SYMPOSIUM ON BUILDING THE
FINANCIAL SYSTEM OF THE 21ST CENTURY:
AN AGENDA FOR CHINA AND THE UNITED STATES
BEIJING, CHINA • SEPTEMBER 14-16, 2012

AGENDA *as of September 15, 2012*

FRIDAY, SEPTEMBER 14

6:00-6:30 p.m. **COCKTAIL RECEPTION** ***Joy City, 2nd Floor, Building 9***

6:30-6:40 p.m. **GREETINGS** ***Joy City, 2nd Floor, Building 9***

- Lu Mai, Secretary General, China Development Research Foundation (CDRF)
- Hal S. Scott, Nomura Professor and Director, Program on International Financial Systems, Harvard Law School

6:40-7:10 p.m. **KEYNOTE ADDRESS** ***Joy City, 2nd Floor, Building 9***

- GUO Jinlong, Party Secretary (Former Mayor), Beijing Municipality
- Terrence Checki, Executive Vice President, Federal Reserve Bank of New York

7:15-8:30 p.m. **DINNER** ***Fortune Palace, 2nd Floor, Building 9***

8:30 - 11:00 p.m. **AFTER-DINNER COCKTAILS** ***Malting Castle, 1st Floor, Building 9***

SATURDAY, SEPTEMBER 15

7:15-8:00 a.m. **BREAKFAST BUFFET** ***Gloria Palace, 1st Floor, Building 9***

- Breakfast Meeting of Panelists, Reporters, and Facilitators (Please sit at the reserved tables)

8:15-8:25 a.m. **WELCOME/OPENING REMARKS**
Sunshine Conference Room, 2nd Floor, Building 8

- LI Wei, Minister and President of the Development Research Center of the State Council

8:25-8:45 a.m. **PANEL SESSION** ***Sunshine Conference Room, 2nd Floor, Building 8***

Topic 1: Capital Market Development in China and Its Impact on the U.S.

- PENG Wensheng, Chief Economist, China International Capital Corporation, Ltd.
- Jose-Luis Guerrero, Co-Head of Global Markets, HSBC Bank Plc

8:50-10:15 a.m. **SMALL GROUP SESSIONS**

GROUP	ROOM	FACILITATORS	REPORTERS
1	Sunshine	Oliver Weisberg	Marsha Vande-Berg
2	Room 1(1st floor, Bldg 3)	Elaine La Roche	Dino Kos
3	Room 2(1st floor, Bldg 3)	Michael DeSombre	Bill Grimes
4	Room 3(1st floor, Bldg 3)	Jim Shipton	Brian Kelly
5	Room 4(1st floor, Bldg 3)	Jim Duensing	Filip Moerman
6	Room 5(1st floor, Bldg 3)	Iris Chan	Christopher Wells
7	Room 6S (2nd floor Bldg 3)	Paul Speltz	Satoru Murase

10:15 -10:25 a.m. **REFRESHMENT BREAK**

10:25-10:45 a.m. **PANEL SESSION** ***Sunshine Conference Room, 2nd Floor, Building 8***

Topic 2: Financial Regulation and Financial Innovation

- HUO Xuewen, Director-General, Beijing Municipal Bureau of Financial Work
- Jeremiah Norton, Director, Federal Deposit Insurance Corporation (FDIC)

10:50a.m. -12:15 p.m. **SMALL GROUP SESSIONS**

GROUP	ROOM	FACILITATORS	REPORTERS
1	Sunshine	Richard Neiman	Marsha Vande-Berg
2	Room 1(1st floor, Bldg 3)	Howard Chao	Dino Kos
3	Room 2(1st floor, Bldg 3)	Marx-Xavier Fancy	Bill Grimes
4	Room 3(1st floor, Bldg 3)	Gene Huang	Brian Kelly
5	Room 4(1st floor, Bldg 3)	Jack Murphy	Filip Moerman
6	Room 5(1st floor, Bldg 3)	Allan O'Bryant	Christopher Wells
7	Room 6S (2nd floor Bldg 3)	Eugene Zheng	Satoru Murase

12:15-1:30 p.m. **LUNCHEON KEYNOTE ADDRESS** ***Joy City, 2nd Floor, Building 9***

- ZHOU Yanli, Vice Chairman, China Insurance Regulatory Commission (CIRC)
  (Introduced by HOU Yunchun, Vice President, Development Research Center of the State Council)

1:30-3:00 p.m. **PANEL SESSION – PLENARY DISCUSSION ONLY**
Sunshine Conference Room, 2nd Floor, Building

The Role of Insurance Companies, Pension Funds and Mutual Funds in the Development of Savings, Retirement, and Long Term Capital Markets

- Chair: Don Kanak, Chairman, Prudential Corporation Asia
- SUN Jie, Chairman, Asset Management Association of China
- Theresa Whitmarsh, Executive Director, Washington State Invest Board
- ZHANG Chenghui, Director-General, Research Institute of Finance, Development Research Centre of the State Council
- Charles Scully, Chief Investment Officer, Asia Region, MetLife

3:00-6:00 p.m. **FREE TIME | REPORTERS MEETING** ***Room 6S, 2nd Floor, Building 3***

- Optional tour to JIETAI Temple

6:15-6:45 p.m. **COCKTAIL RECEPTION** ***Joy City, 2nd Floor, Building 9***

6:45-7:45 p.m. **KEYNOTE ADDRESS**

- Leo Melamed, Chairman Emeritus, CME Group
- LI Jiange, Chairman, China International Capital Corporation, Ltd. *(Introduced by Jesse WANG, Vice President, China Investment Corporation)*

7:45-9:15 p.m. **DINNER**

9:15-11:00 p.m. **AFTER-DINNER COCKTAILS** ***Malting Castle, 1st Floor, Building 9***

SUNDAY, SEPTEMBER 16

7:15-8:00 a.m. **BREAKFAST BUFFET** ***Gloria Palace, 1st Floor, Building 9***

- Breakfast Meeting of Discussion Chairs and Reporters (Please sit at the reserved tables)

8:10 a.m. – 8:30 a.m. BREAKFAST KEYNOTE ADDRESS

Sunshine Conference Room, 2nd Floor, Building 8

- Peter Fung, Global Chairman, Global Practice, KPMG

8:15-9:15 a.m. PRESENTATION & DISCUSSION

Sunshine Conference Room, 2nd Floor, Building 8

Capital Market Development in China and Its Impact on the U.S.

