



SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM  
OF THE 21ST CENTURY:



AN AGENDA FOR CHINA AND THE UNITED STATES  
HALF MOON BAY, CA • JUNE 22 - 24, 2007

**FRIDAY, JUNE 22**

- 6:00-6:05 **GREETINGS** – Ballrooms III & IV  
Hal S. Scott, Program on International Financial Systems, Harvard Law School  
LU Mai, Secretary-General, China Development Research Foundation (CDRF)
- 6:05-6:45 **KEYNOTE ADDRESS** – Ballrooms III & IV  
WU Xiaoling, Vice Governor, People’s Bank of China  
Clay Lowery, Assistant Secretary for International Affairs,  
U.S. Department of the Treasury
- 6:45-7:45 Cocktail Reception – Hallway outside Ballroom and Terrace
- 7:45-9:30 Dinner – Ballrooms I & II
- 9:30-12:00 After-Dinner Cocktails – Pacifica

**SATURDAY, JUNE 23**

- 7:15-8:00 Breakfast – Hallway outside Ballroom and Terrace
- 7:15-8:00 Reporters and Panelists Breakfast Meeting – Miramar 1
- 8:00-8:10 **WELCOME & OPENING REMARKS** – Ballroom/Salon III & IV  
Hal S. Scott, Program on International Financial Systems, Harvard Law School  
LI Jiange, Vice minister, Development Research Center, State Council, China
- 8:10-8:30 **PANEL SESSION** – Ballroom/Salon III & IV  
**Topic 1: The Process of Financial Change in China and the U.S.**  
China Panelist: ZHANG Bingxun, General Manager,  
Financial Institutions Department, Bank of China  
U.S. Panelist: Steven Butters, Partner, Deloitte & Touche LLP

- 8:30-9:55 **SMALL GROUP SESSIONS**
- | <i>Group</i> | <i>Facilitators</i>             | <i>Reporter</i>   |
|--------------|---------------------------------|-------------------|
| 1            | FAN Yonghong, Catherine Simmons | PEI Changhong     |
| 2            | CHANG Richard, John Allison     | Emily Altman      |
| 3            | LIU Manhong, Elaine La Roche    | Alicia Ogawa      |
| 4            | ZHANG Bingxun, Roger Servison   | William Grimes    |
| 5            | ZHOU Yuan, Iris Chan            | Christopher Wells |
| 6            | DING Wei, David Stoughton       | Peter McKillop    |
- 9:55-10:05 Refreshment Break
- 10:05-11:35 **PANEL SESSION – PLENARY DISCUSSION ONLY** – Ballroom/Salon III & IV  
**Topic 3: Joint Ventures and Private Equity in and by China**
- China Panelist: WANG Jianxi, Vice Chairman, Central SAFE Investments Ltd  
China Panelist: CHEN Zongsheng, Deputy Secretary General, Tianjin Municipal Government  
U.S. Panelist: Richard O’Toole, Managing Director, Goldman Sachs International  
U.S. Panelist: Jack Wadsworth, Advisory Director, Morgan Stanley Asia Limited/Morgan Stanley
- 11:35-1:00 Lunch – Ballroom/Salon I & II  
**KEYNOTE ADDRESS**  
*Introduced by ZHU Levin, CEO, China International Capital Corporation Ltd.  
LI Haiyan, Economic Counselor of the Chinese Embassy in USA*
- 1:00-1:20 **PANEL SESSION** – Ballroom/Salon III & IV  
**Topic 2: Reform of the Capital Markets in China and the U.S.**
- China Panelist: ZHU Xiaohuang, Chief Regulatory Officer, China Construction Bank  
U.S. Panelist: Carmen Chang, Partner, Wilson Sonsini Goodrich & Rosati
- 1:20 -2:45 **SMALL GROUP SESSIONS**
- | <i>Group</i> | <i>Facilitators</i>         | <i>Reporter</i>   |
|--------------|-----------------------------|-------------------|
| 1            | FAN Yonghong, Satoru Murase | PEI Changhong     |
| 2            | CHANG Richard, Paul Speltz  | Emily Altman      |
| 3            | LIU Manhong, Jeffrey Shafer | Alicia Ogawa      |
| 4            | ZHANG Bingxun, Ann Shuman   | William Grimes    |
| 5            | ZHOU Yuan, Clarence Kwan    | Christopher Wells |
| 6            | DING Wei, Arthur Mitchell   | Peter McKillop    |
- 3:00-6:00 Free Time
- 3:00-6:00 Reporters’ Meeting – Montara

- 6:00 -6:40     **KEYNOTE ADDRESS** – Ballroom/Salon III & IV  
 Robert Hormats, Vice Chairman, Goldman Sachs (International);  
 Managing Director, Goldman Sachs and Co.
- 6:40-7:40     Cocktail Reception – Gazebo Lawn
- 7:40-9:30     Dinner – Gazebo Lawn
- 9:30-11:00    After-Dinner Cocktails – Miramontes Room and Terrace

**SUNDAY, JUNE 24**

- 7:15-8:00     Breakfast – Hallway outside Ballroom and Terrace
- 7:15-8:00     Reporters and Chairs Breakfast Meeting – Miramar 1
- 8:00-9:00     **PRESENTATION & DISCUSSION** – Ballroom/Salon III & IV  
**Topic 1: The Process of Financial Change in China and the U.S.**  
 China Chair: ZHANG Guangping, Deputy Director General,  
 Supervisory Cooperation Department for Banking Innovation,  
 China Banking Regulatory Commission  
 U.S. Chair:   Stephen S. Roach, Chairman, Morgan Stanley Asia
- 9:05-10:05    **PRESENTATION & DISCUSSION** – Ballroom/Salon III & IV  
**Topic 2: Reform of the Capital Markets in China and the U.S.**  
 China Chair: LIU Xinhua, Assistant Chairman,  
 China Securities Regulatory Commission  
 U.S. Chair:   Peter Fisher, Chairman - BlackRock Asia, BlackRock, Inc
- 10:05-10:15   Refreshment Break
- 10:15-11:15   **PRESENTATION & DISCUSSION** – Ballroom/Salon III & IV  
**Topic 3: Joint ventures and Private Equity in and by China**  
 China Chair: WANG Jianxi, Vice Chairman, Central SAFE Investments Ltd  
 U.S. Chair:   Ellen Pao, Partner, Kleiner Perkins Caufield & Byers
- 11:15-1:30    Closing Lunch – Ballroom Terrace

