30248

WORLD BANK COUNTRY STUDY PAPER

DEVELOPING INSTITUTIONAL INVESTORS IN PEOPLE'S REPUBLIC OF CHINA

Yongbeom Kim
Irene S. M. Ho
Mark St Giles

SEPTEMBER 2003

THE WORLD BANK

ABBREVIATIONS

AIG	American International Group, Inc.
ABS	Asset-Backed Securities
AMCs	Asset Management Companies
BOCI	Bank of China International
BW	Bond with Warrant
CD	Certificate of Deposit
CDB	China Development Bank
CDC	China Government Securities Depository Corporation
CIFs	Collective Investment Funds
CIRC	China Insurance Regulatory Commission
CITIC	China International Trust and Investment Corporation
CP	Commercial Paper
CSRC	China Securities Regulatory Commission
EXIM	Exports and Imports
GDP	Gross Domestic Product
HSBC	Hong Kong Shanghai Banking Corporation
IBM	Inter-Bank Market
IPOs	Initial Public Offerings
M&As	Mergers and Acquisitions
MOF	Ministry of Finance
MOLSS	Ministry of Labor and Social Security
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
NAV	Net Asset Value
NBFI	Non-Bank Financial Institution
NDRC	National Development and Reform Commission
NSSF	National Social Security Fund
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-Counter
PAYG	Pay-as-You-Go
PBOC	People's Bank of China
P/E	Price/Earnings
PRC	People’s Republic of China
QFII	Qualifying Foreign Institutional Investors
Repo	Repurchase Agreement
RMB	Renminbi (Chinese currency: Yuan)
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SDPC	State Development and Planning Commission
SEC	Securities and Exchange Commission
SEM	Stock Exchange Market
SETC	State Economic and Trade Commission
Sinopec	China Petrochemical Corporation
SOE	State -Owned Enterprises
TICs	Trust and Investment Companies
US	United States
UK	United Kingdom
WTO	World Trade Organization

Table of Content

PREFACE

During the finalization of the Government Bond Market Reform Report, the PRC Ministry of Finance requested further work on those parts concerning the market's demand-side, particularly those of institutional investors- pension systems, insurance companies and collective investment funds. In response, this report provides a comprehensive assessment of the existing state of institutional investors; reviews institutional capacity and the regulatory environment; identifies key constraints; and suggests broad principles on how to build a solid institutional-investor base.

The study was conducted under the general oversight of David Scott (Manager, China Financial Sector Program, East Asia and Pacific Region). The report was prepared by a team led by Yongbeom Kim (Senior Financial Economist, Financial Sector Operations and Policy Department) and including Irene S. M. Ho (Capital Market Specialist, World Bank Beijing Office) and Mark St Giles (International Consultant from *Cadogon Financial*). Limei Sun (Team Assistant, World Bank Office, Beijing) provided the invaluable support for logistics. Research assistance for the study was provided by Peixing Jiang (Summer Intern, 2002). The earlier draft benefited from valuable comments from our World Bank colleagues Dimitri Vittas, Jun Wang, and Xiaoqing Yu.

The study team wishes to register our sincere gratitude for the excellent cooperation and warm hospitality rendered by various stakeholders, including: Zhang Tong, Zhou Chengyue, and Yu Gongbin from Ministry of Finance; Wang Jianxi, Li Qingyuan, Wu Qing, Hong Lei, and Ye Chunhe from China Securities Regulatory Commission; Dai Genyu, Xie Ping, Li Chaochun, Xie Duo, Shui Ruqing, Li Zhaojun, Xia Lingwu, and Gao Cailin from People's Bank of China; Sun Jianyong and Zhang Hao from Ministry of Labor and Social Security; An Yikuan from State Development and Reform Commission; Meng Zhaoyi from China Insurance Regulatory Commission; Zhu Shaoping from Finance and Economy Committee of the National People's Congress; Li Keping from National Social Security Fund; Li Yang from China Academy of Social Science; Liu Shian from Shanghai Stock Exchange; Gao Jian from China Development Bank; Tao Xiuming from Jun Ze Jun law firm; Du Shuming from Center for Fund Management Research and Evaluation; and numerous market participants from state commercial banks, securities companies, insurance companies, fund management companies, rating agencies, venture capitals, law firms, and accounting firms. They all generously shared their valuable time and thoughts with the team and contributed immensely to the successful completion of the report. The main thrust of this report was presented at an international seminar on "Promoting Institutional Investors in China," held on April 1, 2003, in Beijing, and we would like to express our thanks to the speakers and participants in the seminar. All remaining errors and omissions are the sole responsibilities of the authors.

EXECUTIVE SUMMARY

1. This note describes the existing structure and activities of institutional investors in China. It identifies key principles for building a solid institutional investor base going forward.

2. The nation's institutional investors are largely comprised of life insurance companies and pension- and investment-fund managers. In addition, trust and investment companies (TICs) and securities companies offer their clients discretionary asset management services. Overall, China's ratio of institutionally-managed assets is small compared to developed markets, representing around 10 percent of GDP. According to some estimates, unregulated privately placed funds may be roughly of equal size.

3. The life insurance industry is the largest repository of savings outside banking, and is enjoying strong growth in premium income. At present, life insurance companies are limited mainly to investing in government bonds and bank deposits, but may obtain CIRC permission to invest in other instruments, e.g., privately placed infrastructure bonds.

4. The pension system entails a pay-as-you-go (PAYG) first pillar, individual defined contribution accounts as a second pillar, and a voluntary contribution third pillar. In some regions, second pillar accounts are used to cover shortfalls in the first pillar. Overall, the prospects for significant accumulations in the second pillar are limited; the odds are better that the voluntary third pillar schemes could eventually accumulate sizeable reserves. In addition, the National Social Security Fund (NSSF) could become a major capital market investor once a means is discovered for funding the establishment of reserves.

5. Closed- and open-end investment funds, both offered by fund management companies, are still relatively insignificant. Closed-end funds now dominate since they have been around longer but open-end funds, despite their short history, hold high growth potential. Both types are subject to a mandatory 20 percent investment in government bonds; beyond that, they invest mainly in equities. Domestic fund management companies have reportedly been prone to irregularities, including collusion and share-price manipulation.

6. Securities companies and TICs offer discretionary management services for portfolios of large investors, i.e., mainly for large state owned enterprises (SOEs). Guaranteed returns are often offered, largely for investments in the equity market. But the market downturn since mid-2001 has impaired the ability of securities companies and TICs to honor the promised guaranteed returns for investors. The collapse of many large TICs in recent years revealed many abusive and imprudent practices.

7. Commercial banks play a limited role in distribution, mainly conducting as-agent sales of mutual funds and life insurance. They are prohibited from engaging in securities and insurance activities as principal, though some banks have been able to circumvent these restrictions through affiliated firms.

8. China has the potential to build one of the largest institutional investor bases worldwide. Promoting the emergence of competent institutional investors is an important complement to an overall capital markets development strategy. Since institutional investors tend to have longer-term investment time horizons, they provide an ideal source of funds for investment in longer-term government and infrastructure bonds. Moreover, institutional investors would add depth and liquidity to the equity markets. Tapping into this demand will improve prospects for the market to better absorb increased equity supply resulting from the sale of state shares. Institutional investors would increase pressure on firms, listed and otherwise, to adopt better corporate governance structures and practices.

9. The benefits cited above can be achieved through a general strategy to build well-capitalized, creditworthy and efficient investment management institutions in China. This would involve steps to substantially improve the corporate governance of all financial institutions offering investment management services and to strengthen their institutional capacity. The latter would include ensuring that proper internal controls and internal audit functions, risk management systems, management information systems and an external audit function are all in place and functioning appropriately. It also would involve ensuring that the managers and employees of investment institutions have adequate professional skills and that they are subject to a system of controls and incentives that promotes prudent behavior and acting in the clients' best interest.

10. For the purpose of efficiency, simplicity and fairness (ensuring a level playing field), common standards would be applied to all investment management institutions that manage discretionary investments of others, including insurance companies, pension funds, investment fund managers, TICs and securities companies. A thorough and coordinated review of existing regulations would be sought with the aim to upgrade them where deficient and to harmonize them for all classes of investment management institutions. Similarly, action would be taken to harmonize the professional qualification requirements of employees who advise clients or make investment decisions on their behalf. The necessary professional skills involve investment analysis and portfolio management.

11. Efforts to strengthen the governance and institutional capacity of investment management institutions are not likely to be sufficiently successful so long as those institutions remain under government ownership, as almost all are today. Only a few examples exist internationally of successful government-run investment management institutions, and these have occurred under social and economic conditions very different from those in China. Thus, integral to building a substantial professional institutional investor base are ownership diversification and privatization of existing institutional investors; promotion of new entry, including foreign participation; and creation of a level playing field for all institutional investors, regardless of ownership.

12. To this end, particular emphasis would be given over the next few years to increasing foreign participation in the institutional investor market. The goal would be to transplant a critical mass of technology and skills sufficient to rapidly and markedly upgrade the capacity of institutional investors in China, and to rapidly train a new cadre

of Chinese investment professionals to lay the foundations for a strong domestic segment of the institutional investor industry.

13. In addition to these general strategies and actions, steps would be taken to encourage increased securities demand by institutional investors. Fixed-income mutual funds would be promoted as a means to increase demand for longer-term government bonds. The proposed strategy essentially is to promote the emergence of new classes of mutual funds that would appeal to the growing demand of investors having less risk appetite and/or longer investment time horizons. Liberalization of interest rates in the primary government debt market would be an essential prerequisite.

14. To create demand for infrastructure bonds, action would be taken to relax investment restrictions currently applied to different types of institutional investors. China currently permits investment managers to invest only in those types of products explicitly listed, thus restricting institutional investors' ability to craft diverse and balanced portfolios. Further, the permitted investments are often limited in comparison to international practices. A thorough and comprehensive review would be sought, with the goal of rationalizing, harmonizing and liberalizing the investment restrictions currently in place. In particular, investments in long-term infrastructure bonds meeting defined information disclosure standards and risk characteristics would be permitted for all classes of institutional investor. A complement to expanding the range of permissible investments would be to improve regulatory requirements on disclosure of risks and probable returns.