- CHEN Youan, Chairman, China Galaxy Securities
- Yvonne Ma, Director of Research, Elliott Advisors (HK) Ltd

9:30-10:30 a.m. PRESENTATION & DISCUSSION

Sunshine Conference Room, 2nd Floor, Building 8

Financial Regulation and Financial Innovation

- Andrew Sheng, President, Fung Global Institute
- Catherine Simmons, Head of Regulatory, Industry, and Government Affairs, Asia Pacific, State Street Bank and Trust Company

10:30-10:40 a.m. REFRESHMENT BREAK

10:40-11:45 a.m. PRESENTATION & DISCUSSION

Sunshine Conference Room, 2nd Floor, Building 8

The Role of Insurance Companies, Pension Funds and Mutual Funds in the Development of Savings, Retirement, and Long Term Capital Markets

- CAO Yuanzheng, Chief Economist, BOC International
- Allan O'Bryant - EVP and Head of International Markets and Operations, RGA Reinsurance Company

11:45-12:45 p.m. CLOSING LUNCH ***Gloria Palace, 1st Floor, Building 9***

1:00 p.m. Buses depart from COFCO Retreat Center to downtown Beijing (Westin hotel on Financial Street) and Beijing (PEK) Airport

2012 Symposium on Building the Financial System of the Twenty- First Century: An Agenda for China and the United States

Beijing, China, September 14-16, 2012

The ninth annual China-U.S. Symposium was held at the COFCO Retreat Center in Beijing. In the face of a slowing global economy, concerns about the sustainability of U.S. economic growth and fiscal deficits, disquiet about the effects of the third round of U.S. quantitative easing, and questions about the pace of rebalancing in China, participants discussed how financial markets could better support the real economy in China and the U.S. Sessions addressed capital market development in China and its impact on the U.S., the balance between innovation and regulation in financial markets, and the role of insurance companies, pension funds, and mutual funds in the development of capital markets.

Session 1: Capital Market Development In China And Its Impact On The U.S.

In Session 1, participants discussed the development to date of Chinese capital markets and opportunities for the future. They recognized tremendous progress and expressed hope that continued financial market development would support China's real economy and provide opportunities for mutual benefit with foreign firms and financial institutions. Major topics of discussion included regulation, risk pricing, the particular challenges of small and medium-sized enterprise (SME) funding, and cross-border capital flows and transactions.

The Promise of Capital Market Development in China

Participants agreed that there had been significant progress in capital market development over the past year, continuing previous years' trend of rapid market development. One key reform was seen in moves toward interest rate liberalization. Participants agreed that market-driven interest rate determination would be an indispensible factor in improving the functioning of financial markets; while liberalization to date was seen as limited, they agreed that the direction of policy was encouraging. With regard to equity markets, participants voiced support for market reforms that simplified the process for both IPOs and delisting from exchanges. The easing of standards for IPOs was seen as adding choices for investors and opportunities for firms to gain access to funding. The delisting reforms were considered an important step in maintaining the integrity of equity markets. Participants also noted efforts to expand the role of institutional investors, including expansion of QFII quotas and liberalization of rules on investment by insurance companies. The latter was discussed in greater detail in Session 3.

Participants agreed that continued development of capital markets would be an important factor in supporting China's real economy. As in any economy, a well-functioning financial system would promote more efficient resource allocation; in China's case, many participants saw it as even more critical, based on two main issues. First, the gap between formal and informal markets in terms of availability of funds and costs of capital was seen as much larger than in more developed markets. Participants expressed concern that SMEs and households were unnecessarily credit-constrained, preventing them from making business or consumption decisions that could benefit them and the economy as a whole. Second, a number of participants argued that the access that large companies (especially state-owned enterprises, SOEs) enjoyed to plentiful, low-cost capital was leading to overinvestment and suppressing consumption. Thus, they argued, better functioning financial markets could address not only allocative efficiency, but also could help the Chinese economy as a whole to rebalance and address issues of economic inequality.

Participants noted that equity markets (the world's third largest) had developed more fully than bond markets (the world's fourth largest). Nonetheless, they saw a number of ways in which equity markets could be improved for the benefit of investors, corporations, and the Chinese economy. One issue was the need for listing opportunities for smaller companies. Several participants noted the ChiNext board approvingly, although there were some concerns that it was being used more for exit by private equity funds than for growth capital. NonethelessOthers argued that was not a useful distinction, since the providing a clear means of exit for private equity would make it more attractive for investors to provide growth capital. , it was seen as a potentially very useful endeavor. With regard to the bond market, a number of participants expressed hope that, despite the dominance of government and financial institution offeringsbonds, corporations would increasingly be able to access credit by issuing bonds.

A particular concern that many participants identified was the extent to which the financial system relied on bank lending. While there was no clear answer as to the ideal balance between banks and capital markets, most participants appeared to agree that the Chinese economy was excessively dependent on bank finance. They saw this situation as leading to several problems in the Chinese economy. One concern was that banks were extremely risk-averse, preferring to lend to to larger and state-owned enterprises while restricting lending to SMEs, enterprises without state ownership, and newer firms. A number of participants also noted that the high level of concentration in the banking system translated directly into concentration of risk; although they did not fear failures of major banks, some participants expressed concern that a reappearance of major non-performing loan problems could lead to credit contraction and other problems.