# SYMPOSIUM REPORT

BUILDING THE FINANCIAL SYSTEMS OF THE  
21<sup>ST</sup> CENTURY:  
AN AGENDA FOR CHINA & THE UNITED  
STATES

JUNE 24-26, 2007  
HALF MOON BAY, CALIFORNIA



**BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY:  
AN AGENDA FOR CHINA AND THE U.S.  
HALF MOON BAY, CALIFORNIA, JUNE 22-24, 2007**

The fourth annual China-U.S. Symposium was held in Half Moon Bay, California. Sessions addressed the process of financial change in China and the United States, reform of capital markets in the two countries, and the role of joint ventures and private equity in and by China. As in previous meetings, participants recognized considerable progress in the infrastructure, regulation, and functioning of China's financial markets. They also expressed confidence not only that China's financial markets constituted a major opportunity for Chinese and foreign investors, but also that continued progress would contribute to the development and restructuring of the Chinese economy as a whole. With regard to U.S. financial markets, there were concerns expressed about the possible effects of costly regulation and litigation, as well as regulatory fragmentation.

## Session I: The Process of Financial Change in China and the United States

Discussion in Session 1 ranged over a variety of topics. With regard to China, these included the banking system, corporate governance practices, and the extent to which the financial system as a whole has served China's economic needs. With regard to the United States, topics addressed included the expansion of Chinese financial institutions into U.S. markets and the implications of direct investments by China's newly-established sovereign wealth fund.

### **CHINESE BANKING SYSTEM**

Participants agreed that China's banking system has continued to improve in terms of supervision, bank practices, and competition. There was a strong consensus that many aspects of the Chinese banking system were unrecognizable compared to ten or even five years earlier. That said, participants also highlighted a number of important concerns, including lack of market discipline, scarcity of human resources, poor risk management, lack of a credit culture, and continuing barriers to foreign participation.

#### *Market Discipline*

Many participants were particularly concerned about lack of market discipline in the Chinese banking system. The analysis focused on four factors: poor disclosure, the unreliability of stock prices as an index of value of banks and firms, the lack of effective markets for corporate control, and the continuing dominance of the state-controlled banks over banking nationwide.

Participants agreed that market discipline was essential to creating a robust and stable banking system that allocates capital efficiently. Non-transparency was seen to be one key factor in reducing the effectiveness of market forces. Weak disclosure rules were seen to make it difficult for outsiders to understand the economic performance of banks, and a number of participants suggested that there was likely much more risk on banks' balance sheets than was being disclosed. Moreover, poor disclosure by borrowers was seen to weaken banks' ability to evaluate creditworthiness, so that the banks themselves could not properly gauge their own performance. Non-transparency of rules – or, more importantly, interpretation of rules by regulators – was seen as compounding the problems of information.

Participants also argued that China's capital markets did not contribute sufficiently to disciplining bank management. Most importantly, they argued that stock prices were not a consistently useful indicator of actual bank, or corporate, performance. The lack of a clear connection between performance and stock price was seen to reduce pressure on managers to improve their performance as well as incentives for shareholders to demand better performance.

Some participants went further, arguing that in the absence of a market for corporate control (in other words, a market for corporate takeovers), no meaningful market discipline could be expected. In this regard, the continuing dominant role of state ownership in the banking sector was seen as particularly problematic – not only would it prevent takeover bids, but it raised the possibility that banks might operate on the basis of satisfying state- or party-determined objectives rather than economic criteria. Given the consensus that this sort of lending had been a major factor in Chinese banks' earlier accumulation of non-performing loans (NPLs), this was a serious concern.

### *Management of Risk*

Another major issue was the ability of Chinese banks to effectively manage risk. Despite consensus that the banks' capabilities and practices have been improving, many participants worried that progress had not been fast enough to keep up with changing conditions, and that this might reduce system stability in the event of an economic downturn.

A primary concern was the lack of pricing of risk. While some participants pointed hopefully to the increased latitude for banks to adjust lending rates to take risk into account, others argued that the actual scope for balancing risk and return was minimal at best. Perhaps more importantly, many argued, the long-standing practice of centrally-set interest rates encouraged highly risk-averse behavior by banks and lending officers. Without the ability to price risk into interest rates, lenders could only lose by choosing riskier but economically promising borrowers over very conservative ones. Thus, bank lending was seen to be skewed toward large state-owned enterprises with implicit government guarantees and, to a lesser extent, collateralized loans such as mortgages. The difficulty of obtaining bank lending for small and medium-sized enterprises (SMEs) was seen to mean that those firms would have no alternative to obtaining financing at higher rates and shorter terms on the curb markets; moreover, they would not be able to grow as quickly as would be ideal for them or for the economy as a whole.

In this regard, a number of participants argued that adequate credit opportunities must be developed for SMEs and consumers. They saw this not just as a challenge, but also as an opportunity for developing new business sectors. Still, they felt that existing regulations and incentives made it unattractive for banks to try to address those potential markets.

Another issue that was raised with respect to risk was the lack of "risk-spreading mechanisms." For example, a number of participants argued that the development of asset-backed securities markets would allow banks to better manage their risk by severing the link between loan origination and management of loan risk. Others pointed to the need for a better-developed bond market that would allow for maturity matching between assets and liabilities. Some participants were skeptical about the prospects for developing these markets quickly, however. (Bond markets were addressed at greater length in Session 2.)

More fundamentally, information on risk was seen to be lacking. Without basic data in place, proper measurements of a given bank's risk exposure would be impossible. Thus, a number of participants voiced doubts about whether China's official target of implementing Basel-2 by 2010 was realistic.