15. To create greater investment demand for equities, actions would be taken to strengthen the professional capacity of institutional investors to manage equity portfolios with a longer-term investment horizon. Of particular relevance are life insurance companies and pension funds. Once appropriate institutional capacity is in place, investment restrictions applicable to institutional investors would be further relaxed to permit investment in equity securities.

16. Complementary actions would be taken to promote greater foreign portfolio investment, whether under the new QFII regime or otherwise. Tapping into demand for Chinese securities by international investors would be leveraged both to increase the absorptive capacity of the capital markets for a wide range on instruments and to create an independent source of pressure for improved instrument design and pricing, better corporate governance, and improved infrastructure project design.

1 INTRODUCTION

1. China needs to develop solid long-term investment institutions, which can be broadly categorized as pension funds, life-insurance companies and collective investment funds.

2. These types of institutions currently exist in China, but they are at a nascent stage of development and would benefit from more clearly defined plans for their future development.

3. China's capital markets and investment sectors have been growing swiftly, but at the cost of being developed ahead of the strategic, legislative and regulatory framework.

4. The resulting institutional landscape is characterized by blurred boundaries among the different institutions and their activities; an insufficient legal base; varied (and sometimes competing) regulatory agencies; and jurisdictional uncertainties by institutions.

5. The rigid and restrictive structure placed on institutional investors along with unclear direction resulted in the emergence of so-called underground funds—informal, semi-legal structures designed to let larger investors seek semi-professional managers for their portfolios.

6. There are few well-recognized and trusted non-bank financial institutions (NBFIs) among the institutional investors. This has discouraged the vast pool of domestic household savings[1] from being constructively mobilized to meet key national, strategic objectives, resulting in a highly polarized deployment of savings by the population.

7. The more risk-averse individuals prefer to keep savings with institutions that they recognize and trust (largely banks, the government, and to some extent life-insurance companies) despite falling yields resulting from a progressive reduction in interest rates; real returns on offer are now very low by international standards. At the other end of the spectrum, those prepared to accept risk gamble in the equity markets. There is little on offer between these two extremes.

8. Currently, Chinese households deposit 75% of their savings into banks, with only 4% invested in the insurance-and-pension sector. In contrast, in the U.S., the insurance-and-pension sector holds the biggest share with 30%, while currency and deposits account for only 15%. Japan's case, in a sense, looks somewhat similar to China's, but Japan has a solid insurance-and-pension sector that attracts more than 25% of household savings.

9. To have a balanced financial system, household savings ought to be well spread across banking and non-banking products as in the U.S. Thus the medium term objective

[1] Household deposits stood at RMB 8.04 trillion, or US$ 971 billion (1 US$ = 8.28 Yuan), which is 83.8% of GDP at end-May 2002, while the total balance of all deposits amounted to RMB 15.33 trillion (160% of GDP).

for China would be to increase its non-bank sector, especially its institutional investors sector, to a level on par with Japan.

10. To reach these goals, this paper notes the existing structure and the activities of institutional investors in China and provides some principles on how to build a solid institutional investor base going forward.

11. Specifically, this paper reviews the relationship between capital market development and institutional investors (section 2); provides a brief overview of China's financial landscape vis-à-vis institutional investors (section 3); outlines the structure of China's capital markets (section 4); focuses on recent changes in the institutional asset management scene, with special attention to the implications of financial sector opening and the emergence of financial conglomerates (section 5); discusses principles for successful development of institutional investors in China (section 6); and summarizes the conclusions and recommendations (section 7).

2 THE ROLE OF INSTITUTIONAL INVESTORS IN CAPITAL MARKET DEVELOPMENT

12. China has strong reasons to develop its capital markets. SOE sector reform, banking system restructuring, and pension reform constitute key economic agendas for the government, and successful implementation of these three agendas will require robust capital markets. SOE reform, for example, will involve increased initial public offerings and strong corporate governance; and banking sector restructuring will need efficient debt capital markets to be developed. Further, China intends to address its pension shortfalls through its sale of state shares, which in turn depends on the absorption capacity of its capital markets.

13. To develop her capital markets, China needs, among other things, to foster the institutional investors sector.[2] Institutional investors play an instrumental role in capital market development in a following ways:

14. First, they provide a means of channeling savings into the capital markets with medium- to long-term investment horizons and with low- to medium-risk to investors. They also provide absorption capacity for issues of public and private debt and equity. One of the most distinctive recent changes in financial markets is the 'institutionalization of saving'[3] --a shift away from individuals' holding equity directly toward intermediaries holding it.[4] The drop in individual holdings to a large degree has been replaced by the increased share of pension funds, life insurance companies, and collective investment funds. Among them, collective investment funds have recently exhibited most rapid

[2] Major agendas include increasing the supply of quality shares; improving securities regulation; better protecting investors' rights; enhancing market integrity; and reforming corporate governance.
[3] David and Steil (2001) provide a comprehensive economic assessment of this important shift.
[4] Individual ownership of equity has fallen in the United States from 79% in 1966 to around 50% in 1993, while corresponding numbers in Japan were 53% in 1953 and about 20% in 1993 (Allen and Gale, 2001, p. 58-67).

growth in many countries.[5] For example, the most recent comparative figures from the Organization for Economic Co-operation and Development (OECD)[6] show that collective investment funds in OECD countries had an average annual growth rate of 20% in the years 1991 - 1998, compared to 13% for pension funds and 11% for insurance companies.

15. Second, institutional investors act as catalysts for financial innovation by creating new products, improving accurate pricing of financial assets, encouraging new market-participant entry, and pursuing better clearing and settlement. In the U.S., for example, institutional investors, especially pension funds, played a key role in introducing such innovative products as zero-coupon bonds, mortgage-backed securities and financial derivatives since the 1970s. Similarly, the development of money market funds (MMF) has contributed to financial innovations in money markets, notably CDs, CP, swaps, and repurchase agreement (RP). Pressure from large institutional investors to lower commission charges for large trading volumes often led to freeing up stock brokerage commissions and sparked even broader capital market reform -- eventually resulting in the so-called the "Big Bang" in the United States in the 1970s and in the United Kingdom in the 1980s.

16. Finally, institutional investors help establish high standards for compliance, disclosure and oversight of information (especially financial statements) and help improve corporate governance of market participants. Only large shareholders such as institutional investors have sufficient incentives and abilities, including the financial ability, to monitor and communicate with corporate management on a consistent basis. In the United States, large public pension funds such as the California Public Employees Retirement Scheme (CalPERs) and Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF) have played a prominent role in shareholder activism. The mode of intervention varies, and may include submission of shareholder proposals to companies and directors; direct negotiation with corporate management; and publicly targeting corporations through the media (see Gillan and Starks, 2002).

17. Cross-country empirical research also supports the importance of strong institutional investors to the development of capital markets. Specifically, this research usually shows that those countries with more developed institutional investors sectors are also the counties with more advanced capital markets, both in terms of market size and value traded (e.g., Calatan, Impavido, and Musalem, 2000). Impavido, Musalem, and Tressel (2003) suggested that the development of contractual savings institutions (pension funds and life insurance companies) had a positive impact on the development of equity markets in countries with a capital market-based financial system, while the development of the contractual savings sector contributed to the bond market more in countries with a bank-based financial system. As a country case, the Chilean pension

[5] Fernando et al. (2003) provides an excellent survey of the global growth of collective investment funds.
[6] OECD(2002a).

scheme[7], initially set up in 1981, and the capital market development that followed is widely viewed as exemplifying the positive interaction between them.

18. The close linkage between strong institutional investors and capital market development should not be seen as a "one-way street," however. Instead, the relationship is interactive: capital market structure can either stimulate or impede development of institutional investors, especially collective investment funds (CIFs). As argued by Vittas (1998a), pension funds and life insurance companies could develop on their own even when capital markets are underdeveloped. They initially could develop on the basis of non-marketable instruments such as loans, bank deposits, non-marketable government bonds, book reserves, and property investment. The case is different for CIFs, however. Unlike insurance contracts and defined benefit employer sponsored pension schemes, in which the insurance company and the sponsor respectively stand between the participant and the capital market as a guarantor, CIFs transfer the investment risk to the investor. In return for accepting risk, investors in CIFs gain considerable advantages, including a higher degree of risk diversification, lower transaction costs, professional management, investor protection and flexibility. To achieve these comparative advantages, CIFs require a deep, wide and liquid capital market supervised by competent regulators under a reliable legal and regulatory framework. CIFs only develop successfully where legal systems provide for clear and fair mechanisms of asset ownership and transfer and for redress if things go wrong; meaning that the enabling legislation plays a major role in creating and sustaining investor confidence. The availability (or lack thereof) of suitable financial instruments is of major importance as well, especially for money market funds whose success depends largely on their easy access to the higher wholesale money market instruments - CDs, CP, swaps, and RP - that are not usually available to ordinary investors.

19. Further, if institutional investors are constrained by restrictive investment limits, they cannot fully exert their beneficial impact on capital market development. For example, empirical analysis by Calatan et. al (2000) found that the positive externalities arising from the development of contractual savings institutions were less likely to materialize if those investors were permitted to hold only non-marketable government bonds. In contrast, a strong causality from contractual savings to stock markets and liquidity was observed in market-based systems in which the 'prudent investment rule' is a norm (Vittas 1998a). These observations support the conclusion that simply increasing the size of institutionalized assets does not automatically lead to development of capital markets.

---

[7] This innovative scheme was designed to replace the state pay-as-you-go (PAYG) system that was among the earliest in the world offering almost universal coverage (established in 1925, ten years before the U.S. scheme). Under Chile's privatized system, which is monitored and regulated by the government, neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect a government-funded pension. Instead, during his working life, he has 10 percent of his wages automatically deposited by his employer each month in his own, individual account. The contribution is not taxed. His pension level is determined by the amount of money he accumulates during the number of years he is working. The steady growth of funds under management has not only achieved the primary purpose, to provide social security benefits for old, age, sickness and unemployment, but has also had the effect of energising the capital market. See Holzmann (1997).