It was also noted that the reliance on bank finance, combined with administered interest rates on deposits and most loans, could have other negative effects in terms of resource allocation and investor interests. One point that was widely made was that the current system did not generate market-based interest rate benchmarks and yield curves that could be a guide for monetary policy and for investors in capital markets. At the same time, participants noted that many Chinese households continued to hold most of their financial assets as bank deposits that earned low, non-market rates of return. They saw the expansion of capital markets as offering an opportunity for better returns for investors, while also addressing some of the needs of underserved borrowers. Finally, a number of participants argued that shifting the balance from capital markets would better meet the needs of investors by addressing problems of maturity mismatch. In particular, they saw a need for longer-term debt securities.

Despite the general consensus that the Chinese economy would benefit by expanding the role of capital markets relative to bank lending, some participants suggested a cautious approach. One reason was concern that, in the context of global economic and financial fragility, deregulation might further complicate the problems of the Chinese economy. Some participants also questioned what they saw as an implicit assumption that the Chinese economy should become more like that of the U.S. They felt that the global financial crisis had significantly weakened the case for seeing the U.S. financial system as an attractive model for China. However, even those participants who urged caution saw the current Chinese system as overly dependent on banks and as potentially benefiting from better-developed capital markets, even if there was not a consensus on the desired balance or speed of transition.

Capital Market Infrastructure Issues

In their discussions of how to improve the scope, scale, and functioning of Chinese financial markets, participants focused on regulation and supervision, quality of information, and investor base as requiring the most attention.

With regard to regulation, a major issue for many participants was what they saw as an excessive requirement for approvals, not only for issuing new types of securities but also for issuing standard securities such as corporate bonds. Participants saw this requirement as cumbersome and the approvals process as time-consuming and unpredictable, all of which reduced the attractiveness of borrowing via capital markets. They also noted that it had the effect of reducing the stock of assets for investors to purchase. Some raised the possibility that approvals-based regulation increased opportunities for corruption, as potential issuers might choose to provide benefits to officials to speed up approvals.

Some participants also complained of the problem of multiple overlapping regulators, although in principle financial regulation and supervision were segmented by activity among CBRC, CSRC, and CIRC. Although acknowledging the principle of segmented regulation, participants noted that overlap had long existed between national and local regulators, and a number of participants expressed concern about the quality and consistency of local authorities. A more recent issue had to do with the blurring lines between different types of financial products and institutions—for example, some wealth management accounts bore strong resemblance to annuity products. As China's capital markets continued to mature, there were concerns that the problems of overlapping and contradictory rules and supervision would multiply.

An additional infrastructureal problem for financial markets was seen to be the quality of information available to participants in Chinese markets. While acknowledging the increasing rigorousness of rules regarding transparency and disclosure, they expressed concern that significant problems remained in terms of actual implementation and enforcement. With regard to disclosure, they noted that there was enormous variation in the amount, type, accuracy, and timing of information released by listed companies. This was seen as allowing managers to conceal negative news from shareholders and market participants and thus shield themselves from punishment. Managers could also delay the public release of positive information and provide it in advance it to insiders. Outright fraud was also cited as a significant problem, as in the highly publicized cases of Sino-Forest and Longtop. These issues of transparency and disclosure were seen as serious problems for the Chinese capital markets, as they reduced investor trust and confidence among both Chinese and foreign investors. It also was seen as weakening the pricing mechanism, as investors could not reliably discern the profitability and financial conditions of firms.

Given to tthe problems of publicly available information, participants agreed that private information was often valued more highly. This point pertained not only to insider trading or fraud, but also to the prevalence of bank lending, since banks would have better access to non-public information. However, participants argued that even banks had insufficient information to calculate risk, which they saw as contributing to bank conservatism. They also noted widespread uncertainty regarding how to analyze available information.

A number of participants saw the further development of ratings agencies as a potential solution to several of these issues. While the ratings industry had developed significantly in terms of numbers of rating agencies and numbers of rated firms, participants noted that data and data analysis had not yet been sufficiently developed to provide really useful ratings. Thus, they put considerable emphasis on the importance of improving the quality of ratings, which they saw as essential to developing corporate bond markets. A number of participants also argued that better ratings could reduce banks' conservatism and emphasis on collateral by improving their ability to evaluate risk. In considering how to improve Chinese rating agencies, participants raised not only the problem of reliable information and accounting, but also analytical challenges. One of these was the lack of long-term data series that could be used to estimate models of risk. This was seen as being complicated by rapid changes in the Chinese financial system as well as lingering questions such as uncertainty over how defaults would be handled by authorities or how bankruptcy law would be applied in the case of non-payment of debt service or corporate failure. Participants saw these factors as contributing to the bias toward investing in and lending to large SOEs, which were seen as unlikely to be allowed to fail regardless of their financial condition or the quality of their business models.

A final infrastructureal issue that received significant attention in Session 1 was the investor base. Participants observed that there had been impressive growth in institutional investors, particularly asset management and private equity firms. Nonetheless, they noted that the role of institutional investors such as pension funds and insurance companies remained limited (as discussed at much greater length in Session 3). Many participants saw this as a problem. They argued that increasing the role of institutional investors would have a number of positive effects. For example, they would likely demand better quality information while introducing more sophisticated analytical models, thus improving capital allocation. Moreover, they could add to the liquidity of markets while a greater variety of institutional investors would likely lead to demand for longer-term securities and more options for diversifying risk. Expansion of institutional investors could also address another concern that participants raised about the investor base—that individual investors lacked sophistication in their knowledge of finance and their understanding of risk. The development of a broader set of institutional investment vehicles, such as mutual funds, could help them to reduce the risk of investing in equities and corporate bonds. Participants also called strongly for improving investor education, noting that the rapid development of the Chinese economy and of Chinese financial markets meant that most investors were inexperienced and lacked understanding of how to analyze risk.