A final concern raised in relation to banks' risk management had to do with under-diversification. One aspect of this concern was that banks are overly dependent upon income from lending, with much smaller revenue being derived from alternative financial products and fee-based services. Combined with the aforementioned argument that banks have been lending to a limited subset of potential borrowers, the overreliance on loan-based revenue was seen to create significant risk if large companies or the real estate markets experience a significant downturn. It was also pointed out that the loan portfolios of the big-four banks are highly similar (at least partly due to regulatory restrictions), meaning that such risk would be systemic and not just confined to a single financial institution. Finally, the high level of concentration within the banking sector was flagged by some participants as an issue of systemic risk as well as a constraint on competition.

### *Foreign Role*

There was also considerable discussion of the role of foreign financial institutions in the Chinese banking sector, although not as extensive as in the 2006 Symposium in Tianjin. Participants addressed two roles: strategic investments in major banks and the entry of fully-owned bank branches as of 2007. The general consensus was that the foreign role has heretofore been limited due to entry barriers.

With regard to strategic investments, many participants with direct experience strongly expressed the feeling that the investments had had beneficial effects on the management of Chinese banks. In particular, they believed that use of information technology, risk management, and internal controls in foreign-invested banks had improved significantly beyond what would have been possible under alternative scenarios. Some other participants expressed skepticism, however, arguing that the minority stakes held by foreign financial firms did not provide enough control to fundamentally change the incentives of bank managers, let alone lending officers. They felt that in cases where there was a clash of interests, the foreigner would always lose, given the dominant position of the state as shareholder.

With regard to the entry of fully-owned branches, discussion was necessarily more provisional, since such branches had only become legal less than six months earlier. It was noted that applications for branches appeared to be moving forward, if in some cases slowly. Participants were cautiously optimistic that the reforms would work as written. If that were the case, some argued, foreign financial institutions could inject some much-needed competition and innovation into the Chinese banking sector. Others were more pessimistic, however, expressing skepticism that foreign banks would be able to function effectively in the Chinese context.

### *Scarcity of human resources*

Finally, a number of participants, especially those from the private sector, worried about the lack of human resources. They felt that the increase in the number of highly-trained personnel was not keeping pace with the expansion of hiring needs in the growing Chinese financial sector. The problem was seen as broadly-based – including not just personnel in financial institutions, but also in legal services and auditing and, perhaps most crucially, in the regulatory agencies.

## **CORPORATE GOVERNANCE**

Corporate governance of both banks and corporations in China remained another concern for many participants. This was discussed in terms not only of a traditional focus of corporate governance, which concentrates on the relationship between shareholders and management, but also of state ownership and internal controls.

A key issue for many participants was that the principal of shareholder control, which is generally seen to be a positive factor in corporate governance, has different implications in China than in the United States, due to the preponderance of companies in which there exists a controlling shareholder. There were concerns raised as to whether the rights of minority shareholders were being adequately protected on a legal and practical basis. An important factor for Chinese corporations – and especially Chinese banks – is the fact that the state is often the controlling shareholder. (The term “state” was used generically, to refer not only to ownership by the central government, but also ownership by provincial and municipal governments, etc.) A number of participants found the role of the state as controlling shareholder particularly troublesome, arguing that (1) banks and corporations may be used as instruments of state policy rather than in the economic interests of shareholders as a whole, and

(2) that minority shareholders could expect less recourse if they were unhappy with the actions of the controlling shareholder when it was the state than if it was a private sector actor.

Turning to more standard issues of corporate governance, two main topics were discussed. First, a number of participants felt that the role of boards remained ambiguous, often leaving managers with great latitude. They expressed particular confusion at the division of responsibilities between boards of directors and boards of supervisors. Although there are some legal guidelines as to how responsibilities are to be divided, they argued that in practice the division varies considerably by firm. In cases where responsibilities overlap, this was seen to create confusion and contention between boards and with management. In other cases, gaps were seen in boards' oversight, leaving important decisions to the discretion of management.

Second, there was discussion of the misalignment of manager and shareholder interests. It was argued that top executives in Chinese banks lacked the incentive to maximize shareholder interests because of the ways in which they are hired and paid. In terms of hiring, it was pointed out that the selection of top executives is essentially similar to appointment of senior officials – drawn from a limited pool, and based on opaque standards. In terms of pay, it was pointed out that even top bank executives are paid salaries, and that performance-based pay (whether bonuses, stock grants, or stock options) is unheard of in the major banks. Moreover, many of the foreign participants were surprised to learn that the overall compensation packages of big-four bank presidents, inclusive of health and other benefits, was approximately RMB 1.5 million (around \$200,000) per year. They felt skeptical that this would be enough to retain the best possible managers or performance, particularly of firms with the size and complicated management problems of the state banks.

A final concern in the general area of corporate governance was over internal controls. It was argued that Chinese banks and corporations have insufficient ability to monitor, and thus control, the actions of employees, particularly in cases where operations are geographically dispersed. This was seen as a serious problem for the major banks, with over 10,000 domestic branches and offices apiece (over 30,000 for the Agricultural Bank of China). Indeed, it was suggested that these banks might more accurately be seen as loose confederations of branches than as unitary financial institutions. Since those branches might well have different incentives than headquarters, some argued that they are likely to pay more attention to the preferences of local governments and other powerful actors than to the dictates of the head office. Other participants argued that the situation was improving considerably, and that this was indeed one of the major accomplishments of strategic investors. But questions remained as to whether it was improving quickly enough, given the rapid expansion and internationalization of the big banks.

## **MACRO ISSUES**

Looking at Chinese finance from a macro perspective, participants agreed that the growth prospects of the Chinese economy meant that opportunities would continue to abound in the financial sector. They also agreed that the need to service existing and new business segments would continue to drive reform, change, and innovation in Chinese finance. In discussing the current situation, a number of macro issues were highlighted that were seen as necessary for the Chinese financial system to deal with. These issues constituted both challenges and opportunities for change and improvement.