3 TODAY'S INSTITUTIONAL LANDSCAPE

3.1 Overview

20. Institutional investors in China today include commercial banks, pension funds, insurance companies, collective investment funds, securities companies, and trust and investment companies. Underground, or privately placed, funds also exist.

3.2 Banks

21. The four state commercial banks - Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China - are the dominant players in the PRC financial sector, accounting for 86%[8] of total bank assets and 66%[9] of total local currency loans.

22. Second-tier nationwide commercial banks[10] are much smaller than the four state commercial banks. Many of these banks, however, are more profit-oriented with better management. In fact, some small- and medium-sized regional banks are emerging as innovative players in banking. For instance, Nanjing City Commercial Bank has played a marked role in government-bond trading.

23. Banks are tightly restricted in their ability to offer clients anything other than deposits, non-tradable government savings certificates or, as a new product offering, marketable government bonds.[11] While banks can and do distribute, on an as-agent basis, insurance policies and investment funds produced and underwritten by other non-bank institutions, they are specifically prohibited from engaging in the securities business or owning or investing in non-bank financial institutions[12]. Prior to this ban, which is contained in the Commercial Banking Law of 1995, the four largest state-owned banks had involved themselves in non-banking activities, including the securities business. Following the separation of banking from non-banking, the People's Bank of China (PBOC) required banks to gradually shed their ownership of non-bank financial institutions.

---

[8] Economist Intelligence Unit (2002).

[9] As at December 31, 2002: PBC website, bank annual reports.

[10] Important banks in this tier include: Bank of Communications, China Merchants Bank, Guangdong Development Bank, Shanghai Pudong Development Bank, Shenzhen Development Bank, China Everbright Bank, Huaxia Bank, and China Minsheng Bank (nation's first private bank).

[11] Beginning in June 2002, selected large commercial banks were allowed to have over-the-counter bond dealings with individuals and corporations, holding custodian accounts for them. In the past, the lack of a sub-depository system impeded banks' ability to trade bonds with retail investors.

[12] The PRC Commercial Banking Law of 1995 (Article 43) states that a commercial bank shall not engage in trust investment or stock business; any investment in non-bank financial institutions or enterprises is also prohibitied. The Securities Law of 1998 (Article 6) similarly states that securities companies must be established separate from banks, trust companies and insurance companies. The Insurance Law of 1999 (Article 104) states that insurance companies are not allowed to use their funds to set up institutions dealing in securities or invest in enterprises.

24. The separation principle - sometimes dubbed the 'Chinese Glass-Steagall' - refers to banks being permitted to offer only non-bank financial products produced and managed by others. Banks thus cannot design, produce, market and manage products that they regard as appropriate for their own customers and that their own customers will trust as a result of the bank's reputation.

25. To date, although banks have played a dominant role in collecting and mobilizing public savings, their role in deploying those savings and advising their customers has been limited, both by the Law and by the burden of lending to SOEs at interest rates — tightly controlled by PBOC and State Council — that are low and undifferentiated by assessments of credit risk, which in turn has promoted artificially low interest-rates for money instruments and short-term deposits.

26. The general population, nevertheless, believes that bank deposits are fail-proof, and thus are prepared to accept low interest-rates in return for 'secure' capital. This has resulted in limited savings choices, with conservative and risk-averse savers (including those who might otherwise be more risk inclined) trapped in bank deposits, since few alternatives exist for short-term savings.

27. Commercial banks are key investors of government and quasi-government securities. As at December 2002, the country's financial institutions had built up loan and marketable securities portfolios of RMB 14 trillion and RMB 2.3 trillion respectively. The marketable securities portfolio is largely comprised of PRC government bonds and financial policy bonds[13]. The risk-free characteristics of these securities, coupled with stringent restrictions on foreign investments, has caused this portfolio to swell overtime. Depending on the size of their foreign currency deposits (which is growing with the surge in foreign reserves), the four state-owned commercial banks and the larger commercial banks also invest in foreign bonds on their own account as well as on behalf of clients.

28. With the emergence of securities investment funds, commercial banks started to develop their custody business as a new source of fee-based income. The custody business is the business area closest to the securities business that is permissible for PRC commercial banks. So far the market is dominated by the four state-owned commercial banks and to a lesser extent, Bank of Communications. Following approvals by PBC and CSRC in November 2002, China Everbright Bank and China Merchants Bank also entered the market.

[13] Offered by China Development Bank and the Export-Import Bank of China.

3.3 Pension Funds

29. In developed countries that have funded pension schemes[14], schemes of various sorts (defined benefit, defined contribution and personal, whether employer-sponsored segregated schemes or insured schemes) are the most significant long-term investors in capital markets. As of end-1999, U.S. pension assets posted 47.5% of all institutional assets[15]. In the U.K., by the same period, pension assets accounted for nearly 50% of all institutional assets.[16] In China, pension schemes should also be important capital market participants.

30. Until the late 1980s, an urban- and state-owned enterprise-based pay-as-you-go (PAYG) system provided a generous pension, i.e., 80% of a worker's total salary in addition to health, housing and basic welfare support (so-called "iron rice bowl"). A shift to a market economy rendered many SOEs, facing increasing competition from the private sector, unable to pay their retirees the promised full pension benefits. More fundamentally, demographic change has made the pension obligations — whosoever should bear such — very costly to fulfill.

31. After years of experimenting with municipal pooling and individual accounts, China's government introduced a new unified three-tier pension system in July 1997.[17] Under the new system, which combines social pooling with individual accounts, local governments, not SOEs, assume responsibility for pension administration. This multi-tier system was intended to settle into the following pattern:

(a) **Pillar I (social pooling)** – A pay-as-you-go (PAYG) defined benefit system, operated at the provincial level, which will provide 20% of the workers' average wages in respective localities from the previous year as a subsistence-level defined benefit[18].

(b) **Pillar II (individual accounts)** – A mandatory defined contribution scheme with contributions directed towards individual accounts, which, in theory, should be funded. It would entitle retirees to a monthly annuity equal to the accumulated individual account contributions divided by 120.

(c) **Pillar III (supplementary)** – Voluntary insurance schemes of various sorts, which may either offer personal pensions or small group pensions for companies whose size cannot justify a fully operational scheme.

---

[14] US, UK, Netherlands, Denmark and Switzerland all have substantial fully funded schemes. Germany, France, Spain and Italy still rely largely on taxpayer funded PAYG schemes, although all these countries, notably Germany and Spain, are taking tentative steps towards a higher degree of funding.
[15] The Conference Board (2000).
[16] UK Office of National Statistics.
[17] The State Council's Document No. 26: " Decision on Developing Unified Basic Old Age Pension System for Enterprise Employees," promulgated in 1997.
[18] Employees with less than 15 years of service will not be eligible for social pooling distribution but the balance in their individual accounts will be paid out in one lump sum.

32. Retirees who have contributed for at least ten years will receive the basic pension benefit and the individual account benefit, estimated to provide a replacement ratio of some 58% for the average employee.[19] Those who retired before the reforms were implemented will continue to receive pensions at about 80% of replacement rate.

33. Contribution rates vary by provinces and municipalities. In general, the enterprise contribution rate is 20% of total wages (initially 13% to Pillar I and 7% to Pillar II; the longer term objective is for the 20% enterprise contribution to go entirely into Pillar I). However, enterprises must contribute additional social security costs of some 14% of total wages[20]; this heavy contribution burden not only hurts their competitiveness but also leads to widespread non-compliance. Total contributions to individual accounts are set at 11% of wages, with individual employee contributions starting at 4% of wages and gradually rising by one percentage point every two years up to an 8% ceiling. The enterprise's contribution rate will gradually decrease from 7% to 3% of wages.

34. In terms of account administration, the current pension system remains highly fragmented, managed by some 5,000 local social insurance agencies. The State Council (in its Document No. 26) envisaged pooling the Pillar I contributions at the provincial level first and then at the national level.

35. By the end of 2001, all provinces have reportedly either put in place pooling mechanisms[21] or established adjustment funds to level out surpluses and deficits across cities/counties[22]. The outcome of actual implementation remains a source of skepticism, however. Evidently because of low compliance and transitional costs, many local pension pools are still running deficits,[23] requiring subsidies from the governments - provincial and central alike.

36. To adjust pension liabilities across provinces, the central government annually arranges a special fund transfer with general budget revenues of the national treasury. For example, the Ministry of Finance (MOF) had to allocate RMB 40.8 billion (0.4% of GDP)[24] in 2002 to finance the pension gap at the national level.[25]

37. According to the 1997 State Council regulations, Pillar II individual accounts were to be funded at 11%, with employee contributions to start at 4% of wage (in 1997) and rise by one percentage point every two years up to the 8% target. The remaining

---

[19] Leckie (2000).
[20] These include: unemployment (2%), medical (6%), and housing (6%) at minimum.
[21] Notably a portion (5% to 10%) such funds at the city/county level is elevated to the provincial social insurance agencies to level out surpluses and deficits across cities/counties.
[22] MOLSS Development Statistical Report (2001).
[23] In 2001, 28 out of 31 provinces registered deficit.
[24] MOLSS Development Statistical Report (2002).
[25] This transfer process is far from smooth. Given the poor recording system at the sub-national level, MOF is legitimately concerned about both false reporting and moral hazard by local governments. Not knowing the extent of the actual provincial-level pension shortfall, MOF is generally reluctant to transfer central budget to local governments.

balance is to be funded by enterprise contributions.[26] In theory, Pillar II pension funds could have opened a new chapter of funded pension schemes in China. In practice, however, individual account accumulations are widely used to pay retirees and to support the unfunded liabilities of first pillar PAYG pensions, preventing any real accumulation of funds. Some municipalities accumulate reserves but in most jurisdictions, individual accounts are notional with no separate funding.[27] In this sense, the overall public pension system, consisting of Pillar I (social pooling) and Pillar II (individual accounts), is currently running on a de facto PAYG basis.