Pricing Risk

A common thread running through much of the discussion of China's financial system was how to evaluate risk and to adjust interest rates and prices of securities appropriately. A number of participants expressed concern that many investors were not willing to accept the fact that debt instruments in a market economy would necessarily carry varying levels of default risk (although this was not considered as large a problem in equity markets, where investors experienced significant volatility in prices). As they put it, bonds were deemed to be "risk-free" by investors. Given the assumption that investors would be bailed out in the event of a default, it was not surprising that regulators would be very conservative about approving bond issues.

Many participants felt the lack of awareness of default risk derived from the fact that most corporate bond issuers were large state-owned enterprises that in fact would not be allowed to fail. These implicit state guarantees had the effect of warping financial markets, by dividing them into firms that would not be allowed to fail or default regardless of profitability on the one hand, and those that could fail and thus could not gain access to market-based funding on the other hand. Since the latter also would generally also face constraints in accessing bank lending, implicit state guarantees were seen as further reinforcing the problems of credit constraints for smaller and non-state-owned firms.

The issue of implicit guarantees was also linked by a number of participants to the fact that interest rates in the formal sector continued to be tightly controlled. Participants recognized that the principle of risk pricing had begun to be introduced for both financial institutions and bond markets and some argued that there were increasing numbers of cases in which interest rates had been adjusted to account for risk. (They also noted experimental policies to try to integrate informal financial markets into a rule-based system, as in Wenzhou.) Nonetheless, most participants agreed that interest rates charged by banks and debt holders did not consistently take into account actual risk and tended to move within very small bands.

Participants felt that the potential contributions of bond markets would remain unrealized until interest rates were set by markets and reflected actual default risk. To encourage better price formation, participants put forward three propositions. The first was to continue, and perhaps hasten, the liberalization of interest rates. The second was to encourage the creation of market-based benchmarks, which would be partly a function of expanding the range and quantity of bonds and related securities (i.e., financial innovation, as discussed in Session 2). Third, they felt that greater liquidity should be encouraged in order to improve price formation and resource allocation—a particular roadblock in this regard was that major bondholders tended to be banks or highly regulated insurance companies that followed buy-and-hold strategies

Financing SMEs

Much of the discussion in Session 12 touched on SME finance. This was raised as an issue from the points of view of efficient resource allocation, fairness, diversification of risk and even macroeconomic rebalancing away from export-led growth. Much of China's rapid growth in incomes and employment had been and was expected to continue to be generated by SMEs, but Pparticipants raised concerns that lack of access to stable, reasonably-priced funds for SMEs was retarding that Chinese economic growth. Thus, participants saw the improvement of SME access to funding (including longer-term debt) as one of the major challenges for the Chinese economy.

ParticipantsThey noted in particulr the difficulty for many SME's of accessing funds through the banking systembanks,. They argued that banks were highly conservative in their lending for several reasons: they did not have the means to effectively analyze risk, there was insufficient scope or authority to price risk into interest rates, and loan officers were highly incentivized against losing money. This conservatism meant not only a preference for lending to larger firms (particularly SOEs), but also an emphasis on collateral rather than rigorous credit analysis as a key criterion for making loans. The emphasis on collateral was seen as reinforcing the advantages enjoyed by larger, more established firms. And aalthough smaller local banks were seen as somewhat more willing to lend to SMEs and start-ups on a relationship or collateral basis, participants agreed that the financial constraints on SMEs were significant.

Given the reluctance of banks to be major funders of SMEs, a number of participants advocated building up bond markets as an alternative source of funds. They felt that expansion of bond markets could diversify the possible funding sources for SMEs while also providing better investment alternatives for China's savers. Indeed, they felt that bonds tied to the performance of SMEs could be quite attractive, given the likely higher yield and the many rapidly growing SMEs in the country. Other participants cited practical challenges, however. They noted that most countries had opposite patterns, in which large firms accessed bond markets while SMEs were more dependent on banks, due to the costs of tracking and verifying financial information for firms and the likely illiquidity of trading in SMEs' bonds. The informational challenge was seen as heightened by the lack of reliable ratings and data. Thus, they wondered how SMEs would be expected to access bond markets. Among the possibilities that participants proposed were development of a high-yield ("junk") bond market and bundling SME bonds through some sort of securitization (e.g., of accounts receivable). Skeptics saw both of these as likely to be difficult to develop. However, several participants noted with approval recent experiments in private placements of SME bonds.

Some participants saw microcredit as a better alternative for small firms. Given the scale of their borrowing, the difficulty of obtaining information and predicting performance for SMEs, and the reliance of many of them on informal markets, these participants felt that the microcredit model might work very well. While specifics were not discussed extensively, microcredit could be financed as an arm of banking operations, via bond markets, or through asset management funds.

RMB Internationalization

RMB internationalization loomed large for many participants as they discussed capital market development more broadly. There was some debate as to how the meaning of RMB internationalization should be understood. For some, the key issue was capital-account liberalization—once Chinese and foreign investors could move funds easily across borders and trade in the RMB was liberalized, then the RMB would be a fully international currency. For others, capital-account liberalization would be only a prerequisite to true RMB internationalization, which they saw as large-scale use of RMB in international finance—i.e., for trade settlement and invoicing, as an investment vehicle for foreigners, and as a reserve currency. Participants saw both capital-account liberalization and expansion of international use of the RMB as a long-term process, with many speaking of the former in a 5-10 year time frame and of the latter in a 10-20 year time frame.