### *Allocating Capital*

Most fundamentally, participants felt that the financial system needed to continue to improve its ability to carry out its basic function of allocating capital in an economically efficient manner. The challenge described was two-fold: to extend the reach of the formal financial system to better address the needs of currently credit-constrained households and firms, and to more adequately balance risk and return within financial institutions and across the economy.

A number of aspects of expanding the scope of the financial system were dealt with in Session 2, but in Session 1 a major focus was on the lack of consumer and SME credit. Many participants argued that improving SME and households' access to credit would be a profitable business niche to fill, if only Chinese financial institutions were to develop a "credit culture," whereby loans were made on the evaluation of future income prospects rather than based on collateral or the expectation of a bail-out. Others were more skeptical, arguing that at least in the short- to medium-term, the information and institutions needed to make large-scale consumer lending attractive – such as default rates, consumer credit reporting agencies, and full-file credit reporting – would be unavailable.

The lack of formal financial opportunities for uncollateralized small borrowers was seen as a problem from a macro point of view as well. A number of participants worried that credit constraints on SMEs would tend to reduce their dynamism – potentially a major problem, since so much economic activity revolves around SMEs.

Credit constraints on consumers corresponded with the major Chinese macroeconomic issue identified by virtually all participants: excess savings. Participants agreed that one of the major macroeconomic challenges for China will be to decrease its reliance on external demand in order to continue to grow rapidly; greater access to consumer credit might induce credit-constrained households to spend more, reducing net savings. (It was also pointed out that improvements in social insurance would likely reduce precautionary savings, which was held to account for at least part of Chinese people's high savings.)

Some participants also argued that savers should have access to a greater variety of investment choices. (This point was also relevant to discussions in Session 2.) They pointed out that savers currently had few choices other than low-returning bank deposits, volatile equity markets, and real estate. It was suggested that the limited variety of debt instruments might be fueling both equity and real estate bubbles. These participants expressed the hope that overheating of asset prices might provide an impetus for more rapid introduction of financial products.

Another macro concern had to do with the lack of interest rate flexibility. As noted above, banks' lack of leeway in lending rates makes proper risk-adjusted pricing of debt virtually impossible. Thus, some relatively risky borrowers may be paying too low a price for access to credit through banks. Risk-adjusted pricing does take place in the informal lending markets, but there the lack of legal protections means that firms are likely paying excessively high interest rates. Overall, this was seen to add up to mispricing of capital throughout the system, presumably meaning less efficient allocation of capital. Some participants argued that although China is growing very rapidly based on extremely high investment rates, the overall return on investment is actually quite disappointing and indeed China could be growing even faster with more efficient allocation of capital.

### *Competition and Pace of Change*

Two additional points were made regarding the pace of change from an overall perspective. First, some participants expressed concern that lack of competition in Chinese finance, and especially banking, might slow the evolution of Chinese financial markets. It was noted that banking is highly concentrated, and that the major banks are able to benefit from formal and informal restrictions on competition. Given the political power of the major banks resulting from both their sheer size and the state role in ownership, concerns were expressed that restrictions on competition may persist. There was also a concern that new activities and products might also open more slowly than would be optimal, in order to accommodate the preferences of the major banks as they move away from their preoccupation with domestic lending.

A number of participants felt particularly strongly about the importance of allowing for more competition from foreign financial institutions. While some acknowledged self-interest, it was also pointed out that the foreign financial institutions had the most to offer in terms of financial product innovation, marketing, and risk management. Many participants felt that a decision to insulate domestic banks from foreign competition would be a grave mistake that could lead to financial inefficiency and instability, paralleling mistakes that Japan had made in the 1970s, 1980s, and 1990s.

The second point regarding pace of change was a paradoxical one. There was a sense among some participants that the extremely rapid pace of change was actually making it more difficult to formulate policies to regulate and promote the financial sector. Although few if any participants seemed to believe that the answer would be to slow down innovation, competition, and change, they expressed unease about the ability of regulators, financial institutions, and investors to keep up.

### **EXPANSION INTO U.S. MARKETS**

Turning away from conditions in the Chinese financial markets, participants also discussed the entry of Chinese financial institutions into foreign, especially U.S., markets. Two issues were discussed in this regard: Chinese financial institutions' business strategies and claims of discrimination by U.S. regulators.

Regarding business strategies, there was some discussion of the circumstances under which Chinese financial institutions should be attempting to enter U.S. markets. While participants generally agreed that Chinese banks were overly exposed to their domestic markets and that the most practical way of expanding overseas would be to service their existing customers as those customers expanded their own overseas operations, a number of participants suggested caution was in order. They argued that Chinese financial institutions were not yet as sophisticated as their foreign counterparts, and that they could easily find themselves in trouble in a highly competitive financial environment like that in the United States. Some drew an analogy with Japanese financial institutions in the late 1980s, which were able to expand very rapidly on international markets due to their sheer size and access to low-cost capital at home, but never earned large returns and in some cases even got into serious trouble. Those participants warned that Chinese financial institutions would do better to postpone their inevitable overseas expansion until they had solidified internal controls and expertise and had more experience operating in competitive domestic markets.

The subject of expansion of Chinese banks into U.S. markets also occasioned a very heated debate on what some participants termed "discrimination" by U.S. regulators. They cited examples of major Chinese banks that had spent years (in one case, over a decade) attempting

to get their applications for U.S. bank branches approved by regulators. They argued that banks of equivalent quality from other economies had experienced many fewer roadblocks, and expressed their sense that regulators were treating Chinese banks differently. Some expressed particular frustration over what they felt were ambiguous and constantly shifting standards, saying that whenever they addressed one set of regulatory concerns, another would arise.

The allegation of discrimination was not universally held among participants. Some participants, particularly those involved in U.S. banking regulation, argued that the standards were in fact very clear, and the Chinese banks had not yet met them. In particular, the requirement of effective consolidated financial supervision was identified as a challenging one for China. Others were sympathetic to the travails of the Chinese banks, but rejected the claim of specific discrimination, arguing instead that all foreign banks have a much harder time getting access to the U.S. market than domestic entrants.