38. Some municipalities are running considerable surpluses[28]. Total reserve accumulation of individual accounts is estimated at 0.8 % of GDP.[29] Reserves are mostly invested in bank deposits or government bonds. On implementation, no clear governance structure exists for the individual accounts, with trustee responsibility for ensuring correct investment policy and allocation of benefits. The local social insurance agencies administer and manage both Pillar I and Pillar II schemes in-house, including collection[30], record keeping and reserve management. For disbursement, four state commercial banks and the Postal Savings Bureau are entrusted.

39. Voluntary supplementary schemes (enterprise pensions, Pillar III) are still rare in China. As of end-2002, China had some 20,000 enterprise pension funds with 6.6 million participants, the combined total reaching RMB 26 billion (0.3% of GDP). The funds from voluntary schemes are invested in bank deposits and government bonds.[31] Voluntary contributions to the plans, up to 4% of wages, are tax deductible. Employers are encouraged to match employee contributions. At present, however, only a few cities (including Shanghai, Shandong and Shenzhen) are running pilot tax incentive schemes for enterprise pension contributions.

40. Employers can establish supplementary schemes utilizing in-house expertise. It is also possible for the social insurance agencies which manage Pillar I and Pillar II schemes to offer these voluntary funds. Finally, financial institutions, including life insurance companies, can initiate and manage these schemes. Sponsors of the voluntary funds include large SOEs and foreign joint ventures.

---

[26] When the system first started in 1997, individuals contributed 4% of the average wage, with enterprises picking up 7% to make it 11%. Currently average individual contribution rate stands around 6%, lowering enterprise contributions to individual accounts to about 5%.

[27] A pilot program in Liaoning, one of the most financially burdened provinces, was introduced in October 2001. One salient feature of the program involves the separation of the individual accounts from the rest of the system and the mandatory full funding of such with 8 % individual contributions. Similarly, the management of individual accounts is required to be segregated from the administration of PAYG system. The resulting deficits in the PAYG system will be covered by improved compliance efforts, within-province fund reallocation, and most importantly, fund transfers from the national budget and the National Social Security Fund.

[28] Guangdong province, for example, registers RMB 10 billion.

[29] Mark Dorfman (2002). The ratio would be equal to RMB 76.7 billion in terms of 2001 GDP.

[30] Currently both local social insurance agencies and local tax bureaus share collecting duties. Eventually, however, local tax bureaus are expected to assume full responsibility for the collection.

[31] " Provisional Regulations for Improving Urban Pension System."

41. Legal and regulatory frameworks for enterprise pensions are, at most, scant and in need of much improvement. Although a new trust law would safeguard voluntary pension funds by allowing enterprises to appoint trustees, there is no regulation requiring separation of pension assets from sponsors' other assets. Consolidated investment guidelines are being considered by the Ministry of Labor and Social Security (MOLSS) but have not yet been issued.[32] Tax-exempt contributions to the accounts are not linked to any specific form of pension management.

42. One of the most recent initiatives for China's pension reform is the creation of the National Social Security Fund (NSSF)[33] in September 2000. The NSSF does not form part of the mainstream state pension pool but is being built up as a reserve fund to cover potential unfunded liabilities in the PAYG system resulting from an aging population and an increasing dependency ratio.

43. The NSSF is to be funded by budgetary transfer by the central government, proceeds from the sales of state shares, and other sources such as receipts from national lotteries. The State Council decided in June 2001 to sell a portion of state shares during initial public offerings (IPOs) to finance pension shortfalls[34]. Specifically, when SOEs (including companies listed overseas) launched IPOs or issued additional stocks in the secondary market, they were to sell state shares — up to 10 % of the total funds to be raised – to replenish the NSSF. However, the sell-off of state shares, being widely unpopular, was blamed in part for the subsequent equity market decline. Thus the government suspended the sell-off in October 2001, forcing the Inter-ministry Joint Conference to search for new measures to make the program work. In June 2002, however, the government finally decided to scrap the June 2001 program altogether for domestic issuances.

44. Since its inception, the NSSF has grown to a value of RMB 124 billion (1.2% of GDP) in December 2002; with investments mainly in bank deposits (76%) and government bonds (22%). The fund's only capital market investment was a subscription of Sinopec's A-shares[35] as a strategic investor in August 2001.

45. In December 2001, the MOF and the MOLSS jointly issued "Provisional Regulations on the Management of Investment by Social Security Fund." According to the Regulations, the NSSF can be invested in bank deposits, government bonds and other liquid financial instruments including securities investment funds, equities, and corporate

---

[32] MOLSS is considering various measures to improve supervision and regulation of enterprise pension funds. Key regulatory agenda include: a) formulating regulations on institutions managing/safekeeping enterprise pension accounts; b) strengthening supervision and management of pension funds, including separation of the pension fund from other assets; and c) enacting rules on enterprise pension fund investment management. See Sun (2001).

[33] The NSSF is a public agency under the State Council and is primarily supervised by the MOF. The Council of the NSSF, which includes the finance vice-minister as an ex-officio member, is the highest decision making body of the Fund.

[34] " Provisional Measures on Management over the Reduction of State Shares to Raise the Social Security Fund."

[35] See section 4.3 for a definition of A-share.

and financial policy bonds above investment-grade.[36] Although these new Regulations would permit up to 40% of the NSSF's assets to be invested in equities, the NSSF Council opted out of portfolio equity investment, owing to the volatility of the equity market and to the low share quality of some of its listed companies. Finally, in January 2003, the Council awarded 11 equities and fixed-income portfolio management mandates to six qualified[37] domestic fund managers. This decision marked the historical beginning of pension fund participation in the equity market to anchor the otherwise highly speculative and short-term oriented market.

46. Clearly, the NSSF and the second and third pillar schemes are potentially substantial sources for regular investment flows into the capital market in China. Under the existing pension system, however, the prospects for pension funds will largely depend on the means by which the state covers the pension shortfall.[38]

47. If local governments stop borrowing from the second pillar individual accounts to finance the first pillar PAYG deficits, thereby helping individual accounts accumulate as envisaged in the Liaoning pilot program, the PAYG shortfalls will likely increase accordingly. This means that the central government will likely have to increase budgetary transfers to fill the bigger gaps, leading to an increasing fiscal deficit and placing a greater strain on the national budget. Despite the central government's reluctance to subsidize provincial and municipal pension shortfalls (even with the current practice of commingling funds between the first and second pillars), barring any major pension and/or fiscal reforms, the status quo of a de facto PAYG pension system is expected to continue.

48. Still, selected regions along China's prosperous east coast, e.g., Guangdong province and Shanghai municipality, will witness robust growth of second pillar individual accounts. These regions are less burdened by pension obligations originating from the large poorly-performing SOE sector and have also experienced greater economic growth. However, so long as individual accounts are managed by local government staff who may lack financial expertise, the funds of second pillar individual accounts will likely exhibit inertia toward bank deposits and government bonds, limiting their impact on capital market development.

---

[36] The investment portfolios of the monetary assets included in the NSSF may at cost value conform with the following: a) investment in bank deposits and government bonds may not be less than 50%. Of this amount, bank deposits must be at least 10%, but deposits with one bank may not be more than 50% of total bank deposits of the NSSF; b) investment in corporate bonds and financial bonds may not be more than 10%; and c) investment in securities funds and equity securities may not be more than 40%. Investment through one fund manager in the securities or securities investment fund issued by any one enterprise may not exceed 5% of the securities or total fund portion, nor exceed 10% of the total NSSF asset value.

[37] Fund management companies or other institutional investors are qualified if they (a) meet minimum paid-in capital requirements (RMB 50 million for a fund management company but not yet decided for other institutional investors); (b) have a minimum two years experience in securities investment; (c) demonstrate good corporate governance; (d) have no record of severe irregularities; (e) have sound internal management; and (f) have control systems and qualified staff for investment business.

[38] McKinsey & Company, Inc. (2002), the consultancy, estimated that China's pension gap will increase to $15 billion by 2005 and to $110 billion by 2010.

49. State-owned share sales proceeds would continue to serve as the main revenue source for the NSSF. China's government holds two-thirds of listed SOE shares and hundreds of those non-listed. Thus, if the government successfully employs effective methods for selling state-owned shares, the NSSF holds great potential to amass huge reserves, and would become a dominant institutional investor in China. However, it remains to be seen how long the government, facing increasing pension shortfalls, would leave the NSSF untouched. Currently, it is unclear how and when the government will distribute the NSSF to subsidize the pension shortfalls of provinces/municipalities.

50. Even if the state share sell program is reactivated in the future to build up NSSF's reserves, the fund's net impact on the stock market will be limited. Unlike typical funded pension schemes that collect contributions from participants, China's NSSF would be funded mainly through share sales proceeds, i.e., the potential supply of a portion of such shares to the local equity markets.[39] Therefore even though some of the NSSF reserves would be reinvested in shares of different listed companies, the Fund's impact on demand in the equity market will be partially offset, or in some extreme cases be outweighed, by supply pressure in the market.

3.4 Insurance Companies

51. The role of insurance companies in the development of capital markets in China could be potentially significant. In the U.S., for example, insurance companies account for nearly 30% of the institutional market, while in continental Europe, they play an even greater role with nearly 40%.

52. As of end-2002, 54 insurance companies are licensed, with some 10 companies expected to follow. Of those licensed, 19 are foreign companies operating through joint venture or branch operations. Combined assets of insurers stand at RMB 649 billion (6.3% of GDP), making the insurance sector by far the largest institutional investor in China.

53. In 2002, total premium income aggregated RMB 305 billion (life: RMB 227 billion, non-life: RMB 78 billion), up 44.7% over 2001. Insurance premiums have been growing at an average compound rate of 43.5% per annum between 1985 and 2000[40]. The reason for this growth lies not with any particular tax advantage, a factor that often drives insurance elsewhere, but more with the fact that insurance is, in the well known phrase, "sold, not bought". Insurance salesmen exceed 1,000,000 nationwide and are largely motivated by their sales commission; their meager salary is seen as a retainer rather than wage.

