge-loan borrowers,” has been estimated as high as RMB 17 trillion as of the end of 2012, or roughly one-third of GDP.⁸⁸ Even by this largest and most expansive estimate, the shadow banking system is still smaller than China’s commercial banking industry, which had an estimated \$21 trillion in assets as of September 2012.^{89,90} And by comparison with the shadow banking systems of the West, China’s shadow banking is also relatively small. According to the Financial Stability Board, shadow banking had \$23 trillion in assets in the United States and \$22 trillion in assets in the European Union in 2012. Nevertheless, the recent exponential growth of the Chinese shadow banking sector, combined with the continued growth and increasing economic importance of the private sector relative to the state sector, is driving a “reduction in the use of the official banking system to perform basic functions of finance.”⁹¹ In some parts of China, informal lending now exceeds official bank lending.⁹²

Chinese Shadow Banking Terminology

Bank Trust Products

Bank trust products are packaged by trusts and sold by banks, frequently resulting in a lack of transparency as to whether the bank or the trust is responsible for their performance.⁹³

Entrusted Loans

Entrusted loans are products that allow banks to serve as middlemen by identifying high-net-worth individuals who can provide corporate loans. According to Bloomberg News, entrusted loans last year accounted for nearly 8 percent of the RMB 14.27 trillion (\$2.3 trillion) raised in private placements—loans and other funding sources, such as returns on stocks and bonds—compared with 0.9 percent in 2002.^{94,95}

Passageway Deals

In passageway deals, trusts and brokerages cooperate with banks to act as passive reservoirs for loans that banks originate but cannot keep on their own balance sheets without exceeding lending quotas or transgressing capital requirements or loan-to-deposit ratios. Investors who have purchased wealth manage-

Chinese Shadow Banking Terminology—Continued

ment products from the banks often bear the risk if borrowers default on the loans that the trust companies and brokerages have purchased from the banks.⁹⁶ Industry executives say at least 50 percent of trust company assets and 80 percent of brokerages' entrusted funds are related to this so-called "pas-sageway business."⁹⁷

Peer-to-Peer Lending

Peer-to-peer lending is a form of microcredit, and the companies that facilitate it online match borrowers with lenders able to offer small, short-term loans. The peer-to-peer lending market is worth approximately \$3.2 billion and is comprised of approximately 2,000 online sites.⁹⁸ Peer-to-peer loans can be as small as RMB 50. One of the better known Chinese peer-to-peer lending companies, Creditease, reports that its average loan is RMB 50,000 (\$8,200), "too small for banks but attractive to online micro-financiers."⁹⁹

Trust Companies

There are 64 Chinese trust companies today, with assets valued collectively at approximately \$1.2 trillion.¹⁰⁰ Trust companies have surpassed the insurance industry in China in terms of the value of their assets and are now second only to the banking industry.¹⁰¹ Bank of America Merrill Lynch estimates that trust companies account for 8.9 percent of all bank loans.¹⁰²

Wealth Management Products

Wealth management products are the fastest-growing investment vehicle in China. Banks funnel money deposited by savers into these riskier investments that are mostly held off of their balance sheets and sell them to support their credit growth, since wealth management products allow them to circumvent the China Banking Regulatory Commission's caps on interest rates for bank loans. These are highly nontransparent products because of a lack of disclosure requirements.¹⁰³ Total outstanding issuance of wealth management products was approximately RMB 6.7 trillion (\$1.1 trillion) in the third quarter of 2012, an increase of 47 percent from the end of 2011.¹⁰⁴ Bank of America Merrill Lynch estimates that wealth management products comprise 8 percent of all bank loans.¹⁰⁵ Fitch Ratings Agency recently estimated that these products now account for approximately 16 percent of all commercial bank deposits.¹⁰⁶ Wealth management products generally offer 4 to 5 percent yields, roughly 1 percent higher than the ceiling on deposit rates. The China Banking Regulatory Commission was initially supportive of the growth of wealth management products offered by banks, but amid recent concerns over defaults, regulators have cracked down on the practice.¹⁰⁷

Shadow Banking Risks

According to recent analysis by the Federal Reserve Bank of Dallas, "Shadow banks are [now] at the center of our global market-

based financial intermediation system, conducting maturity, liquidity, and credit transformation without explicit public sector credit guarantees or liquidity access.”¹⁰⁸ The explosion of new financing vehicles presents risks that investors may not understand and that appear to outstrip government regulatory capacities. In the aftermath of the 2008 financial crisis, there has been a push among regulators, both in the United States and abroad, to increase scrutiny of these financial intermediaries in order to reduce risks in the global financial system as well as in domestic ones.

In December 2012, the IMF released an assessment identifying shadow banking as one of the key risks to China’s continued financial stability.¹⁰⁹ According to Ms. Prasso, “The primary risk to the [Chinese] government lies in its potential inability to intervene if a large number of underground loans suddenly go bad in a crisis; there is no centralized place to put the money, as in a bank bailout.”¹¹⁰ Dr. Abrami also notes that the Chinese government may not be able to sufficiently regulate the risks posed by the rapid proliferation of private lending activities.¹¹¹

A particular cause for worry is the extent to which traditional Chinese banks may be exposed to the risks of the shadow banking system. Fitch Ratings Agency estimates that about 80 percent of new shadow banking credit is tied to the big commercial banks and that an even bigger percentage of outstanding shadow banking loans is linked to these banks.¹¹² The banks are moving undesirable assets into the shadow banking system “on an unprecedented scale, reinforcing suspicions that bank balance sheets reflect only a fraction of the actual credit risk lurking in the financial system.”¹¹³ Trust companies and brokerages are a vital source of credit for banks seeking to “arrange off-balance-sheet refinancing for maturing loans that risky borrowers cannot repay from their internal cash flow.”¹¹⁴ As the *Financial Times*’ Kate Mackenzie explains:

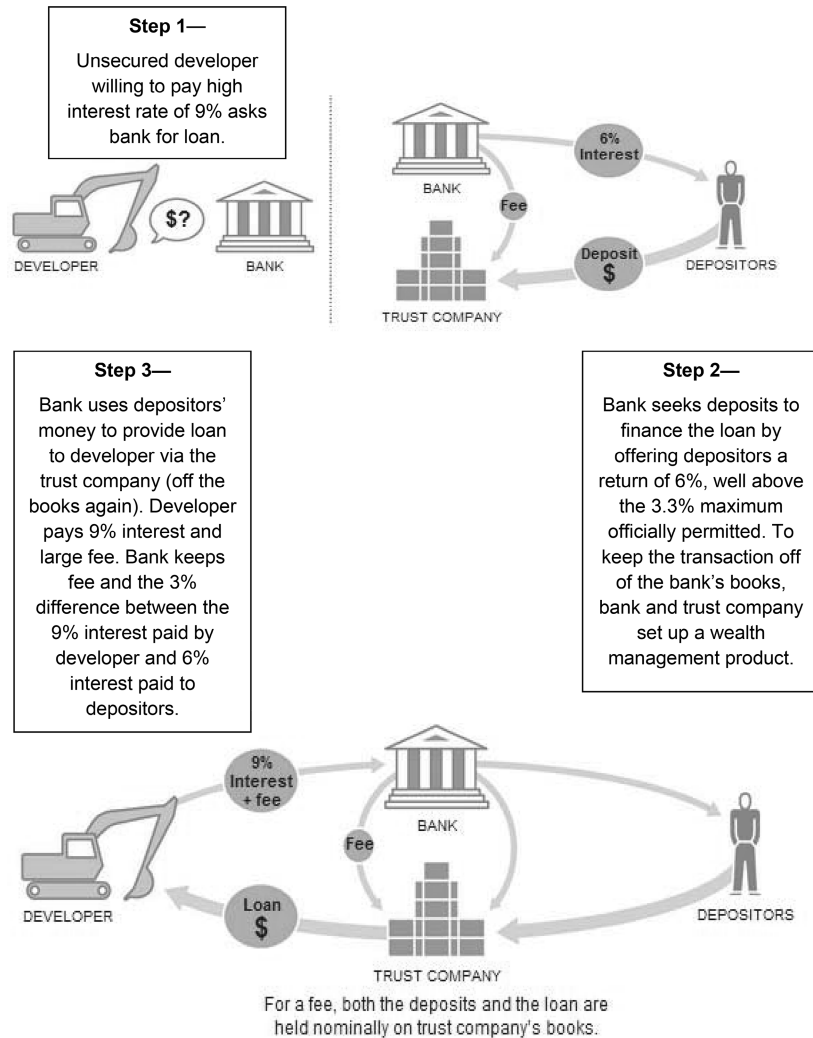
*The elephant in the room is that the shadow institutions are the co-dependent evil twins to the commercial banks . . . banks are reliant on the shadow institutions to supply their liquidity, and shadow institutions get a lot of their capital from the banks. . . . Not only does the shadow market fund the banks, but banks fund the shadow market: banks are the ultimate source of many ‘non-standard’ financial products. . . . The whole market is running on the rate arbitrage between official channels, which lend at 6.5–9.5 percent, and gray channels, which lend at 12–60 percent.*¹¹⁵

Whenever the central government eases monetary policy, the big banks tend to lend excessively, but when it tightens monetary policy, the shadow banking system steps into the gaps. With the banks so closely tied to the shadow banking system, it appears that tighter official lending rules not only fuel the growth of unofficial lending but also specifically encourage the banks to engage in more risky, less transparent lending.¹¹⁶ Banks are increasingly pressing customers to shift money from the older, regulated parts of their operations to newer, off-the-books products. “The key question is no longer how much risk banks are carrying,” but how many risky loans have been shifted to lightly regulated, shadow banking prod-

ucts offered by the banks and to “lightly regulated shadow banking institutions—mainly trust companies, brokerages and insurance companies.”¹¹⁷

Figure 5, below, illustrates one means by which banks create and issue off-balance sheet loans.

Figure 5: Example of Off-Balance Sheet Lending by Chinese Banks



Source: *The New York Times*, “Questionable Lending in China,” July 1, 2013. <http://www.nytimes.com/interactive/2013/07/02/business/Questionable-Lending-in-China.html?ref=global>. As noted in *The New York Times* article, this is but one example of how shadow banking might work.