Regardless of how participants interpreted the difficulties of Chinese banks in gaining U.S. licenses, however, there was a general sense that this was the sort of issue that could have political resonance in both countries. Moreover, given the massive extent of China's current account surpluses and the need to recycle them through ongoing and large-scale foreign investment, it was generally expected that such concerns would increase over time unless they were effectively managed through inter-governmental processes.

## **SOVEREIGN WEALTH FUNDS**

A final subject of discussion in Session 1 was the emergence of sovereign wealth funds, particularly the new Chinese fund that was in the process of being created. Several concerns were raised about sovereign funds in general and the Chinese fund in particular, in addition to questions about how such funds should be managed. It was also acknowledged that this was likely to become an important political issue in both the countries that maintain sovereign wealth funds and those that receive investment from them. In this regard, there was some discussion about the recent Blackstone transaction, and its potential political implications.

### *Economic Concerns*

Three major concerns were raised about sovereign wealth funds from an economic perspective: their origins in excess foreign exchange reserve accumulation, the possibilities of mismanagement of the investment capital, and crowding out of private investment. The first concern dovetailed with a broader issue that underlay much of the discussion at the Symposium, that of global imbalances. While some sovereign wealth funds were understood to be a means of managing commodities-based revenues, most (including China's) reflect states' currency management. In the case of China, its massive foreign exchange reserves were seen to reflect an overvalued RMB that contributed to large current account surpluses, combined with a system of capital controls that ensured that the vast bulk of the foreign exchange accrued through those surpluses remained in the hands of the state. A number of participants felt that the imbalances themselves needed to be addressed at least as urgently as whether or how sovereign wealth funds were to operate.

Turning to the management of investments, concerns were raised as to competence, transparency, and the potential for politicization. The first of these was straightforward: Would officials be able to make the most efficient use of these potentially vast sums? While Singapore's Temasek was held out as a model, it was not seen as guaranteed that its success could be replicated in China, given both the rapid accumulation of funds and the relative lack of sophistication of its financial sector. It was pointed out that sovereign wealth funds in other countries did not necessarily have an excellent track record. Certainly, it would be expected

that much of the actual investment and planning would be carried out by private sector managers, but it was pointed out that oversight and evaluation of funds of this nature was itself a challenging task.

Transparency of management was another issue – participants appeared unanimously to share the view that some level of transparency would be important for the effective management of sovereign wealth funds. Economically, the concern was that lack of transparency would make objective evaluation difficult, and thus shield managers from pressures to maximize profitability or even allow them to cover up losses. Politically, transparency about objectives was seen as particularly important from the point of view of countries in which the fund would be investing. This point linked with concerns over whether the fund might be managed (or be perceived as being managed) to achieve political rather than economic ends.

A final point raised was the possibility of crowding out of private investment. Most participants appeared skeptical that this would be a major problem on a macro level. However, there were some concerns about whether the sheer size of the Chinese fund might make it an unfair competitor. Here again, most participants appeared to disagree, arguing that as long as the fund purchased assets based on accurate valuations, crowding out would not be important. As noted, however, there was some skepticism about the ability of the fund to operate on such a basis.

#### *Political Concerns*

For many participants, economic concerns were dwarfed by political concerns, both about the possible uses of the Chinese sovereign wealth fund and U.S. perceptions of the fund. The first issue was whether the fund might be used to further political goals of the Chinese state. Possible political ends might include access to defense or dual-use technology, preferential treatment for Chinese firms, or influencing political debate by taking stakes in politically-connected firms in the U.S. and elsewhere.

Even participants who did not see such politicization as a major issue *per se* expressed concerns about the ways in which U.S. public opinion and the Congress might perceive investments. Part of this would have to do with the actual targets of Chinese sovereign wealth fund investment – as seen in the investment in Blackstone (which holds equity stakes in some defense contractors) and the attempted investment of CNOOC in Unocal, even tangential connections to security could be taken as threatening.

One way or another, however, most participants appeared to agree that sovereign wealth funds were something with which the United States would have to learn to live with, as a result of overseas accumulation of dollar reserves and the its own needs for massive capital inflows. Three main suggestions were made for reducing the actual and potential political fallout of the rise of sovereign wealth funds. First, it was agreed that such funds would need to be managed on an economic, rather than political, basis. Second, transparency concerning goals and operations was seen as essential for reassuring the American public and elected officials that this was indeed the case. Third, some participants argued that concerns over such funds could only be reduced if global imbalances and excessive accumulation of dollar reserves could be addressed in a multilateral manner.

With regard specifically to China's reserves and sovereign wealth fund, some suggested that a better use of the money would be for domestic public spending on infrastructure and social safety net programs. While they acknowledged that dollars could not be used directly for

those purposes, they argued that increased public sector spending would reduce China's excess savings, thus reducing at least the pace of accumulation of foreign exchange reserves. Even if that were to occur, however, it was recognized that the massive stock of existing foreign exchange held by the Chinese government would inevitably need to be managed in a productive manner.

## Session II: Reform of the Capital Markets in China and the United States

Session 2 looked at the development of capital markets in China and the United States. In this session, there was considerable discussion over the successes and failures of U.S. capital markets, with a particular focus on perceived problems of regulation and litigation. Discussion of U.S. markets suggested reform agendas for both the United States and China. With regard to Chinese capital markets, there was a particular focus on bond markets. The discussion revisited a number of themes that had been discussed in Session 1, including problems of enforcement and information.

### **UNITED STATES**

The U.S. capital markets have long been held up as an example to other countries as the deepest, most liquid, most innovative, and most efficient in the world. But Symposium participants raised a broad range of issues that they argued were reducing the competitiveness and attractiveness of the United States as a center for global finance. While some aspects of the U.S. system were still seen by most participants as the global standard, many felt that other systems – particularly that of the U.K. – were more worthy of emulation. Participants saw defects in the U.S. system as important not only for the United States, but also as an object lesson for Chinese regulators as they seek to create efficient and attractive capital markets at home.