54. Despite this strong growth, in 1999, insurance premium was only 1.5% of GDP, compared with 11.3% in South Korea, 8.6% U.S., 6.9% Taiwan and 4.7% Hong Kong.[41] Insurance is predominantly sold as a savings product rather than some protection-form

[39] If the sales involve block sales to strategic investors or M&As, the shares will not be immediately supplied to the secondary equity market for portfolio investment.
[40] China Statistical Yearbook, 2000.
[41] Swiss Re Economic and Research Consulting.

product. In other words, insurance policies are used as a means to accumulate capital rather than as a household safety-net. Insurance policies also appear attractive to wealthy entrepreneurs who fear that any perceived malpractice may result in their bank accounts being frozen; insurance policies are believed to be protected.

55. Under the "Provisional Regulations on Investment in Insurance Companies" issued by the China Insurance Regulatory Commission (CIRC) in 1999, 'banks' and 'securities institutions' are excluded from the definition of qualified shareholders "unless the relevant laws or regulations have otherwise stipulated or have gained State Council approval."

56. Currently, most established insurance companies are believed to be operating with substantial negative equity. This situation is a result of the fact that, prior to 1999, insurance companies could only invest in government bonds and bank deposits. At the same time, they were required to offer guaranteed returns over the life of the policy (up to 20 years) and guaranteed surrender values. Given the progressive cuts in interest rates (bank deposit rates have fallen from 11% in 1997 to 1.98% to date) insurance companies were faced with an impossible investment management situation, burdened with outstanding guarantees of returns far exceeding that of market rates subsequently available.

57. More recently, there has been some relaxing of the strict rules governing investment by insurance companies. New regulations[42] that became effective in March 2000 and to a lesser extent January 2003 have been used by the CIRC to liberalize investment restrictions to a limited extent. The following relaxations have occurred or may occur:

(a) In 1999 the CIRC permitted insurance companies to invest 5% of their assets, and later up to 10%, in investment funds, investing largely in equities. This investment limit was raised in January 2001 to 15% for a select group of 6 insurance companies and 12% for 2 others.

(b) Plans for licensing special investment funds whose investors are limited to insurance companies (which would be prohibited from managing such); rather, those permitted would be asset management companies licensed by the China Securities Regulatory Commission (CSRC).

(c) In June 2001, insurance companies were allowed experimentally to establish in-house asset management capacity. This was structured as a department; in the case of China Life, the nation's largest insurer, it has been functionally and physically separated from the rest of the business. One can surmise that this may have been a preparatory move for granting permission to insurance companies to manage their own equity portfolios. Such in-house asset management departments may also manage under contract segregated pension funds, and even sponsor and manage investment funds.

[42] " Regulations for the Administration of Insurance Companies" enacted by the CIRC on January 13, 2000 and subsequent amendments on October 2002.

(d) Permitted investments are expanded to include bank deposits, government bonds, financial debentures, corporate bonds (double-A or higher rated bonds issued by central government enterprises), securities investment funds and repos.

(e) In October 2002, certain investment related negative clauses of the "Regulations for the Administration of Insurance Companies" were amended, although no new permitted investments were introduced.

(f) In November 2002, CIRC abolished the verification or pre-approval requirement for 58 corporate actions, including those pertaining to investments in securities investment funds, purchases of corporate bonds and overseas deployment of funds.

58. Rigid investment restrictions mean insurers have investment portfolios skewed toward bank deposits (53.7%), government bonds (19.2%) and policy bonds (7.2%), while repos of government bonds, corporate bonds and investment funds make up the remainder with 11.0%, 3.3% and 5.6%, respectively[43]. This investment composition of PRC insurers is a stark contrast to those observed in Europe and North America, where bonds and shares usually account for two-thirds of total investment.[44]

59. Further, in China, unlike in other countries, the life business is dominated by one company, China Life, which held a 57% market share in 2002[45], followed by Ping An with 27%. Foreign entrants must have a local partner, but such are hard to find.[46] There is a long queue of foreign life insurance companies awaiting a license.

60. The combination of restrictive investment regulations and virtual monopoly by China Life has meant that product innovation has been lacking. One exception has been the introduction of unit-linked policies[47], notably by Ping An, which reports growth in its new premium income in excess of the industry average as a result.

61. Another innovation has been group and personal pensions (third pillar type), which may offer a choice of investment portfolios, conceptually similar to the US 401(k) product. In fact, the 1997 pension reform that allowed life insurance companies to offer supplementary schemes sparked rapid growth of the life insurance sector, surpassing for the first time the non-life insurance sector in premium income.

---

[43] As at December 31, 2002 per CIRC.
[44] But for China, one would say two-thirds is much too high.
[45] CIRC and World Bank.
[46] The one exception to this requirement, American International, a subsidiary of AIG, for historical reasons is 100% foreign-owned.
[47] In general, unit-linked policies, popular in Britain and elsewhere, offer the minimal level of death benefit necessary to qualify as life insurance policies, with the balance of premiums invested in equity or a managed portfolio. These can expose policyholders to the stock market and possibly superior returns over a long period. Investors can be offered a range of "funds", where their premiums may be invested in products ranging from conservative (investing largely in bank deposits) through medium risk and to aggressive growth.

62. Substantial revisions in the Law covering insurance[48] were prepared by CIRC and submitted to the State Council for review in the first half of 2002 and subsequently endorsed by the NPC in October 2002. Salient features of the amendment are as follows:

(a) More flexibility in product design and pricing: The basic insurance clauses and premium rates will be no longer determined by CIRC. Rather, insurers will be granted more flexibility to price and design new products.

(b) Relaxation of investment restrictions: The revised Law removes certain specific investment restrictions and delegated authority to the State Council to approve new forms of permitted investments.

(c) Lifting of restrictions on agents[49]: The revised Law states that individuals can only act for one insurer but institutional agents can accept delegation from multiple insurers.

(d) Business scope expansion. Property insurance companies are now permitted to engage in accidental injury insurance and short-term health insurance businesses.

63. With further liberalization of investment restrictions and product innovation, insurance companies' role in the development of capital markets in China will be potentially significant.

64. Given the fast rate of growth in the PRC insurance market, it is imperative to put in place sound policy, as well as an adequate regulatory and supervisory framework. Notably the systematic risk to financial markets from insurance company failures can be substantial (although the degree of risk will depend on the type of insurance contract being written). The greatest growth area in China currently is unit-linked insurance, which stipulates that market risk will be borne entirely by the policyholder with the insurance company offering only minimal life cover. As such, unit-linked insurance will not likely post huge systemic risk to the system. But it will be important to supervise this product in areas such as charges and the distribution mechanism.

3.5 Collective Investment Funds

65. By the end of 2002, 54 closed-end and 17 open-end investment funds have been established by 17 fund management companies under two provisional regulations[50]. In 2002, new offerings of closed-end and open-end funds amounted to RMB 12.7 billion and RMB 44.8 billion respectively. However, such securities investment funds still represent a relatively insignificant part of the savings spectrum, with aggregate funds

[48] Insurance Law of the People's Republic of China, 1995.

[49] In a number of countries, notably in both Britain and Ireland, growth in the insurance market had been facilitated by the fact that bank branch managers acted in their personal capacity as insurance agents. However most banks have abandoned the practice of permitting bank managers to earn commissions personally from sales of life insurance products.

[50] " Provisional Administrative Regulations on Securities Investment Funds" (State Council, 1997) and " Provisional Regulations on Open-end Securities Investment Funds" (State Council, 2000).

under management of RMB 123 billion (1.21% of GDP) by end 2002. Of this amount, closed-end and open-end funds stood at RMB 72 billion and RMB 51 billion respectively. The recent state of the stock market (with indexes down some 30% to end 2002 since peaking in June 2001) is not conducive to sector growth.

66. Nevertheless, 2002 also saw major progress in the investment fund industry. Notably the NPC reviewed the draft Securities Investment Funds Law, which was meant to regularize the investment funds sector and clarify the roles of the stakeholders. In the same year, China Securities Investment Funds Industry Association was established as an SRO. The CSRC has promulgated four key regulations for the sector. These are:

(a) Securities Investment Fund Management Companies Internal Control System Guidelines;

(b) Circular on the Transfer of Ownership in Regularized Investment Fund Management Companies by Shareholders;

(c) Circular on Questions Concerning the Authorization of Investment Funds; and

(d) Regulations on Foreign Participation in Fund Management Companies, which heralded the establishment of China Merchants Fund Management Co., Ltd.[51] in January 2003 as China's first joint-venture fund management company.

67. Originally, only securities companies and trust and investment companies were allowed to establish fund management companies.[52] The current view of the CSRC is that any institution that has good credit standing and that is operating legally is a qualified shareholder.[53] Nonetheless, banks and insurance companies are banned from investing in fund management companies by the Banking Law and the Insurance Law, respectively.

68. With open-end mutual funds introduced in September 2001, more securities companies are scrambling to establish fund management companies.[54] Some foreign fund management companies are already providing advice to their domestic partners regarding establishing open-end funds.

69. By the end of 2002, closed-end funds dominated the market with a 58% share, down from 85% in 2001. However, the nascent open-end fund sector is expected to become the most popular form in the future (42% of market size by end 2002), as they are everywhere else. In the U.S., closed-end funds account for less than 2% of the total value of investment funds[55], while in the U.K. they account for some 25%[56] (the reason

[51] China Merchants Fund Management Co., Ltd., is held 40% by China Merchants Securities Co. Ltd.; 30% by ING; and 10% each by China Power Finance Co., Ltd., China Huaneng Finance Co., Ltd., and COSCO Finance Co., Ltd.
[52] " Provisional Administrative Regulations on Securities Investment Funds."
[53] " Notice on Several Issues Regarding Establishment of Fund Management Companies" (CSRC, 2001).
[54] As of July 2002, 16 applications have been filed with the CSRC to establish fund management companies.
[55] Investment Company Institute.