China’s leadership is turning a sharper eye toward the risks in the shadow banking system.¹¹⁸ Regulators have, for instance, begun issuing prohibitions against certain types of lending.¹¹⁹ In

December 2012, the Ministry of Finance, the National Development Reform Commission, the People's Bank of China, and the China Banking Regulatory Commission issued a communiqué on curbing illegal financing by local governments, banning local government borrowing from individuals or nonfinancial institutions such as trust companies and fund management companies.¹²⁰ In June 2013, PBOC dramatically tightened credit in the interbank market, where banks have been lending money to each other and to large shadow financiers to fund higher-yield offerings. Despite signs of a liquidity crunch, the central bank delayed injecting more money into the markets, insisting that “overall bank liquidity conditions are at a reasonable level” and that banks should “prudently manage liquidity risks that have resulted from rapid credit expansion.”¹²¹ China's official Xinhua news agency said on June 23 that the cash crunch was engineered to curb risky bank funding of shadow banking activities.¹²²

On April 26, the Chinese government announced that more than 1,400 people had been sentenced to prison terms of at least five years for illegal shadow banking activities. A total of 4,170 people have reportedly been convicted of violating shadow banking rules since 2011.¹²³ People charged in the most recent crackdown were convicted of violations such as illegal fundraising, public advertising to find lenders, and promising excessively high rates of return.*¹²⁴ Legal experts complain, however, that the central government has not sufficiently clarified what is and is not legal for lenders and borrowers. They argue that many of those netted in crackdowns and sweeps are engaged in practices that have not been explicitly prohibited.^{125,126} Another problem in cracking down on shadow banking in the absence of increased access to official lines of credit is that it threatens to starve China's entrepreneurial companies of capital, which in turn may hinder China's indigenous innovation.¹²⁷

Market Conditions and Access Issues for Banking, Investment, Insurance, and Other Services Firms

Expanding access to traditional bank lending for China's 42 million SMEs would be a key way for Beijing to allow the private sector to thrive without compromising the government's regulatory powers. U.S. financial services firms say China should provide them with greater market access and operating capacity so that they can help to develop the Chinese financial sector. They note that, in contrast with China's bank-dominated financial system, in the United States, more credit is provided by financial markets and nonbank lenders than by banks, and they argue that they offer knowledge, experience, and products that China needs.¹²⁸ Though China has taken some steps to expand foreign firms' access to its financial markets since joining the World Trade Organization (WTO) in 2001, this access remains quite limited (see *Chinese Rationales for Market Barriers* later in this section).

* China's Supreme Court website defines “illegal fundraising” as applying to individuals who receive more than RMB 200,000 (\$32,000) of informal loans or cause losses to lenders of RMB 100,000 (\$16,000) or more. “Enterprises can face charges if they receive RMB 1 million (\$160,000) or cause losses of RMB 2.5 million (\$400,000).” Joe McDonald, “China jails more than 1,400 in lending crackdown,” Associated Press, April 26, 2013.

China's economy has long been heavy on manufacturing and light on services, but the services sector is growing. Manufacturing accounted for 45.3 percent of China's GDP in 2012, while the services sector (transport, wholesaling, retailing, hotels, tourism, financial services, real estate, scientific research, and other services) accounted for 44.6 percent, according to official statistics.¹²⁹ Strengthening this sector is a key goal of China's 12th Five-Year Plan for Economic and Social Development, as its expansion promises the creation of new jobs, increased domestic consumption and decreased dependence on exports and state investment projects for economic growth—all vital to the economic rebalancing needed to reduce the U.S.-China bilateral trade deficit.¹³⁰ Unfortunately, the financial services subsector has not been growing as quickly as services overall, despite the fact that the development of this subsector is particularly crucial to China's achievement of its rebalancing goals. As Mr. Dearie told the Commission, "Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity."¹³¹ An obvious way to increase access to capital is to spur development of the financial services sector in China. Fundamentally, the financial services sector struggles to thrive because of the extent of government intervention in the overall financial system. While the explosion of the shadow banking sector and the government's tolerance of it indicate the leadership's recognition of the need for financial liberalization, the government has been slow to embrace financial liberalization. This foot dragging continues even as the risks attendant in shadow banking underscore the importance of developing more comprehensive and well-regulated financial services than the informal shadow banking trend offers. The shortage of financial services inhibits the very consumption that China's leaders have committed to cultivate. While domestic consumption per capita continues to grow, it has actually fallen as a percentage of GDP from more than 60 percent to less than 50 percent between 2000 and 2013, and more than half of the wealth in Chinese households today is still held in the form of low interest rate savings.¹³²

Empowering the Chinese consumer requires the broad availability of financial products and services, including personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products. This would in turn persuade Chinese citizens to reduce their precautionary savings.¹³³ U.S. financial services firms have long argued that if China would open its market to more investment, they could grow their own business. China has taken some steps to further open its financial services market in recent years. Foreign direct investment in financial services increased 122 percent between 2007 and 2010, but foreign access to China's financial markets more broadly remains heavily restricted, and this apparent high growth rate belies the fact that investment grew from a very small market share.¹³⁴ Foreign ownership in the Chinese banking system, for example, currently amounts to less than 2 percent.¹³⁵ And, according to Steve Simchak, director of International Affairs at the American Insurance Association, foreign property-casualty insurers in China cur-

rently hold only a 1.2 percent market share as a result of significant market entry barriers and a lack of national treatment.*¹³⁶

U.S. financial services companies complain that even as the United States has taken steps to allow increased Chinese access to its financial services market, China is not reciprocating. The *Wall Street Journal* reported that China's state-run Citic Securities is applying for a license with U.S. regulators, making it the latest Chinese firm to expand into the United States as the Chinese government continues to encourage its financial services companies to invest more of the nation's foreign exchange reserves in foreign markets. Yet within China, foreign banking, securities, and insurance affiliates all continue to be subject to ownership restrictions and regulatory approval processes for their investments that are far more stringent than those that apply to domestic competitors. China's minimum capital requirements for foreign banks seeking to operate in the Chinese market exceed international norms, and foreign banks also cannot open new branches without permission from regulators and face cumbersome and lengthy approval processes.¹³⁷ Foreign-owned securities and asset management firms are limited to joint ventures in which foreign ownership is capped at 49 percent, while foreign life insurance companies remain limited to 50 percent ownership in joint ventures and to 25 percent equity ownership of existing domestic companies; and, until a 2012 WTO dispute settlement panel ruling, market access for foreign electronic payment providers was virtually nonexistent.¹³⁸