The concerns about the U.S. capital markets were not about market operations or the competence of financial institutions. Rather, they were about the politics and policies that affect capital markets, increasing costs and uncertainty for market participants. It was argued that in an era of financial globalization, more and more businesses would prefer to list their shares in more attractive markets such as London, and financial institutions as well would prefer to do business in lower-cost and less-cumbersome regulatory environments.

#### *Regulatory Environment*

Several regulatory issues were seen as creating unnecessary costs in U.S. capital markets, particularly requirements of the Sarbanes-Oxley Act (SOX), regulatory fragmentation, and excessive exposure to lawsuits. In addition, some participants expressed frustration about rule-based, as opposed to principles-based, regulation.

Complaints about SOX were voiced by virtually all participants with direct experience in U.S. capital markets. Although the SEC implementation of Section 404 (which mandates internal controls) came in for particular criticism, participants also voiced displeasure with SOX's mechanistic requirements regarding organization of boards of directors and provisions regarding corporate auditing and accounting. It was pointed out that the costs imposed by these requirements are particularly onerous for smaller firms, due to the high fixed costs. Many participants argued that they also have a major impact on foreign companies' decisions on whether to list in the United States or elsewhere – even if the costs would be relatively small compared to revenues, the difference between U.S. costs and those of other (e.g. U.K.) markets would be significant enough at the margin to make them prefer the alternatives.

A second major complaint was over regulatory fragmentation. In contrast to a U.K.-style unified regulator, U.S. financial markets are overseen by a variety of state and federal regulators, depending on specific functions and locations of activity. Maintaining compliance with all the relevant (and sometimes apparently contradictory) rules was seen by many participants as burdensome and costly.

Finally, the U.S. legal system was seen as creating unnecessary costs and risks for firms operating in the capital markets. A big component of this was what participants perceived as excessive ease of filing class-action and shareholder-derivative lawsuits, and the high degree of uncertainty as to jury decisions and awards for such suits. They argued that exposure to such lawsuits was very costly in terms of the risk of judgments, legal fees, and settlements out of court even where suits were not seen as justified. Some participants also saw the use of the court system by some states' attorneys, such as various actions in New York State under former Attorney General (now Governor) Eliot Spitzer, as having a chilling effect on legitimate corporate and financial activity.

### *Policymaking and Politics*

While much of the discussion of defects in the U.S. regulatory environment addressed the problems themselves, there was also some discussion of how U.S. politics and patterns of policymaking were seen to contribute to their persistence. Among the concerns highlighted were lack of cost-benefit analysis, crisis-driven policymaking, and an outdated understanding of U.S. and global financial markets. Some participants also noted worries about what they saw as the emergence of financial protectionism, particularly toward China.

A key complaint about U.S. policies on the part of many participants was that they did not reflect cost-benefit calculations. This was seen as being in direct and unpleasant contrast to the policymaking of the U.K. Financial Services Agency. The problem was seen as greatest in the case of legislation, but participants also worried that autonomous regulatory agencies such as the SEC and the PCAOB also paid insufficient attention to balancing costs and benefits of regulation.

With regard to legislation, there was a general perception that it tended to be driven by crises. SOX was given as a prime example of a major piece of legislation that was rushed through in response to specific crises. Although legislators suggested that they would likely revisit and readjust the legislation as needed, many participants felt that SOX followed a typical pattern of overreaction followed by readjustments that were too slow and incremental to adequately address the situation. Particularly in a field that changes as rapidly as finance, this pattern was seen as inappropriate.

Most broadly, a number of participants expressed the belief that U.S. financial policymaking was based on a fundamental misunderstanding of financial markets, which are increasingly global and dominated by institutional investors. As already noted, the global nature of finance means that financial activities can easily leave the United States on the basis of cost considerations. Thus, the unwillingness or inability of U.S. legislators and regulators to seek to compete with foreign markets on a cost basis was seen as a basic weakness in the policymaking system. Some participants argued that policymakers also misunderstood the nature of domestic capital markets. They pointed in particular to what they saw as an excessive emphasis on protecting retail investors, whose access to information and analysis is more limited than institutional investors. They argued that the "classic retail investor" was in fact a myth, and that investment by small investors working without professional management or advising was a small portion of total investment in U.S. capital markets. Thus, they felt, it was not rational for concern over retail investors to be driving policy for the capital markets as a whole.

### *Lessons for China*

Given the nature of China's political system, several of the complaints about the United States were not seen to apply – for example, federalism is not an issue and legislation is not

dependent on expectations about the next election. However, participants did suggest a few lessons that could be learned from U.S. successes and failures. From U.S. successes, they argued that China's regulators should value free competition and transparency above the stability or interests of specific financial institutions or corporations. From U.S. failures, they argued against crisis-driven policymaking and in favor of cost-benefit analysis as the basis for capital market policymaking. There was also a general sense that an autonomous unified regulator would be an attractive long-term goal for China, and that in the mean time regulatory overlaps should be avoided and complementarity pursued.

## **CHINA'S NEEDS**

Although Chinese capital markets have grown rapidly, it was recognized that there are a number of important defects that need to be addressed if they are to become an efficient means of allocating capital and meeting the needs of investors and borrowers alike. Specific concerns raised included the lack of a yield curve, lack of basic instruments of risk management, insufficient variety of financial products, poor information, excessive role of the state as market player, and excessive volatility created partly by the composition of the investor base. Moreover, concerns were raised over regulatory overlap and bureaucratic competition among regulators within the state structure. While this constituted a comprehensive agenda, participants expressed their strong belief that if policies were handled correctly, China would become a major capital market for domestic and global actors.

### *Debt Markets and Risk Management*

The relatively undeveloped state of Chinese bond markets was a matter of particular concern for many participants, not only in terms of the development of capital markets but also in terms of the economy as a whole.

A key concern was that, in the absence of developed bond markets, there could be no meaningful yield curve. Although lending rates remain administered, as noted above, liquid government debt markets could create a mechanism for a transition to more flexible interest rates through the economy, which would accurately reflect societal actors time preferences and inflationary expectations. In this respect, developing a yield curve would also be essential to monetary policy as it continues to change into a more market-oriented system. Moreover, if and when high-quality ratings become available, the existence of a robust yield curve would make it possible for corporate debt markets to develop relatively quickly.