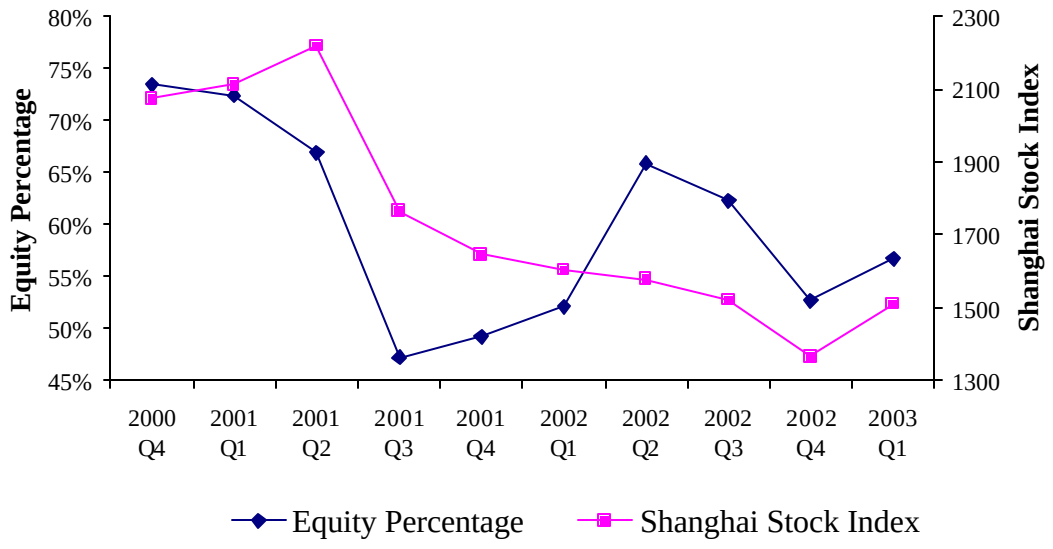
for such is historical; closed-end funds' share of the total is steadily declining). In the rest of the developed world, e.g., continental Europe, closed-end funds are equally insignificant.

70. Both open- and closed-end funds invest largely in equities apart from the mandatory 20% in government bonds. The fact that no fixed-income fund existed until recently [57] may be indicative of the management companies' views of demand — or lack of such demand — in the market for bond funds. The recent decline in the equity market has caused an increase in asset allocation to bonds exceeding the 20% floor requirement; in fact, the ratio exceeds 50% for selective portfolios.

71. It is unusual that, during a period of falling interest rates, and consequently rising bond prices and falling equity prices, there has not been greater supply of fixed-income funds in China. In other countries whose equity markets have suffered during the global bear market since early 2000, fund management companies have actively promoted fixed income funds as an alternative and more stable form of investment. This reverses the trend that saw a lackluster supply of and demand for money market and bond funds during the long bull run of the 1990s.

72. In China, it may be that the equity culture is too strong for a move to fixed income funds to have been contemplated, or that there is a market perception that there are insufficient instruments for effective portfolio diversification and active management. More likely though, investors see no clear and significant advantage in fixed-income investments through the intermediation of investment funds as opposed to using existing direct channels (bank deposits and government savings certificates).

Figure 1: Equity Holding of Investment Funds



[56] Investment Management Association and the Association of Investment Trust Companies.
[57] Huaxia Fixed Income Investment Fund was launched in October 2002 and remains the only pure bond fund to-date. It is an open-end fund with initial subscription of RMB 5 billion.

Source: China Galaxy Securities Company, World Bank

73. Another unusual feature of closed-end funds in China is that many such funds trading at a premium over net asset values (NAV) saw more active trading than comparable discount funds. This clearly indicates a lack of understanding on the part of investors, since fund performance does not justify a premium for management. Investment funds are clearly regarded by many investors as just another form of listed stock. Once the relationship between market price and NAV is better understood, a preference will grow for open-end funds, whose price and NAV must always be the same and which carry the advantage of redemption whenever at full NAV. This will also put pressure on fund managers to produce better performance. It will clearly take some time for ordinary investors to gain a better understanding of the merits and characteristics of investment funds.

74. Performance assessment is already actively carried out by a number of specialist fund analytical companies. These companies regularly publish the results of their research and the performance evaluations in the financial newspapers and on company and industry websites. This is a useful and valuable development since it indicates that fund managers will become subject to public scrutiny based on independent-source quoted statistics. This kind of regulation, often termed "reputational regulation," is a valuable addition to the supervision of the securities regulator and means that the pressure to produce good results is driven by both commercial and legal considerations.

75. Domestic fund management companies are reportedly prone to irregularities, including collusion and share-price manipulation. In January 2001, the CSRC criticized some fund managers for misconduct in their IPO application process. This episode indicates that getting the inside track on IPOs is still the most important aspect of investment in China, a very myopic view. Such practices were, however, dampened by the persistent market decline and the realization that stocks may also open at below IPO price.

76. If mutual funds are to become mainstream savings vehicles for ordinary retail investors, as they are in many countries, it is imperative that the image of the industry be clean and honest. The passage of the Securities Investment Funds Law (widely expected to be in 2003), accompanied by detailed regulations and effective enforcement, could be a milestone for sector development.

77. At the same time, certain restrictive rules prevail. Fund management companies, which are licensed to manage investment funds, are prohibited from offering discretionary management services to individuals, although they may be permitted to manage segregated pension assets in the future.

78. A highly positive development has been the publication of the long-awaited regulations on joint ventures between domestic and foreign asset managers. This will permit the foreign partner initially to take up a maximum stake of 33% in the joint venture; the ceiling will then rise to 49% after three years. Some concerns have been expressed about the large amount of initial capital (RMB 300 million) that the foreign

partner will need to subscribe, but given the substantial nature of the known foreign participants to date and the perceived potential in the Chinese market, this may not prove to be a great barrier.

79. The drafting of the Securities Investment Funds Law, which is now under review by the National People's Congress, is also subject to major market scrutiny. The scope of the draft law had long been subject to a variety of views and debate, specifically, should the Law cover "special" funds (i.e., venture capital funds, industrial funds and private equity funds) or should it confine itself to legislating only the more classical, retail securities investment funds? Evidently it has been decided that only classical securities investment funds would be covered, with a separate law to be drafted for specialized funds (venture capital, private equity and corporate restructurings, etc.) in the future. Other key issues raised by the drafting group include the types of fund permitted (trust-type and corporate-type); limitations on investments; and the relationship among the fund management companies, the custodian and/or the trustee.[58]

3.6 Securities Companies

80. As of October 2002, 124 securities companies are operating in China[59], of which 18 have been licensed as comprehensive securities companies, i.e., are licensed to engage in underwriting, dealing, and brokerage businesses. According to the PRC Securities Law of 1998 (article 6), securities companies must be established separately from banks, trust companies and insurance companies.[60] Further, financial institutions, with the exception of securities companies and trust and investment companies, are not permitted to hold shares in securities companies.[61] CSRC-promulgated "Administrative Rules of Securities Companies" (2002) impose few restrictions on qualification of shareholders except for some financial standards, however.

81. Securities companies have a narrow business scope in China, focusing on brokerage of and dealing in equities. Revenues from their investment banking business only account for a marginal proportion.[62] In profitability terms, strict entry barriers, coupled with rapid market expansion, guaranteed monopolistic rents to incumbents. However, concentrated revenue sources imply that profits are highly subject to market conditions.

---

[58] Available on request are short notes which catalogue key issues raised with the drafting team and comments on them.

[59] According to the PBOC, as of 9 January 2003, these companies fall into four categories: Comprehensive (18), Broking (27), Rectifying (25), and Transitional (54).

[60] Prior to the effective date of the Securities Law of 1999, TICs were permitted to engage in securities brokerage business. The Securities Law of 1999 required TICs to separate their securities business. Of the 124 existing securities companies, 26 companies have been transformed from the securities business units of TICs.

[61] "Certain Opinions on Further Strengthening the Administration of Securities Companies" (CSRC, 1999).

[62] Recent research on China's securities industry by China International Capital Corporation, Ltd. (July 16, 2001) shows that one of China's big-ten securities companies earned most its revenues from brokerage (44%) and securities trading (38%) in FY 2000.

82. Prior to the promulgation of the "Notice on the Regulation of Securities Business with Clients' Power of Attorney" in November 2001, securities companies were prohibited from operating discretionary management accounts for their clients[63]. Since this was an ill-defined product area, however, many activities were left being neither legal nor illegal, and many securities companies viewed it as a legitimate and essential business area. Securities companies were prohibited prior to 1999 from directly managing investment funds (but they can invest in fund management companies).

83. In practice, many securities companies have engaged in the discretionary asset management business, mainly for large corporations. Several types of management styles exist: with/without minimum guarantee return and guarantee with profit-sharing.[64] The market downturn since mid-2001[65] however meant that securities companies could not honor their promises, therefore resulting in huge capital losses. In order to maintain their liquidity positions, securities companies competed even more aggressively for new discretionary asset management businesses. By so doing, they bid up the guaranteed return and created a vicious cycle in an adverse market environment. One striking example was China Southern Securities, one of the country's largest stock brokerages, which applied for bankruptcy in June 2002. To bail out the company, the Shenzhen municipal government, as majority shareholder, reportedly had to raise RMB 2 billion. The troubled company was estimated to manage RMB 50 billion of funds directly and over RMB 100 billion indirectly.[66]

84. As of October 2002, the total funds securities companies managed for clients stood at RMB 51 billion (0.53% of GDP). Because this figure was derived from balance sheets filed by securities companies, it is believed to be substantially under-represented.

85. In order to rectify irregularities surrounding the investment management business of securities companies, the CSRC introduced the "Notice on the Regulation of Securities Business with Clients' Power of Attorney" in November 2001. According to the Notice, securities companies must now obtain a separate business line license from CSRC to offer investment management services to clients. The appointed securities company must sign a power of attorney with the appointer (client) so that both share accounts and cash accounts are opened under the appointer's name. Guarantees of minimum returns or promises of loss sharing are strictly prohibited[67], though the policies and objectives of investment may be negotiated between the parties. In addition, the Notice includes investment fund-like regulations, *inter alia*, diversification of funds with a 10% maximum ceiling on securities issued by a single company, separation of client assets, and prohibitions on conflict of interest. On disclosure and transparency requirements, the securities company must provide the client a quarterly update of portfolios, and must file a monthly report on its investment management business with the CSRC.