In his testimony to the Commission, Professor Saulski noted that studies by the Organization for Economic Cooperation and Development and the World Bank ranked China as "one of the most restrictive markets for financial services among the G20." China is also far more restrictive than its fellow major developing economies: Brazil, Russia, and India.¹³⁹ Professor Saulski further explained that "the current lack of significant competition in China's financial sector hinders efficiency, limits investor choice, and restricts access to capital by non-state-owned firms. Furthermore, the lack of competition in China's financial markets facilitates destructive rent seeking behavior by special interest groups and well-connected individuals. In its most pernicious form, this creates a perfect environment for fraud, insider dealing, and corruption."¹⁴⁰

Chinese Rationales for Market Barriers: The General Agreement on Trade in Services (GATS) and the Global Economic Crisis

Though China's restrictions on market access to the financial services sector are significant, they are compatible with the country's 2001 WTO accession agreement, which was largely negotiated by the United States acting on behalf of other WTO members. Under the WTO's General Agreement on Trade in Services, Most Favored Nation (MFN) status and national treatment apply only as specified in a member country's schedule and MFN exemption

*National treatment is a principle of international law by which states guarantee that they will not favor their own citizens or businesses with treatment better than what they afford to those of their trading partners.

list.*¹⁴¹ WTO members are explicitly allowed to provide non-MFN treatment if they record the exemptions in their WTO schedule of services commitments, though these exceptions are subject to negotiation in future multilateral trade talks. Members also are not obligated to provide national treatment except for the service categories that they choose and only to the extent recorded in their schedule of WTO services commitments. Agreements to gradually eliminate or reduce limitations to market access are also voluntary, “applying only to those service categories included in a Member’s schedule and only to the extent specified.”¹⁴² Because many of the obligations under GATS are voluntary, most WTO members, including China, were selective about the service sector categories for which they undertook obligations in their accession agreements.¹⁴³

At the ten-year review of China’s WTO accession agreement in 2011, the United States criticized China’s lack of progress in fully implementing its financial services obligations, honing in on continued restrictions on foreign ownership of Chinese banks and insurance companies. The Office of the U.S. Trade Representative (USTR) noted in its 2012 report to Congress on China’s WTO compliance problems that “China has continued to maintain or erect restrictive or cumbersome terms of entry in some sectors.” USTR also underscored problems with “informal bans on new entry, high capital requirements, branching restrictions or restrictions taking away previously acquired market access rights.”¹⁴⁴ The Chinese claimed that their refusals to fully open the financial services sector were justified by the 2008 financial crisis, which cast developed nations’ financial systems in an unfavorable light. As a senior official at the Shanghai Stock Exchange reportedly put it in 2009, “The master has been proven to be a fool.”¹⁴⁵ Mr. Dearie noted in his testimony that a major increase in negative Chinese perceptions of the U.S. financial system due to the global economic crisis damaged the ability of U.S. financial services firms to access the Chinese market and of USTR to negotiate greater access.¹⁴⁶

In June 2010, China proposed new WTO financial services discussions aimed at examining “the gains and pains” of financial liberalization and financial regulatory practices suited to developing countries. China reportedly noted:

While many see liberalization of trade in financial services as an essential contributing factor towards the development of the sector, others regard excessive and premature liberalization of the financial sector as a key ingredient for financial instability. . . . This is a particularly relevant subject in the post-crisis era, as many countries are now concerned about how to develop their financial sector so that it generates real economic growth rather than asset bubbles. . . . There is increasing evidence that the developed Members may also have taken excessive liberalization commitments.

*Most Favored Nation treatment is a means of establishing equality of trading opportunity between states by ensuring that all nations accorded MFN status are treated equally by any given trading partner. An importing country cannot discriminate against the goods from one MFN country in favor of another MFN country’s goods. If an importing country grants any type of concession to one MFN trading partner, this concession must also be given to all other countries with MFN status.

*Before the financial crisis, deregulation was the main trend in the domestic financial market of the developed countries, and in the international arena, the developed countries pushed for more liberalization commitments to gain greater financial deregulation in the markets of their trade partners. The financial crisis has brought a sharp turn in the way we think about financial deregulation, and now the most popular word for the financial regulators is 'reregulation.'*¹⁴⁷

China also warned that foreign services firms would dominate the most profitable sectors of the Chinese market, impeding the development and success of domestic firms. In addition, China worried that foreign firms might act as conduits for household savings to be funneled out of the country rather than invested domestically and that the increased linkages with the global financial system could leave China more susceptible to volatilities in the global market.¹⁴⁸

China's Financial Sector—Foreign Investors Experience Problems with Governance, Transparency, and Accountability

Even if foreign service firms were given access to household savings in China, weak corporate governance, regulatory oversight, and accounting practices in China create problems for potential foreign investors. Investor confidence in China's securities markets and in Chinese companies trading on U.S. and other foreign exchanges is important to the Chinese government's economic rebalancing efforts. Selling shares of Chinese companies to foreign investors has become an increasingly significant means of raising capital. However, China's traditional banking system and its publicly traded corporations are hobbled by poor audit quality and unreliable financial statements. Investor confidence depends on transparent and reliable accounting and audit regimes—to which the Chinese government has shown resistance. Improvements in the governance of China's companies and its capital markets are critical to protecting American shareholders and American investments in China.