Bond markets were also seen to be important as a means of providing more investment and borrowing choices for Chinese firms and households. For the moment, households are largely confined to placing their savings in safe but low-yielding bank deposits or the volatile stock market. Access to bond markets could allow them to receive higher returns than in bank accounts, but with significantly less risk than in the stock market. They would also be able to match maturities to their own needs. Corporations would also benefit from access to lower-cost debt with a broader range of maturities.

Bond markets were also seen as essential for better risk management by all sorts of economic actors. Financial institutions such as life insurers and pension funds need to have access to high-quality, long-term debt securities in order to match their assets and liabilities and thus reduce risks both to policyholders and to the financial system as a whole. Other financial institutions would also benefit from effective bond markets as a means of managing and diversifying risk. In this regard, several participants emphasized that, although bond markets are often seen as substitutes for bank lending, banks could in fact benefit from the development of better bond markets. Not only would they be able to better match maturity and risk, but they

may also be able to benefit by selling financial products such as bonds and bond funds. In the longer term, banks could enhance risk management through securitization of loans.

The eventual development of bond-based derivatives markets was seen as an essential goal for the Chinese capital markets if they were to compete over the long term with more sophisticated capital markets elsewhere in the region and globally. It was argued that risk could be better managed and the system made more robust and stable if a full range of derivative products were available. Some participants urged caution in this regard, however, arguing that it was premature to think about derivatives and complex risk management strategies at a point where no meaningful yield curve exists, information on default risk is lacking, and most financial players remain unsophisticated. There was no clear consensus on the proper sequencing or timing of such liberalization, although participants appeared to agree on the long-term goal.

#### *Developing Bond Markets*

Based on their general agreement on the importance of the development of bond markets, participants spent time considering the question of how such development could be promoted. Discussion focused on liberalization, information and ratings, and the role of government bonds. Participants agreed that in the end the liquidity and depth of bond markets would depend on market forces, but felt that a clear commitment to creating a strong market infrastructure would be essential.

With regard to liberalization, it was noted that many restrictions apply to bond markets (as well as to capital markets in general). Participants pointed out the difficulties involved in actually issuing corporate bonds, restrictions on foreign financial institutions' participation in bond markets, and limitations on financial instruments such as asset-backed securities and bond options and futures. While there was a general agreement on the diagnosis, there appeared to be no consensus on sequencing and timing of liberalization: some participants called for cautious and incremental liberalization in deference to financial institutions' and regulators' lack of experience with handling sophisticated debt instruments, while others expressed concern that moving too slowly or in a piecemeal fashion would increase market distortions and actually impair the stability of capital markets.

The quality and quantity of information available to market participants was seen as a major concern for financial institutions. In addition to concerns over disclosure, participants argued that the operations and decision-making of both government and enterprises (whether privately- or state-owned) remained opaque, increasing uncertainty as to their current situation and future prospects. Moreover, it was noted that important data – such as default rates under various scenarios – had yet to be developed, adding to the general level of uncertainty regarding corporate bonds.

In addition to the general prescription of improving the quality of information, a number of market participants stressed the importance of the establishment of competent ratings agencies using consistent approaches to data. Without credible bond ratings for corporations, they agreed, the costs of calculating riskiness of debt instruments would be too high to merit meaningful secondary markets in them. While there was no clear statement on exactly how the Chinese government should go about fostering the development of ratings agencies, participants generally appeared to see a government role in their promotion.

Finally, participants agreed that the overall development of the bond markets – not to mention useful side effects such as a robust yield curve – would depend crucially on government bond issuance. The point was made that only government bonds could providing a

default-risk-free store of value; moreover, only the government would be capable of rapidly increasing quantity and variety of bonds outstanding in the overall debt markets. In this regard, many participants felt that the Ministry of Finance should be issuing more debt, in a broader range of maturities, on a more regular basis, and allowing markets to determine bond pricing.

## **STOCK MARKETS**

Participants agreed that China's equity markets were better developed than bond markets, but also raised some concerns. These included the quality of information available, the role of the state, and the composition of the investor base. In addition, there was some discussion about lessons that could be learned from Hong Kong.

With regard to information, the same points were made with respect to equity markets as were made with respect to bond markets and the financial system in general. These included the need to address deficiencies in disclosure and financial reporting, as well as to address lack of lack of robust data series and ratings agencies. The problems were seen as existing not only in formal rules, but also enforcement and corporate practice. Indeed, some participants argued that Chinese law is stricter on insider trading and stock manipulation than Hong Kong law, but that both are rampant in China due to poor enforcement.

Turning to the role of the state, participants pointed out that the state is involved in all aspects of Chinese stock markets, rather than being confined to regulation. State-owned enterprises remain by far the largest category of listed companies, state-owned banks have major interests in the development of stock markets, and state organs such as Central SAFE are major institutional investors. The incentives of the "state" point in all directions, and indeed many participants argued that it was not useful to think of the state as a unitary actor in financial markets. Nonetheless, there were concerns that market regulators might be swayed by the short-term needs of SOEs or banks in their decisions regarding oversight and liberalization. Moreover, the sheer scale of state investment funds was seen to make them a formidable force in markets, potentially distorting prices and transactions. It was argued that transparent and autonomous management, along the lines of how Central SAFE has developed, would be the best guarantee of non-intervention of policymakers.

Concerns about investor base went beyond the role of government investment funds. A number of participants expressed concerns about the predominance of small retail investors with minimal experience and sophistication. They argued that such investors were much less likely to act rationally than institutional investors, potentially leading to much higher volatility in equity markets as investors flocked to or abandoned specific stocks or the stock markets in general. They called for the creation of a much broader base of institutional investors, including not only foreign financial institutions, but also domestic asset managers, pension funds, and the like.

Finally, some participants suggested that Chinese authorities should take greater advantage of Hong Kong as a model for capital markets. In particular, they suggested that Hong Kong had maintained a better balance of regulation and market forces than other potential models such as the United States or Japan, and that it would be relatively easy to transfer knowledge and practices from Hong Kong to the mainland.