A number of participants argued that capital-account liberalization would be an important element in the continuing shift away from administered prices toward market-based prices. As with interest rates, they argued that liberalization of the capital account would improve pricing throughout financial markets, and thus contribute to more efficient capital allocation as well. Other pricing issues included the gaps between prices of A-shares and H-shares and between onshore and offshore RMB bonds. Capital-account liberalization also had the potential to expand the investor base significantly—reductions of inflow controls would provide more opportunities for foreign investors, while reduction of outflow controls would reduce their perceived risk. In this regard, participants noted with approval the continuing expansion of QFII quotas, widening of RMB trading bands, expansion of products available to foreign investors, and gradual easing of controls on transferring the proceeds of "dim sum" bonds from Hong Kong to China. Reduction of outflow controls for Chinese nationals could also provide domestic investors with valuable opportunities to diversify their portfolios.

At the same time, participants were cognizant of the potential dangers of capital-account liberalization and, in particular, the dangers of fully liberalizing capital flows before financial markets, regulators, and monetary policymakers were properly prepared. This led to discussion of pacing and sequencing. With regard to sequencing, many participants agreed that the first steps should be to in liberalizeing interest rates, starting from deposit and lending rates and then moving throughout the financial system. Participants also discussed sequencing with regard to market infrastructure. Several argued that liberalization of retail interest rates should proceed only when deposit insurance and other guarantee funds had been put in place to protect savers in case banks, pension funds, or insurance companies did not manage rate liberalization well. In terms of markets themselves, participants felt that money markets as well as bond markets would need to be developed in order to provide a means of market pricing, expand the variety of financial assets, and allow for the central bank to implement monetary policy through open market operations. Finally, many participants argued that in order to make Chinese capital markets an attractive place for foreign investors and foreign governments to hold assets and reserves, there would need to be a significant expansion in the variety and liquidity of hedging instruments.

Prospects for Cross-Border Bank Entry

While much of the discussion in Session 1 concerned the development of China's capital markets, there was also some discussion of the impact on the U.S. as well. The main issue in this respect had to do with opportunities for Chinese and U.S. banks to penetrate each other's markets.

A number of participants observed that, despite the significant development of China's financial markets and the growing sophistication and impact of its financial institutions, Chinese financial institutions—especially banks—had had little success in expanding into U.S. markets. Some saw the persistence of entry barriers as the key problem. There was some disagreement as to the reason—some felt that Chinese banks were facing discrimination relative to other foreign banks in the approvals process, while others felt that their difficulties had to do with the way that U.S. law was written and Chinese banks were structured. But most participants agreed that Chinese banks had had a particularly difficult time entering the U.S. market, although some pointed to a few recent successes as being harbingers for better luck going forward.

At the same time, some participants questioned whether Chinese banks would—or should—want to enter the U.S. market on a large scale. While they recognized that Chinese banks would likely want to increase their presence in the U.S. in order to service Chinese firms investing there, they voiced doubts about the benefits of doing more than that. They argued that, in contrast to China, the U.S. banking market was slow-growing and already saturated. Moreover, as newcomers, Chinese banks would be at a disadvantage within that highly competitive milieu. These participants felt that, for most Chinese banks, a continued focus on the fast-growing Chinese market and perhaps onf some emerging market neighbors, would be far more attractive. They thus felt that even if entry barriers were cleared, there would still be very little penetration in U.S. markets by Chinese banks.

Looking in the other direction, some participants complained that Chinese barriers to foreign banks remained substantial. They focused in particular on the difficulty of setting up commercial banking operations in China. They noted that very few foreign banks had taken advantage of rule changes that allowed for wholly-owned operations, and that there remained significant restrictions on the establishment of joint ventures. For example, in the case of one U.S.-Chinese joint venture, the joint venture itself was not allowed to engage in RMB business; rather, it had to refer such business to the Chinese partner for the first three years. However, the operation was also required to show profits in two of the first three years in order to be able to retain its license. Other participants were skeptical that entry barriers were difficult to surmount, pointing out the presence in China of many of the world's money-center banks and noting that there was no parallel success story for Chinese banks in the U.S.

Financial Regulation and Financial Innovation

Session 2 examined the relationship between financial regulation and financial innovation. While much of the discussion focused on China, participants also addressed the U.S. and global regulatory regimes. Participants discussed the benefits and costs of financial innovation, principles of good regulation, and concerns about regulatory overreach.

Balancing Innovation and Regulation

A core question in Session 2 was how best to balance market innovation with regulation to prevent destabilization. Participants recognized that, in the wake of a global financial crisis caused in part by the misuse of sophisticated financial products, many people had begun to ask why innovation should be promoted, or even allowed, in financial services. In contrast, Symposium participants generally favored the idea of financial innovation. For some, it was a question of survival in a world of technological change—as one presentation put it, financial institutions and markets must "innovate, adapt, or die." In this point of view, attempting to stifle innovation in financial services would not work because of competitive pressures.

Further, However, most participants sought to make a positive case that financial innovation could provide important benefits to economies. They argued that financial innovation could improve resource allocation, management and transfer of risk, and market liquidity. With regard to resource allocation, these participants pointed out that many investors and firms—for example, Chinese households and SMEs—were constrained in their ability to access markets or faced adverse pricing structures. With regard to risk, participants argued that innovation could allow market participants to hedge against risks as well as to better match their differing appetites for risk and maturity. Finally, market liquidity would be essential to lowering the cost of risk management, producing better market prices, and reducing investors' risk by assuring them that they would be able to enter and exit positions as needed.