China's Corporate Governance Creates Challenges for Investors and Regulators

Demand for credit has led Chinese companies to seek capital overseas even as its shadow banking system has expanded. In the late 1990s, Chinese companies began raising capital on major international stock exchanges. This trend has been driven by large Chinese companies, many state owned, that have sought to broaden their shareholder base, increase the liquidity of their shares, and enhance the visibility of their brand names. In part, it has also been driven by small- and medium-sized private Chinese companies seeking alternative capital options beyond the state-controlled banks that dominate China's financial system, and the limited domestic exchanges.

U.S. stock markets are among the most popular alternate global exchange destinations for Chinese firms. According to Commission

witness Paul Gillis, professor at Peking University and Standing Advisory Group member of the Public Company Accounting Oversight Board (a quasi-public entity established by the Sarbanes-Oxley Act that polices auditors and reports to the U.S. Securities and Exchange Commission (SEC)), there are more than 200 Chinese companies that have offered shares of stock on the New York Stock Exchange and NASDAQ in recent years, and hundreds more have entered U.S. over-the-counter markets.¹⁴⁹ However, many of the Chinese companies listing in the United States have proved to be poor investments.

Initially, U.S. investors purchased stock in U.S.-listed Chinese companies in hopes of profiting from China's rapid growth rate. However, investors in U.S.-listed Chinese companies have increasingly found that insufficient corporate governance standards make these companies high-risk investments. Many have been implicated in frauds and accounting scandals, and U.S. regulators have deregistered about 50 Chinese companies in the past two years following fraud probes.¹⁵⁰ The stigma attached to U.S.-listed Chinese companies as a result of this regulatory scrutiny has lowered returns for nearly all of them. The 82 companies in the Bloomberg Chinese Reverse Mergers Index lost 52 percent of their market value between June 2011 and July 2012.¹⁵¹ U.S.-listed Chinese companies are "deserting U.S. stock markets in record numbers as regulatory scrutiny mounts and the advantages of a U.S. listing slip away."¹⁵² Six U.S.-listed Chinese companies announced plans to go private through buyouts in 2010, but by 2012, 27 Chinese companies had announced they would go private. In addition, approximately 50 mostly smaller U.S.-listed Chinese companies deregistered with the SEC, ending their requirements for public disclosures, in 2012.¹⁵³ In addition, far fewer Chinese companies are listing on U.S. exchanges. Only three Chinese companies successfully went public on U.S. exchanges in 2012, down from 41 in 2003.¹⁵⁴

Two types of Chinese companies in particular have sought access to U.S. capital markets: smaller enterprises with limited ability to use Chinese capital markets, and some of the largest state-owned enterprises in industries such as petroleum and telecommunications.¹⁵⁵ Larger Chinese state-owned enterprises have primarily entered the U.S. markets by openly filing IPOs on the New York Stock Exchange and NASDAQ in the form of American Depositary Receipts (ADRs) or ordinary shares.*¹⁵⁶ In 1993, state-owned Sinopec Shanghai Petrochemical was the first Chinese company to list on a U.S. exchange by issuing an IPO in the form of ADRs.^{157,158}

Smaller private Chinese companies have most commonly sought access to U.S. markets because they lack sufficient domestic sources for capital and have entered the markets by merging with existing, registered U.S. shell companies in reverse mergers. Reverse mergers do not require approval from the China Securities Regulatory Commission (the Chinese counterpart of the U.S.'s Public Company Accounting Oversight Board) and involve much less

*An ADR is a certificate representing one or more shares of a foreign firm's stock, denominated in U.S. dollars.

regulatory scrutiny by the SEC than do IPOs. A reverse merger involves a private company purchasing a publicly traded company and shifting its management into that company. This allows the private company to become publicly traded without going through the regulatory and financial disclosure processes associated with an IPO. Most Chinese reverse mergers are traded on the over-the-counter market until they satisfy various requirements, such as size and capitalization level, that qualify them to list on the New York Stock Exchange or NASDAQ. Between 2000 and 2011, approximately 443 Chinese companies entered U.S. markets via reverse mergers, but relatively few of these have made it off of the over-the-counter market and onto the New York Stock Exchange or NASDAQ.¹⁵⁹

As of May 2012, there were approximately 112 Chinese companies traded on the New York Stock Exchange or NASDAQ in the form of ADRs, 21 traded in the form of ordinary shares, and 79 that listed via reverse merger transactions.¹⁶⁰ Large Chinese companies entering U.S. markets via IPOs, including state-owned enterprises, have accounted for the greatest share of Chinese companies' market capitalization, but they have been greatly outnumbered by smaller Chinese companies entering U.S. markets via reverse mergers. This latter group has also generated a sizeable portion of Chinese companies' market capitalization. According to the Public Company Accounting Oversight Board, between January 2007 and March 2010, 159 Chinese companies entered the U.S. securities markets using reverse mergers and generated market capitalization of \$12.8 billion. In the same period, 56 Chinese companies, including a number of very large, state-owned enterprises, completed U.S. IPOs and had an aggregate market capitalization of \$27.2 billion.¹⁶¹

Chinese Reverse Mergers Skirt Oversight

Chinese reverse merger transactions have attracted the bulk of the critical attention from U.S. regulators. Companies that enter the U.S. market via reverse mergers are riskier investments, because they do not go through the disclosure processes associated with traditional IPOs and thus offer less information to investors. In response to increasing complaints involving foreign reverse mergers, the SEC issued a bulletin in June 2010 warning investors of the risks of fraud and other abuses involving reverse merger companies. The SEC also set up a task force to investigate the foreign company reverse merger trend and associated investor risks. In November 2011, the SEC approved new NASDAQ, New York Stock Exchange, and American Stock Exchange rules that impose more stringent listing requirements for reverse mergers. Under the new rules, a reverse merger company cannot apply to list on the New York Stock Exchange, NASDAQ, or the American Stock Exchange until it has completed a one-year "seasoning period" of trading on the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following its reverse merger. It also must file all required reports with the SEC, including audited financial statements, and maintain a minimum share price of \$2.00 to \$4.00 for at least 30 of 60 trading days immediately prior to filing its listing application.^{162,163}