---

[63] Securities Law of the PRC December 1998, Article 142.
[64] This practice has help create a constituency against government attempts to deflate the equity market – which in turn has undermined its ability to execute a sale of state shares program. See Naughton (2002).
[65] Shanghai Stock Index was down 32% from its peak on 14 June 2001 to 6 May 2003.
[66] www.chinaonline.com, June 21, 2002.
[67] Despite this, many securities companies maintain that guaranteed return discretionary asset management schemes stand to be a legitimate and essential business area for China's transitional economy.

3.7 Trust and Investment Companies

86. Trust and investment companies (TICs) were one of the most important sectors in China's capital markets in the two decades after 1979, when the State Council first established the China International Trust and Investment Corporation (CITIC). By the late 1980s, some 700 TICs were established by ministries, municipalities, provinces and large SOEs, first as a vehicle to attract foreign capital but later as an omnibus financial arm of public organizations. Until the mid-1990s, given their universal business scope, flexible fund-raising capability and minimal supervision, TICs were highly regarded financial institutions, dominating the PRC non-bank financial sector even though their business scope involved quasi-banking.

87. The TIC sector began to encounter difficulties in 1993, when the central government began to restrain the overheating economy, which produced slower output growth, tighter liquidity conditions and high inflation rates. In January 1997, the second largest TIC, China Agribusiness Development Trust and Investment Corporation, filed for bankruptcy. Thereafter, several TICs began defaulting on loans, leading to operation closures. The Asian financial crisis further aggravated the TIC sector, and some international TICs began defaulting on their foreign debt. What soon resulted was the TIC sector becoming one of the weakest links in China's financial system.

88. TICs suffered from several common problems:

(a) Before the mid-1990s, TICs relied on investments in property and equity markets for quick returns. However, the scope of such activities narrowed as the economy slowed down its spectacular growth rates. TICs then experienced heavy losses in the property and equity markets.

(b) The success of TICs in attracting deposits traditionally depended on their ability to offer double-digit interest rates. However, the PBOC banned all such activities under the unified interest rate regime. TICs were then left with little option but to rely on the volatile and risky inter-bank lending market for funding. Whereas inter-bank loans have short maturities, most of the projects in which TICs were engaged were long-term in nature. This mismatch exposed TICs to the risk of considerable liquidity problems.

(c) A selected and fortunate few TICs were permitted to borrow long-term funds from the international capital markets to finance their domestic operations. Proceeds were then lent or invested in the original currencies to projects with predominately RMB-based revenue streams, thus creating substantial currency mismatches for the all parties concerned.

(d) The absence of rigorous supervision by regulators led to TICs being poorly managed. As a result, TIC activities were often the focus of fraud, embezzlement, corruption and other malpractices.

(e) TICs extended loans under their own name and provided guarantees to their numerous subsidiaries in off-balance sheet accounts. As a result, they often incurred larger liabilities than their annual reports would suggest.

89. After 1999, the central government immersed itself into restructuring the TIC sector as TICs became a potential source of instability for the macro-economy. The main purposes of the 1999 restructuring plan, heralded by the closure of Guangdong International Trust and Investment Corporation (GITIC), included:

(a) TICs should be restructured to become "intermediary financial institutions" which practice trust business[68]. TICs would not be allowed to engage in banking businesses such as deposit-taking and lending.

(b) The trust and investment business would be segregated from the securities business in terms of structure, regulation and operation. TICs' securities business would be spun-off and merged into new securities companies.

(c) TICs should meet strict standards such as minimum capital. Small, undercapitalized TICs would be consolidated or closed.

90. According to the 1999 rectification plan, TICs have been undergoing a long period of restructuring, involving closure, liquidation, reorganization, merger and acquisition. The PBOC announced that of the 239-then existing TICs, only 60 would be allowed to continue operations under much stricter prudential regulation. As at 10 February 2003, 42 out of the some 60 TICs have re-registered with PBOC.

91. During this process, some important laws and regulations were enacted. At present, China has put in place the framework of a complete set of laws and regulations on trust businesses. The Standing Committee of the National People's Congress passed the Trust Law in January 2001, which became effective on October 1, 2001. Based on the new law, PBOC issued a series of attendant regulations, notably the "Administrative Rules on Management of Trust and Investment Companies," which came into effect on January 12, 2001 and was subsequently renewed on May 9, 2002.

92. Under the new regulatory framework, TICs will be subject to strict licensing requirements, disclosure and transparency rules and better-defined business scopes:

93. First, establishing a TIC is subject to PBOC examination and approval (these functions are now assumed by the newly-established China Banking and Regulatory

[68] According to Article 4 of the "Administrative Rules on Management of Trust and Investment Companies" by the PBOC (2001), trust business refers to "the business activities of a trust and investment company that accepts trust and handles fiduciary matters as a trustee while being paid." The PRC Trust Law (2001) fails to address what the trust business is and who can engage in that business, however. To address this omission, the Administrative Office of the State Council hastily issued the "Notice Concerning the Relevant Issues in the Implementation of the Trust Law of the PRC" in December 29, 2001. The Notice prohibits the operation of trust businesses by legal persons other than TICs and fund management companies until the State Council formally promulgates "Administrative Regulations on Trust Institutions" (which have not yet been proposed). For a comparative review of the PRC Trust Law, see Guo (2001).

Commission[69], CBRC). Commercial and industrial entities, securities companies, and local bureaus of the MOF can invest in TICs. Investments in TICs by individuals and banks will be subject to special CBRC approvals.

94. Second, TICs are required to establish a series of internal control and risk management systems. TICs must submit their operational reports and financial statements to the CBRC. Within the TIC, a 'Chinese wall' must be established between the trust business department and other business departments.

95. Third, TICs may engage in various trust businesses, including the following: capital trust; trust for tangible and intangible properties; investment fund business; intermediation of M&A activities; project finance; asset management; underwriting of government and corporate bonds; financing leases; and other such CBRC-approved businesses.

96. Fourth, in performing the above trust and investment businesses, TICs are subject to a set of regulations. For example, the term for such trusts shall not be less than one year, and the amount of a trust contract shall not be less than RMB 50,000.[70] Further, TICs must also observe specific asset and liability ratios in their business operations.

97. There are also many provisions in the Administrative Rules prohibiting TICs from conducting the trust businesses in a manner that contravenes the basic norms of a trust, e.g., a trust company must not manage trust assets for non-trust purposes, or post collateral on trust assets for its own debt obligations, or co-mingle trust assets with its own assets, or undertake to maintain the value of trust assets, or guarantee minimum returns, etc. (Article 31). According to the Rules, TICs are not permitted to take deposits, issue debt securities, or borrow in foreign currencies (Article 9).

98. Despite recent efforts by PBOC, regulation of the TIC sector still needs much improvement, especially in the area of "capital trusts". When the PBOC "Provisional Measures on Administration of Capital Trust for Trust and Investment Companies" became effective on 18 July 2002, TICs were allowed to manage capital trusts for individual schemes with less than two hundred settlers. TICs wasted no time launching capital trusts in Shanghai. However, the lack of a clear definition of public offering combined with lax supervision led to offering capital trusts to retail investors without implementing proper measures for investor protection. For example, TICs got around the ban on new product advertisements by asking the financial press to carry a detailed story about the product. Between July 2002 and 10 February 2003, over RMB 5 billion was raised from 39 collective capital trusts[71].

99. Indeed, the regulation of capital trusts is still quite rudimentary compared to similar collective investment schemes (e.g., mutual funds). There is no required pre-review of a collective trust by the regulator before a plan is offered to the public; the investment guidelines are too lenient (particularly with regard to industrial funds) and

[69] CBRC was officially established in April 2003.
[70] Article 45, the Administrative Rules on Management of Trust and Investment Companies.
[71] Per Jun Ze Jun Law Offices, such schemes were offered by 23 TICs.

there are no provisions on conflicts of interest; and there is a lack of regulations and standardization on valuation, redemption, and disclosure.

100. If the CBRC fails to develop a comprehensive regulatory framework and to rigorously supervise TICs' trust business, the TICs sector will be vulnerable to repeating past mistakes. After watching TICs manage the newly introduced capital trusts as long-term infrastructure funds or hybrid industrial funds, PBOC promptly issued "Notice Concerning Capital Trust Business of the Trust and Investment Companies" on October 9, 2002. In this Notice, PBOC clarified key definitions including "collective trusts". In addition, a distinction was drawn between "securities investment capital trust" and "non-securities investment capital trust," and additional requirements were introduced for the latter. Except for securities investment capital trusts, multiple capital trusts managed by the same TIC cannot concurrently invest in a particular company. This ban seems intended to prevent industrial capital trusts from being effectively used as M&A tools.

101. In sum, China's TICs sector remains in a state of flux. Notably, the restructuring process is thwarted by a combination of complex ownership, heavy debt burden and the need to negotiate loss-sharing agreements among domestic and foreign investors and creditors under their complicated financial structures. Because the serial collapse of large TICs revealed many abusive and imprudent practices, the sector will need time to rebuild public confidence. At the same time, the sector also faces increasing competition from securities and fund management companies as the divide between investment advisory, fund management and trust businesses becomes blurry. Furthermore, as these institutions are supervised by different regulators, there also exists room for regulatory arbitrage. Other impeding factors for sector growth include China's weak credit culture, unclear registration guidelines for trust properties, and weak information disclosure, accounting and tax provisions. However, as long as the trust business — albeit poorly-defined — is exclusively set aside for this sector, revamped TICs could have their chapter in China's capital markets in the future.

3.8 Underground Funds

102. The so-called underground funds[72] have fast proliferated in China since the introduction of stock exchanges in the early 1990s. They exist since other means by which larger investors can obtain professional discretionary management have not been freely available, and because of the rigid, bureaucratic and expensive licensing regime.