Participants also recognized that financial innovation could create costs for societies. Remembering the origins of the global financial crisis in the U.S. subprime lending market, they noted that in some cases innovation could introduce new systemic risk if investors and supervisors did not understand the risks associated with new products. Some participants also argued that many firms and investors sought innovative financial products primarily as a means of avoiding taxes or prudential supervision, thus creating potential costs for society at large.

Innovation and Regulation in China

Participants agreed that the balance between financial innovation and regulation in China should be understood in a fundamentally different way from that in the U.S. As one noted, the major imperative for China remained economic growth and that therefore creating a regulatory framework to support financial innovation would be a secondary concern. Using the metaphor of "crossing the river one stone at a time," he argued that Chinese policymakers approached regulation and other economic policy issues through a strategy of directed trial and error ("innovate, adapt, implement"). This was necessary because, as a developing economy, so many factors remained unknown and unpredictable. Thus, rather than following a U.S. approach of developing markets based on an existing regulatory structure, China was trying to develop markets and regulatory structure simultaneously.

For China,It was also noted that the meaning of financial innovation itself varied considerably, depending on the role and sophistication of financial institutions—as one put it, what was right for Goldman would not be right for Chinese rural banks. And although much of the discussion concerned the introduction of new financial products or enhancements to the functioning of financial markets, participants also emphasized the importance of using financial innovation as a means of improving risk management.

With regard to financial products, participants suggested several areas where they felt that financial innovation could benefit markets and the economy as a whole. One of these was developing better mechanisms for SME finance, as noted above. A more controversial question concerned hedging instruments. Many participants argued strongly that Chinese equity, bond, and currency markets would be stunted by a lack of hedging instruments, including options, futures, CDS, and short-sales. Others worried about those instruments' possible misuse in ways that would increase volatility and disadvantage less sophisticated market participants such as households. They advocated a gradualist approach to introducing such products. There was a similar discussion of securitization.

A major question for many Chinese participants was how to distinguish "good" innovation from "bad" innovation. A number of participants raised a distinction between the use of financial innovation purely for speculation as opposed to supporting the real economy. There was a general sense that Chinese authorities were not in favor of innovations that would contribute to speculation and thus were cautious about liberalizing rules on derivative products. Other participants argued that there could not be a useful distinction between speculation and legitimate investment purposes, stating that managing risks was always a legitimate business activity. They also pointed out that speculators were often essential to the liquidity and even viability of a given market—for example, they argued that many commodity future markets are dominated by non-users and non-producers, but that without that liquidity, "legitimate" hedges would be much more expensive and positions would be difficult to unwind.

Another critique of the rapid introduction of new financial products was that China should not necessarily be adopting the U.S. model. Some participants argued that even if that model worked for the U.S. (which they did not all accept), it may not suit China's circumstances and needs. They noted that China was a rapidly changing emerging market economy where uncertainty was high and financial institutions and households were still relatively unsophisticated in financial terms.

Participants also discussed innovation in terms of market infrastructure, service provision, and internal management, arguing that there were many opportunities to use IT to improve governance, access, and efficiency. A number of participants saw this as an area in which U.S. and other foreign financial firms could contribute to improving China's capital markets and financial system.

Regulating Financial Innovation

Participants discussed at length how best to regulate financial innovation. Key issues included how to deal with the problem of complexity and how to coordinate across various levels and actors. At the same time, a number of participants argued that the main elements of good regulation of financial innovation did not differ from the main elements of prudential regulation in general, such as ensuring transparency and disclosure, protecting retail investors, preventing moral hazard such as "too big to fail," and managing cross-border risks.

A common theme in Session 2 was the complexity of national and global financial systems. The continued creation of new financial products, business models, and processes was seen as only deepening that complexity, further challenging regulators. Following the global financial crisis, the response of regulators (particularly in the U.S. and Europe) was to add significantly to the complexity of regulations and regulatory structure. Many participants expressed concern about this approach. They argued that, rather than matching market complexity with ever-greater regulatory complexity, less may be more. A number of them advocated focusing on simple principles rather than on trying to stipulate and manage every action or contingency, as complex rules-based regulation would inevitably create unpredictable effects across markets. Principles-based regulation was attractive to a number of participants for other reasons as well. One argument was that the costs of compliance might well outweigh the benefits, and that many regulatory reforms including the Dodd-Frank Act made no effort to measure or balance benefits and costs. Some participants also debated whether principles-based or rules-based regulation was more susceptible to regulatory capture. Advocates of principles-based regulation pointed out that the drafting of highly detailed rules offered multiple opportunities for interested parties to try to advantage themselves. Other participants, in contrast, argued that it would be too easy for market participants and supervisors to justify misbehavior on the basis of principles if there were not clear red-lines as to what was allowable.

While a variety of specific issues were discussed in regard to Chinese, U.S., and global financial regulation, much of the discussion of principles addressed one of four challenges: transparency and disclosure, consumer protection, "too big to fail," and cooperation among regulators and between regulators and industry. A number of participants saw transparency and disclosure as central issues on which regulators should focus. Reliable and timely information was seen as essential both to formal supervision and to market discipline. Participants saw the issue as particularly urgent in China, with many arguing that standards of disclosure and consistency of accounting and audits remained weak despite significant progress. In addition to questions about the accuracy of financial statements, there were significant concerns about timing—some participants noted that many Chinese firms issued statements and announcements only sporadically, and often well after insiders had had a chance to act on it. Some participants were skeptical of the quality of information in the U.S. financial system as well, noting the various accounting scandals that had erupted in recent years; however, at least as many participants expressed the concern that after Sarbanes-Oxley and Dodd-Frank, U.S. regulators were demanding excessive amounts of information, much of which was not necessarily relevant or informative.