An ABC News investigation in January 2013 found that since 2010, more than 70 Chinese companies have been removed from or left NASDAQ and the New York Stock Exchange after reports of alleged fraud and financial irregularities.¹⁶⁴ In 2008 and 2009, there were very few U.S. federal securities class actions filed against companies domiciled in China. In 2010, Chinese companies were the target of 15 such suits, and by 2011, that number had risen to 38 suits—accounting for 17 percent of the 224 U.S. federal securities class actions filed in 2011 and nearly 66 percent of the 60 such suits targeting non-U.S. companies.¹⁶⁵ At least 42 of the Chinese companies targeted by U.S. securities class actions to date were listed on U.S. stock markets via reverse mergers and have been subjects of SEC investigations of financial schemes that former SEC Chairman Mary Schapiro described as “brazen.”¹⁶⁶ According to analysis by the Harvard Law School Forum on Corporate Governance and Financial Regulation, “Over 85 percent of U.S. securities class actions filed against Chinese issuers from 2008 to mid-2012 have included accounting-related allegations.”¹⁶⁷

In order to be publicly traded on the U.S. capital markets, companies have to make public certain information about their business strategies, operations, material risks, and financial results. The financial statements contained in companies’ annual reports filed with the SEC are required to have an independent external audit for consistency with U.S. accounting standards. These standards are the same for all companies notwithstanding where they are registered. In its *2010 Annual Report to Congress*, the Commission noted that SEC standards for assessing material risks may benefit from singling out certain nations for special scrutiny, based on their domestic accounting standards. For example, there is no reporting requirement that takes note of the unique and politicized role that the CCP plays in the selection of Chinese corporate leadership.

The House Financial Services Committee sent a letter to the Public Company Accounting Oversight Board and the SEC on September 9, 2010, complaining of the quality of auditing of U.S.-listed Chinese companies. The Big Four accounting firms (PricewaterhouseCoopers, KPMG, Deloitte Touche Tohmatsu, and Ernst & Young) audit 88 percent of all U.S.-listed Chinese companies, including a number of the companies named as defendants in U.S. government-filed law suits.¹⁶⁸ Public Company Accounting Oversight Board standing advisory group member and Commission witness Paul Gillis noted in a recent report that fraud and accounting issues associated with U.S.-listed Chinese companies have brought mounting pressure for these accounting firms to verify that they have conducted their audits properly.¹⁶⁹

SEC Cracks Down on Accounting Firms of Chinese Companies

During recent probes, the SEC has sought audit work papers from the accounting firms, a common request during fraud investigations. To date, the firms have refused to produce these documents, arguing that doing so would put them in violation of Chinese state secrets laws. In China, sharing accounting information with foreign regulators and removing audit papers from the coun-

try violates state secrets laws. Chinese authorities also do not permit non-Chinese regulators to conduct investigations in China.¹⁷⁰ Chinese law “prohibits firms from producing audit working papers directly to any foreign regulator and requires those foreign regulators to seek such documents through the China regulator,” according to Commission testimony by Cynthia Fornelli, executive director of the Center for Audit Quality.¹⁷¹ China has several times amended its Law on Guarding State Secrets to be more inclusive of a variety of information, including economic statistics.¹⁷² China is also applying its State Secrets Law to private companies. In the SEC’s investigation of Deloitte Touche Tohmatsu’s auditing of China-based Longtop Financial Technologies, for instance, Deloitte said Chinese regulators had warned them that turning over working papers to the SEC could lead to sentences of life imprisonment for the partners involved and to the banishment of their firm from conducting further business in China.¹⁷³ In the United States, however, withholding foreign public accounting paperwork of U.S.-traded companies violates both the Securities Exchange Act and the Sarbanes-Oxley Act, which require foreign audit firms to produce documents concerning U.S.-listed clients at the SEC’s request.¹⁷⁴

In December 2012, the SEC charged five firms with breaking U.S. securities laws by refusing to turn over the requested audit work papers. The defendants in the case are Beijing-based BDO China Dahua, Ernst & Young Hua Ming, KPMG Huazhen, Shanghai-based Deloitte Touche Tohmatsu Certified Public Accountants, and PricewaterhouseCoopers ZhongTian. China-based affiliates of these accounting firms face the possibility of losing both their right to practice and their registration with the Public Company Accounting Oversight Board.

Initially, U.S. audit firms entered the Chinese market as joint ventures with Chinese partners. The Big Four in most countries are owned by local partners, operating more like a franchise than a typical multinational corporation. China has required the Big Four to convert into limited liability partnerships as their 20-year joint venture terms began to expire in late 2012. In May 2012, the Chinese government announced that by December 31, 2017, the Big Four must evolve into partnerships in which Chinese-qualified accountants are a majority of the firm’s accountants. The new regulation will cap the level of foreign-qualified accountants at the firms at 40 percent initially and at 20 percent by the end of 2017. In addition, the regulation will limit the voting rights of all partners with foreign qualifications and require that all senior partners be Chinese citizens. This change will limit U.S. corporate opportunities to manage audit operations, further complicating SEC enforcement efforts in China.^{175,176}