## **GLOBAL ISSUES**

Discussions of capital market development in China and the United States were also colored by the global context. As noted, global competition among exchanges animated much

of the discussion of U.S. markets. For China, the role of foreign financial institutions and the utility of existing models of regulation were also important.

While not an official topic of conversation, global imbalances were a recurring theme in speeches and as background to substantive discussions. Although participants acknowledged a number of benefits of Chinese surpluses – including China's contributions to non-inflationary world growth and global low interest rates – they expressed concern over their economic and political implications. Economically, many of the concerns were about the Chinese domestic economy, where excess liquidity and lack of exchange rate flexibility were seen as contributing to asset price bubbles and hampering monetary policy implementation. Additionally, there was some anxiety over how the global overhang of dollars in foreign exchange reserves might be unwound. Politically, much of the concern was over the possibility of financial protectionism in the United States, particularly aimed at China.

The most explicit discussion of global issues, however, revolved around regulatory harmonization. Some participants raised the broad questions of how far global standards could go toward creating full harmonization of regulation in all the major markets and whether that would be a positive or negative development. While there was no clear answer offered for either question, there were two general points of agreement. First, participants agreed that global consensus on basic principles would facilitate mutual recognition cross-nationally and would reduce transaction costs for internationally-active financial institutions. Second, they agreed that as Chinese markets grew in size and quality, it would become imperative for Chinese regulators to be involved in the creation and modification of global standards.

## Session III: Joint Ventures and Private Equity in and by China

In discussing the prospects for private equity and venture capital in China, participants looked at both opportunities for corporate restructuring and at whether existing regulations and capital markets would allow for profitable exit. The exit issue was considered in regard to both domestic and foreign actors, whose incentives were seen as likely to differ in some respects. With regard to the United States, there were some questions as to whether the private equity boom was likely to be sustained.

### **OPPORTUNITIES IN CHINA**

It was generally agreed that there are many potentially attractive opportunities for private equity, venture capital, and corporate joint ventures in China. This was due to partly to the need for modernization of management and production in many enterprises, the lack of financing options for smaller firms, and the remaining overhang of state-owned enterprises (including enterprises owned by provinces, municipalities, and townships). There were some participants who were skeptical about the ability of foreign private equity funds to function well in the Chinese economic and political context, but they too felt that there were significant opportunities.

One roadblock that was noted for private equity firms was the lack of an LBO market in China. Although not all global private equity firms have used the LBO as a primary means of acquiring businesses, it has been important for many. Several points were made about the difficulties of carrying out LBOs in China. First, culture was seen as necessitating friendly takeovers. Second, state owned enterprises, while in many cases presenting the best options for restructuring, were seen as particularly difficult to deal with due to the ambiguous legal status of various stakeholders. Finally, it was pointed out that financing was likely to be difficult to obtain, given the lack of any tradition of LBOs within China.

Other regulatory issues were seen as retarding the growth of private equity in China. One of these was the inability to form limited-liability partnerships, which only became legal in June and was thus not yet tested. Moreover, partnerships remain subject to an approval process, as do acquisitions and joint ventures with state-owned enterprises.

Although most private equity investment in China to date has been in large firms, many participants felt that for the time being the bigger market opportunities were to be found in start-ups and SMEs that lacked access to growth finance. Some suggested that venture capital would thus be more promising than traditional private equity. In some cases, domestic funds might have an advantage in terms of identifying attractive prospects and navigating the political, organization, and cultural aspects of restructuring or otherwise taking control of the direction of firms. However, it was noted that few such financial institutions have arisen to date. Some participants felt that foreign funds could provide an important demonstration effect for the development of domestic funds.

### **EXIT OPTIONS**

There was also considerable discussion over whether the current configuration of exit options was sufficient to make the Chinese market attractive for private equity and venture capital firms. From the standpoint of domestic private equity and venture capital funds, the key question was seen to be whether domestic IPOs would be feasible as a means of cashing out their investments. Foreign funds were seen to have to worry additionally about repatriation of funds, whether through international IPOs or by exchanging RMB gained in domestic IPOs.

Concerns over the feasibility of domestic IPOs boiled down to two factors. From a practical point of view, some participants pointed out that listing rules on Chinese exchanges could preclude many SMEs or recent start-ups from listing at all. (The establishment of the Shenzhen Exchange's SME section gave some grounds for optimism.) Participants also wondered whether there would be sufficient demand for the shares of such firms to justify the risks that investors had taken on.

The issue of repatriation of investment was linked with Chinese capital controls, which was understood to be a much larger issue. Although some participants pointed out that petitions for foreign IPOs and for repatriation of investments are often approved on a case-by-case basis – and indeed foreign IPOs have been the primary form of exit for foreign private equity firms – many felt that this was an insufficient guarantee for risk capital. An additional concern was raised by some participants who foresaw the possibility that Chinese authorities might seek to force domestic rather than foreign IPOs in order to improve domestic capital markets. They felt that funds would want to have a choice of exiting in the most beneficial way, and worried that restrictions for any purpose would make initial investments less attractive.

## **U.S. MARKETS**

Discussion of private equity and joint ventures in the United States was more limited than that on China. Two questions were raised: prospects for Chinese investment into the United States, and more generally whether the current attractiveness of LBOs might be coming to an end.

With regard to Chinese investments into the United States, discussion essentially mirrored the earlier discussion concerning sovereign wealth funds. In other words, much of the focus was on politics rather than economic issues.

With regard to the future of LBOs in the United States, some participants suggested that much of what has been driving their attractiveness has been global excess liquidity. This has tended to keep down interest rates, and has also led to greater investment in hedge funds and private equity funds in search of higher returns. Participants who saw U.S. interest rates as likely to rise, whether due to dollar depreciation or other factors, wondered whether this might significantly dampen enthusiasm for LBOs. In contrast, many participants saw private equity as a more efficient form of ownership than the traditional joint-stock corporation; they saw the question of how takeovers would be funded as less relevant, and they predicted that going private would be an ongoing trend.