Consumer protection was seen as another important challenge. While a number of participants expressed the view that Dodd-Frank had granted the new U.S. Consumer Financial Protection Bureau excessive powers, there was a general agreement that some level of consumer protection was appropriate in the marketing of sophisticated financial products. In the case of China, participants saw considerable need for consumer protection, because of both financial innovation and the large share of inexperienced investors in markets. Given the newness of Chinese capital markets and the rapid introduction of new savings and investment vehicles, participants felt that measures to prevent fraud and to ensure that investors understood their investments were essential. A number of participants also made the point that there was a need for investor education in general, as they felt that many individual investors did not have a firm grasp of basic concepts such as definitions of different financial instruments and the relationship between risk and return.

A number of participants also expressed concern over the problem of "too big to fail" as an issue that continued to plague the U.S. and Chinese financial systems. It was noted that concentration in the U.S. banking system had actually increased since the crisis, despite the attention of lawmakers to the problem of systemically important institutions. Some participants also expressed concern over the problem of excessive size and concentration in China, where the big four banks dominated the financial system. While acknowledging that, as state-owned enterprises, they would be unlikely to default on their obligations, these participants worried about the potential cost of a bail-out if the major banks again amassed large stocks of non-performing loans as they had in the late 1990s. There was no clear consensus as to how to handle the problem of "too big to fail." A few participants advocated breaking up large U.S. and Chinese banks, but most participants appeared to favor stricter prudential supervision and regulation of their business activities, as well as clear plans for their orderly resolution in the event of a failure ("living wills"). Others suggested that markets might in the end demand the break-up of some large financial institutions, and that a market-driven process would be preferable to a government-mandated solution.

A number of participants stressed the important role of coordination, cooperation, and communication in dealing with complexity and innovation. In particular, they felt that regulators and market participants needed to maintain a constant dialogue in order to improve regulation and prudential supervision in the face of new products, technologies, and business models. For some, this was essential to address what they saw as the gap between the knowledge and sophistication of financial institutions and less capable regulators and supervisors. Others cautioned that, while financial institutions often had an advantage in terms of knowledge of what they were doing and what market conditions they were facing, in many cases they might actually know far less than regulators about systemic risk or potential interactions among market segments. They pointed to the failure of even highly sophisticated financial firms such as AIG or Lehman Brothers to understand the risks that they had taken on. Thus, they felt that only an ongoing dialogue between industry and regulators could adequately address the issues arising from financial innovation. Some pointed out that failure of cooperation on such issues might also lead to more populist reactions in the event of a crisis, as perhaps in the case of the Dodd-Frank Act.

Participants saw the need for cooperation at other levels as well. In the U.S., participants also emphasized the importance of cooperation among domestic regulators, both across functional bodies and between local, state, and national regulators. Some also thought these regulatory bodies should be consolidated. Meanwhile, some participants argued that investors and financial institutions themselves would need to take responsibility for addressing conditions that weakened market discipline, rather than putting all blame on regulators.

A particular concern among many participants was the need for international cooperation and communication among regulators and supervisors. One major issue for many participants, although it was not discussed at length, was the issue of cross-border resolution of failed multinational financial institutions. There was also some discussion of global standards. Some participants questioned, for example, whether Basel III correctly defined risk. Much of the discussion addressed the trade-off between international consistency and the need to tailor regulations to local conditions. On the one hand, some participants worried about regulatory arbitrage, particularly between the U.S. and Europe or with regard to offshore banking centers. A question that many saw as having greater relevance to China was whether a "one size fits all" set of standards such as Basel III, which was mostly designed to address the problems of the highly developed financial markets of the U.S. and Europe, was really appropriate to the needs of China or other emerging market economies. Some participants considered major portions of the new global standards to be irrelevant to Chinese financial markets, where the activities of banks, insurance companies, and other financial institutions remained highly circumscribed by regulations and approvals processes. For example, some of the regulation on systemically important financial institutions seemed not to be relevant to the major Chinese banks—although very large, their simple business models, and conservatism, and the fact that they were owned by the stateof state ownership, made them look quite different from other globally systemically important banks in the U.S. and Europe. Some participants also noted that China's closed capital account meant that it was not subject to or able to cause contagion in the same way as more developed economies. However, other participants were skeptical of the idea of customizing global rules to fit China. They pointed out that China's financial markets were developing rapidly in the general direction of the more developed systems and that capital account liberalization was a stated goal of the authorities. They felt that Chinese regulators would do well to work with global standards as the traditional means of control became less and less viable.

Dangers of Regulatory Overreach

Several other concerns were expressed regarding trans-border regulation and global regulatory cooperation. A key concern for many participants was loss of flexibility. Given the difficulty of achieving agreement among many national governments, they worried, regulatory systems would be unable to adapt rapidly enough to financial innovation. While some standards could be revised relatively easily in response to changing conditions through consultative processes in the FSB, IOSCO, and other international regulatory bodies, changing other rules and standards would require extensive negotiation and even ratification. More generally, a result of the global financial crisis had been attempts in many countries as well as globally to legislate standards and rules that had previously been left more to the discretion of administrative bodies, thus reducing flexibility.

In addition, several participants raised the possibility that the new global standards were creating new vulnerabilities for the world economy. They argued that requirements for central clearing of derivatives would have the effect of concentrating risk in the new clearinghouses, thus creating a whole new category of institutions that would be too big to fail. (While this was not really applicable at the moment to China, participants saw it as a potentially serious problem for the U.S.) They also expressed concern that designation of SIFIs would reinforce the problem of "too big to fail." Although new laws and standards called for more stringent regulation and the creation of mechanisms for orderly resolution of SIFIs, these participants were skeptical that stricter supervision would necessarily prevent a failure and worried that in the event of an actual crisis SIFIs would likely be bailed out. They also saw SIFIs as having a cost of capital advantage relative to their smaller competitors, creating fairness issues and raising the incentives for other financial institutions to expand to become SIFIs themselves.