Accounting Fraud Impacts U.S. Companies Operating in China

Fraud and accounting problems associated with China are not limited to U.S.-listed Chinese companies. U.S. companies have directly invested \$54 billion in Chinese businesses, factories, and property, most of it in the past decade, according to the Department of Commerce. U.S. corporations' China operations are facing increasing problems. For example, on January 18, Caterpillar disclosed "deliberate, multi-year, coordinated accounting misconduct" at a unit of ERA Mining Machinery Ltd., a company it paid \$654 million to acquire in June 2012. Caterpillar has disclosed inventory discrepancies, inflated profits, and improperly recorded costs and revenue at the ERA Siwei unit, located in Zhengzhou, China. The Caterpillar experience and the growing catalog of smaller instances of deception and abuse involving U.S. companies' China corporations indicate that U.S. companies' Chinese investments experience unique accounting and governance challenges. The financial and legal advisors for Caterpillar and ERA included Citigroup, Freshfields Bruckhaus Derringer LLP, Blackstone, and DLA Piper. It appears that they did not detect the fraud prior to the deal closing.¹⁷⁷

Risk Management and Bilateral Cooperation

All accounting firms that audit U.S.-traded public companies and their employees must register with the Public Company Accounting Oversight Board. The Public Company Accounting Oversight Board sets auditing standards and rules for U.S.-listed companies and is charged with inspecting and regularly reviewing the audits of all public accounting firms that audit U.S.-listed companies, including those firms that audit foreign-domiciled, U.S.-listed companies and are themselves domiciled outside of the United States.¹⁷⁸ According to Ms. Fornelli, as of June 2011 there were 54 Chinese mainland auditing firms and 55 Hong Kong firms registered with the Public Company Accounting Oversight Board, and the board had performed more than 200 inspections of non-U.S.-domiciled accounting firms in over 35 jurisdictions, including Brazil, India, Japan, and Russia.^{179,180}

Recognizing a need to improve U.S. financial regulators' ability to gauge the financial health of companies domiciled in other jurisdictions, Congress empowered the Public Company Accounting Oversight Board to negotiate agreements for reciprocal inspections with audit regulators outside the United States as well as the confidential exchange of information with other regulators. This was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Such cooperation between the board and foreign auditing oversight bodies was intended to encourage jurisdictions to better harmonize auditing standards and requirements. The goal was to eliminate such conflicts as the SEC's requests for documents that U.S. accounting firms cannot produce under Chinese law but must produce under U.S. law.¹⁸¹ Ms. Fornelli testified that the Public Company Accounting Oversight Board now has cooperation agreements with 16 nations and that after the 2010 Strategic and

Economic Dialogue, the United States and China announced their intent to negotiate such an agreement on the sharing of confidential information for regulatory purposes.¹⁸² However, the Public Company Accounting Oversight Board and the China Securities Regulatory Commission have yet to achieve that goal.

The inability of the Public Company Accounting Oversight Board to inspect in China creates a gap in investor protection. This lack of an information-sharing agreement with China does not just limit U.S. regulators' ability to ensure proper conduct at the Big Four accounting firms. It also limits their ability to ensure proper conduct at the Chinese-domiciled accounting firms that audit or play a substantial role in auditing U.S.-listed Chinese companies and the Chinese operations of U.S. companies. Though U.S. securities law requires overseas auditing firms that audit U.S.-listed companies to undergo inspection by the Public Company Accounting Oversight Board to ensure that they are following U.S. standards, China wants the United States to allow the China Securities Regulatory Commission and the Chinese Ministry of Finance to conduct and control all investigations of accounting firms in China, via an audit oversight agreement similar to the one it struck with the European Union. According to a statement by Mr. Gillis:

*In a 2009 letter commenting on the PCAOB's [Public Company Accounting Oversight Board] proposed delay in the deadline for foreign inspections, the CSRC [China Securities Regulatory Commission] said that any oversight of Chinese accounting firms should rely solely on the CSRC. In 2011, the European Union recognized the equivalence of the audit oversight systems in 10 third countries, including China. The third countries and EU [European Union] member states can now mutually rely on each other's inspections of audits. Chinese regulators want the same treatment from the United States, but U.S. laws do not permit the PCAOB to rely on foreign regulators.*¹⁸³

Chinese regulators have been reluctant to offer joint inspections, as they view such access as a breach of national sovereignty. If they do agree to some form of joint inspections between Chinese and U.S. regulators, they will likely insist on retaining full control over punishment of violations by Chinese auditors. The Public Company Accounting Oversight Board has been in negotiations with Chinese regulators since 2010 to try to work out an agreement and previously set a December 31, 2012, deadline to complete inspections of Chinese accounting firms. With this deadline passed, failure to reach a breakthrough in negotiations in the near future "could lead to the deregistration of Chinese accounting firms and a mass delisting of Chinese stocks," since U.S.-listed Chinese companies would no longer have a registered auditor and thus would have to delist.¹⁸⁴