Finally, a number of participants expressed strong concerns with what they saw as U.S. extraterritoriality. The Volcker Rule came under particular criticism for its extraterritorial provisions, which could have the effect of forcing any bank that does business in the U.S. to restructure its operations globally to comply with the U.S. law. New rules on derivatives and clearing could have similar effects of regulating what foreign financial institutions do outside the U.S. if they were to engage in derivatives transactions through U.S. clearinghouses. The Foreign Account Tax Compliance Act (FATCA) was also seen to have significant extraterritorial provisions that would likely affect Chinese financial institutions. While some participants expressed optimism that the apparently extraterritorial provisions would be handled through mutual recognition or other mechanisms, not all were convinced. They instead saw the U.S. as compounding the problem of domestic overregulation by extending it overseas and worried that it would stifle financial activity and innovation.

The Role of Insurance Companies, Pension Funds and Mutual Funds in the Development of Savings, Retirement, and Long-Term Capital Markets

Session 3 addressed the role of insurance companies, pension funds, and mutual funds in Chinese capital markets. While still at a relatively nascent stage, these entities were already seen to be a significant force in China's equity and bond markets. Participants expected to see them continue to grow rapidly in terms of both assets under management and impact on China's capital markets in general.

Aging Society and Long-Term Capital Markets

Despite high rates of savings, most household assets in China remained confined to low-yielding bank deposits. But with China's population aging rapidly, participants agreed that it would be critical to develop financial products to allow today's workers to retire comfortably. This was seen as particularly pressing given the transformation of China's pension system during the reform era and growing concerns about the adequacy of provisions to date.

Participants pointed out that, in comparative terms, Chinese households were underinsured and that pension funds (which had shifted from pay-as-you-go to funded) had relatively low capitalizations. This was seen as both a massive opportunity and as a potentially significant social safety net problem. Authorities were therefore encouraging insurance companies, pension funds, and mutual funds to market products that would support households in retirement.

These entities were also seen as providing a potentially significant boost to capital markets. It was noted that on a global level, insurance companies, pension funds, and mutual funds were among the largest institutional investors in equities, bonds (especially longer-term bonds), and alternative investments such as private equity funds. Because of the long time horizons of pension funds and life insurance companies, their development was seen as likely to spur the development of long-term bond markets, as well as to continue to support equity markets and alternative investment vehicles. Other forms of insurance (e.g., casualty, shipping, and crop) would likely be major users of hedging instruments, and thus help to develop derivatives markets.

Status of Insurance Companies, Pension Funds, and Mutual Funds

Participants noted that the funds under management had been growing rapidly, with the total assets of the insurance industry alone exceeding RMB 6.8 trillion, managed by 150 firms diversified across all sectors. One undeveloped part of the industry was reinsurance, in which there were only a handful of firms, most of them foreignjoint ventures involving foreign firms-invested. Asset management including mutual funds was also growing quickly, with new products (e.g., ETFs) being introduced over time.

Still, a number of challenges were noted. Perhaps the largest of these was improving investment performance and risk management, especially in the highly regulated insurance and pension industries. While participants noted the importance of liberalizing regulations on how these entities could invest their funds, they also emphasized the need for them to improve their risk management as the restrictions on investment in certain asset classes were gradually dismantled. At the moment, some participants argued that insurance companies were overinvested in equities and expressed hope that bond markets would develop quickly enough to offer alternative long-term investment opportunities. There were also some suggestions that insurance companies should be encouraged to provide funding for SMEs. This was seen by many as a good idea, but not necessarily feasible until better ratings information and thus new SME financing products became available.

A number of participants saw the insurance industry as an excellent opportunity for foreign firms, who would be able to bring their expertise in product design, marketing, and risk management to the table. There was some debate over how open the market already was to foreign firms. Some noted that the only restriction in life insurance was a 50% cap on ownership, while the mandatory insurance sector, like health, was completely open. With over fifty foreign firms in the Chinese market, they saw insurance as a very open sector of the financial system. Other participants stated that China was still a difficult insurance market to enter, although it was a very attractive one.

Asset management companies had developed primarily as a result of the privatization of state-owned enterprises, which left government entities with large stock holdings. But it was anticipated that the asset management industry would shift increasingly toward managing private wealth.

The View from Households

Some participants expressed the view that Chinese households should hold much more of their assets in the form of life insurance products or investment funds rather than in banks. Thus, there was discussion of the reasons for the relatively low penetration.

One aspect of low penetration was seen to be lack of knowledge. Participants noted that most Chinese people had relatively little knowledge of how insurance products and mutual funds worked or how they could support long-term financial goals. Thus, they were much more suspicious of these financial products compared to bank deposits or even individual equities. Moreover, several participants argued that improper selling practices had harmed the reputation of insurance products. They noted some efforts to improve that situation, such as shifting from agent-based marketing to bank-based marketing and rules that allowed new policyholders to get full refunds if they changed their minds in a set period. Nonetheless, they felt that insurance companies and regulators would need to do much more to educate potential policyholders of the usefulness of insurance products.

A final topic of discussion was the need that a number of participants saw for the introduction of tax-free defined-contribution retirement savings plans, like 401(k) plans in the U.S. Given the uncertainties associated with societal aging and a rapidly changing economies, they saw Chinese-style 401(k) plans to be an urgent need to shore up the social safety net. While there was a great deal of support for this idea at the Symposium, several participants stated that it was, perhaps unfortunately?, not a high priority for China's economic leadership.

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