On May 24, 2013, the United States and China announced a deal for limited information-sharing between their regulatory agencies when there are questions regarding audits of U.S.-listed Chinese companies. Under the agreement, the U.S. Public Company Accounting Oversight Board will be permitted access to audit documents from Chinese accounting firms to use in board investiga-

tions. This deal to facilitate information-sharing during investigations related to possible sanctions is a step in the right direction, but it does not resolve the board's challenges with regard to regular inspections of Chinese auditing firms, and it is inspections, rather than investigations, that are the Public Company Accounting Oversight Board's main function. Under U.S. law, "firms that issue reports on public companies are to be inspected at least every three years" to ensure that they are in compliance with U.S. auditing standards, but Chinese law still prohibits auditors from providing documents to the Public Company Accounting Oversight Board for such inspections.¹⁸⁵ At the July meeting of the Strategic and Economic Dialogue, U.S. Treasury Secretary Jack Lew announced that Chinese regulators had agreed to turn over to the SEC certain requested audit work papers of some Chinese companies listed on U.S. stock exchanges, a move that will assist the SEC in ongoing investigations.* However, no further progress has been made toward achieving more general direct access to documents for U.S. regulators conducting investigations or inspections. The May deal also permits China to withhold documents from the Public Company Accounting Oversight Board "on grounds of public interest or essential national interest."¹⁸⁶ As Mr. Gillis explained in a May 2013 Op-Ed for the *Wall Street Journal*, failure to resolve these issues more fully could lead the SEC and the Public Company Accounting Oversight Board to ban Chinese accounting firms from auditing U.S.-listed companies, which could in turn lead to Chinese companies being delisted from U.S. exchanges. However, this is a "nuclear option" that U.S. regulators are likely reluctant to pursue.^{187,188}

Implications for the United States

The rate of China's economic growth over the last 30 years, and its integration of a fifth of the world's population into the global economy, has profound implications for economic growth and job creation in the United States. China is currently America's third-largest export market and its fastest-growing export destination. U.S. exports to China have increased sixfold since 2001, with 48 states experiencing at least triple-digit growth in their exports to China and 20 states experiencing quadruple-digit growth. That is seven times the pace at which U.S. exports to the rest of the world have increased over the same time period.¹⁸⁹ However, the growth of U.S. imports from China still far surpasses this growth in exports to China. (For further discussion of the deficit, see chap. 1, sec. 1, of this Report.) A more consumption-driven Chinese economy would mean an expansive growth in Chinese demand for American products and services. But China lacks the modern and sophisticated financial sector needed to accomplish the shift to greater domestic consumption.¹⁹⁰ Without a more open and mar-

* Achieving direct access to documents that the Big Four auditing firms have refused to turn over will aid the SEC in moving forward with its investigations into certain Chinese companies listed on U.S. exchanges, including specifically the Deloitte-audited company, Longtop Financial. As of the drafting of this Report, the SEC's administrative trial against Chinese affiliates of Deloitte and the other Big Four audit firms in response to their refusals to turn over audit documents is ongoing. The presiding judge has reportedly requested a 100-day extension in the case, pushing the due date for a decision to January 7, 2014.

ket-oriented financial system, China cannot deliver on its promised economic rebalancing, and the costs of the imbalances in the U.S.-China economic relationship will continue to accrue.

While available measures indicate that China's shadow banking sector remains smaller than that of the United States, its size relative to China's formal banking sector continues to expand, and Beijing's efforts to curb the risky lending in this sector to date may perversely be fueling it. Expressing concerns about wealth management products in January 2013, Xiao Gang, former chairman of the Bank of China and current head of the Chinese Securities Regulatory Commission, reportedly characterized the shadow banking sector as "a potential source of systemic financial risk," whose model is "fundamentally a Ponzi scheme."¹⁹¹ In September, the G20 echoed this view when it endorsed new global rules for shadow banking issued by the Financial Stability Board.¹⁹² While the potential risks of China's shadow banking sector are not fully understood, to the extent that it poses systemic risks to China, it is fair to surmise that it poses risks for international financial stability more broadly. It is in the interest of the United States for Beijing to succeed in its efforts to curb risky, off-balance-sheet lending and establish greater regulatory control over nonbank financial institutions.

China's opaque policies and practices with regard to corporate accountability present serious challenges for U.S. companies and U.S. investors seeking information on the risks entailed in their transactions.

Conclusions

- The Chinese economy weathered the first few years of the global economic downturn by doubling down on its time-tested strategy of funneling capital into domestic development projects. But five years on, global demand for Chinese exports remains too weak to sustain the country's factories, much less new ones, and the merits of massive infrastructure projects have more than run their course. The policy decisions that kept the Chinese economy chugging over the last few years have also sped it closer to a reckoning that economists have long forecast would eventually be necessary.¹⁹³ If a rebalancing of the U.S.-China economic relationship is to be achieved, China must reform its financial system to support newer, nonstate sources of economic growth, which will require that China's banks better service its private sector.
- As long as China's official, regulated channels of credit do not possess the flexibility to meet the needs of the Chinese economy's main job creators, China will be at risk of depressed economic growth, which in turn may limit the growth of U.S. exports to China and the prosperity of U.S. investments in China, slowing economic recovery here at home. The shadow banking system that Beijing has allowed to step into this credit gap is insufficiently regulated and, if left unchecked, will pose an increasingly serious threat to Chinese and global economic stability.

- The opacity of Chinese corporate governance and accountability policies, as well as conflicts with U.S. securities laws and regulations, hurts investor confidence in Chinese companies trading on U.S. exchanges. The current situation threatens U.S. investors with unforeseeable and unmanageable losses and may lead to a broad delisting of Chinese companies. China's lack of sophisticated banking, corporate governance, and auditing policies and practices also hinders much-needed growth and opportunity for the very U.S. financial services firms that could help China to restructure its system if they were allowed greater access to the Chinese market.
- Insufficient transparency and accountability in China's financial sector put U.S. firms at risk of violating laws in both China and the United States; pose unreasonable hazards for U.S. investors with shares in Chinese companies; and render some U.S. laws and regulations unenforceable. Without greater regulatory transparency and assurance of China's regulatory, oversight, and enforcement capabilities, Chinese firms also risk curtailment or even revocation of access to the U.S. market.

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