103. Privately placed funds may be a better description than "underground" since the operation of such funds does not appear to be illegal as such. Research into the activities of such funds[73] indicates that the total value of assets managed may be as high as RMB 700 billion, or 7.3% of GDP (compared to RMB 123 billion and 1.2% of 2002 GDP for

[72] Large existing underground funds are basically devoted to equity market speculation and not productive investment. Underground funds encourage enterprises to use their spare cash and often funds borrowed from the state-owned banks for speculation. In this sense, this sector is distinguished from informal credit sector characterized as breaking through rigid monetary control and providing finance for growth of private enterprises in China, particularly in prosperous coastal regions.
[73] Xia (2001).

licensed securities investment funds), but the fact that the funds are not licensed and recorded indicates such data is thin and largely inferred.

104. Privately placed funds are not controlled in any form and are often managed by unlicensed entities. They are neither illegal nor legal, and can be seen as a good example of an unintended outcome of the nebulous legislative base.

105. The passage of the Trust Law in 2001 has provided the opportunity to formalize these activities, however. The "Administrative Rules on Management of Trust and Investment Companies" requires all companies with business operations falling under this law to be registered.

106. Also, starting in 2003, securities companies that have acquired a special license may manage discretionary funds on client's behalf (see our comments below at section 6.1 as to how these operations should be legally structured).

107. The preceding two measures should result in the legitimization of unregistered funds through the intermediation of fully licensed entities – TICs, securities companies or fund management companies. Investors who have suffered losses in private funds managed by unlicensed entities may migrate to more competent licensed service providers in the future.

108. Meanwhile, it is hard to see what great harm such funds do apart from the fact that they act as short-term speculators rather than long-term investors. The research suggests all but no attempt to sell such funds to private citizens. The main client base of private funds consists of wealthy enterprises and financial institutions. Most funds have fewer than 25 participants. In most countries there would be no attempt to regulate such funds on the basis that expert investors who are capable of risk assessments and investment decision-making need no protection at all. There would, however, be a requirement that any firms offering such management services be licensed, which appears to be the approach pursued by the Chinese authorities.

109. Any problem that exists may more likely have resulted from investment losses by enterprises, which seem to be the principal participants and investors, and by the fact that such investments may be financed by money borrowed from the four state-owned commercial banks. Notably the bulk of the enterprise sector remains under State control, and investment losses are not to be tolerated. Thus the solution may lie in better governance of the state-owned enterprises sector (as investors) and in restraining banks (as lenders) from illegal lending to these enterprises for speculation purposes.

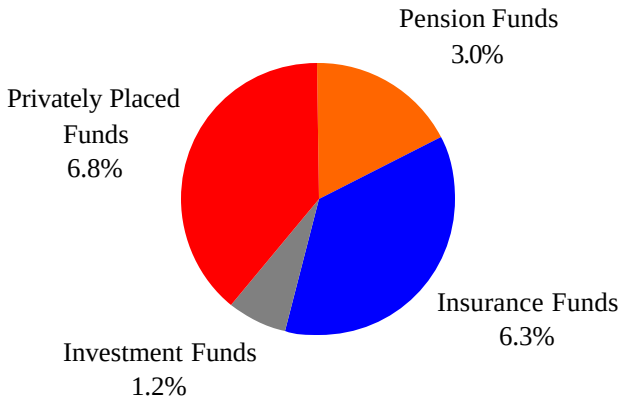
110. It is likely that a clearer definition of mainstream asset management and the ability of licensed entities to offer comparable portfolio management services will eventually transform unlicensed funds into legitimate undertakings.

3.9 Summary of the Institutional Landscape and International Comparison

111. Given the largely unfunded pension system and fledgling collective investment funds, China's formal institutional assets register 10.6% of GDP (Figure 2). In addition

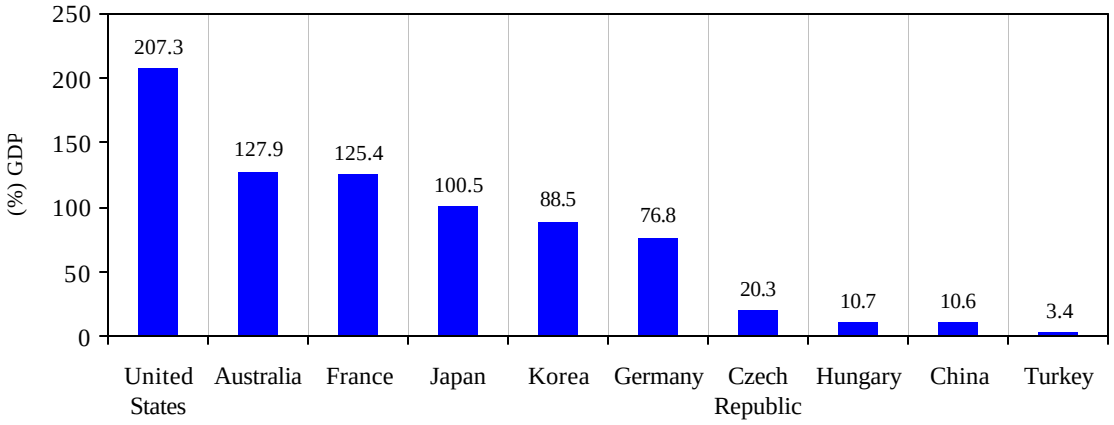
to this formal institutional investor base, large sums are believed to be managed privately by securities companies, TICs, and unlicensed entities. Should privately placed funds be included, total institutional assets might be around 17.4% of GDP.

Figure 2: Institutional Assets in China (as per cent of 2002 GDP)



112. When compared globally, as Figure 3 illustrates, China certainly has a much smaller institutional base than that of most OECD countries. If privately placed funds are incorporated, institutional investor penetration in China seems not unlike the degree observed in leading transitional economies in Eastern European countries.

Figure 3: Financial Assets of Institutional Investors (as per cent of GDP)



Source: OECD (2001).
Note: China's figure is based on 2002.

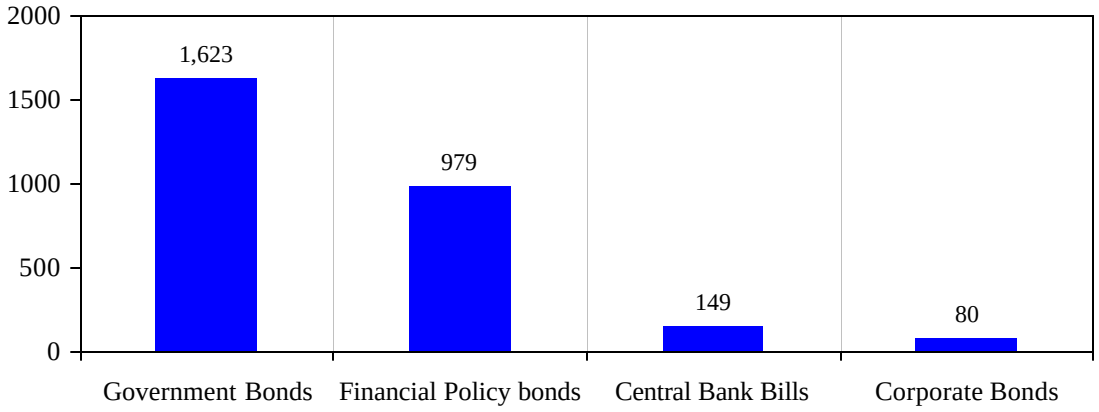
4 STRUCTURE OF CHINA'S CAPITAL MARKETS

4.1. Bond Markets

113. PRC bond markets, to date, have exclusively served the public sector, i.e., national Treasury, central bank and state-owned policy banks; the privilege to issue corporate bonds was only sparingly given to state-owned enterprises. Debt instruments include government bonds, financial policy bonds, and central bank bills, accounting for 57.3%[74], 34.6% and 5.3%, respectively. Outstanding corporate bonds make up an anemic 2.8% (see Figure 4 and Table 1).

[74] This figure excludes the non-marketable RMB 270 billion State-bank recapitalization issue due 2028.

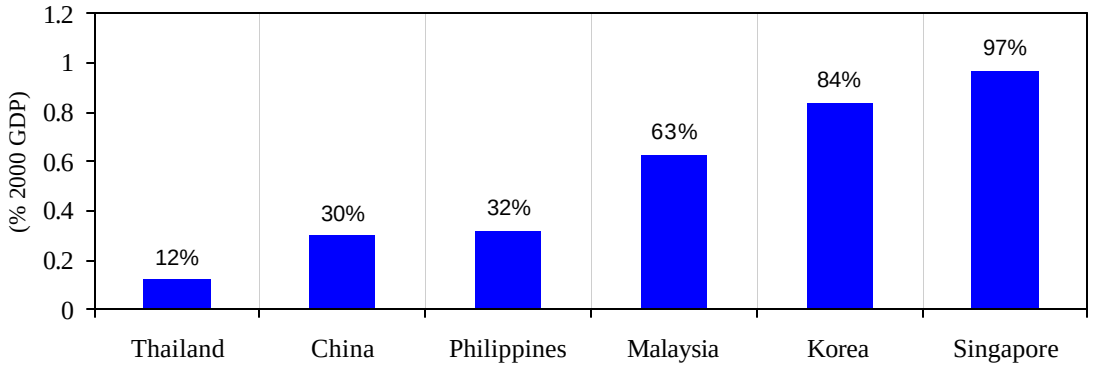
Figure 4: Bonds Outstanding in China (as of December 31, 2002, RMB billion)



Source: www.Chinabond.com, CDC, World Bank (for estimates of corporate bond outstanding)

114. China's bond market represented about 30% of GDP as of end-2000, one of the lowest ratios among the Asian bond markets (see Figure 5). This ratio fell slightly to 28% by the end of 2002, evidencing the slow expansion of the bond market amid the fast growing economy. Furthermore, China's bond market has perhaps the highest concentration of issuers from the State sector, a market largely unaccessible to private sector borrowers.

Figure 5: Size of Bond Market as a Percentage of GDP (2000)



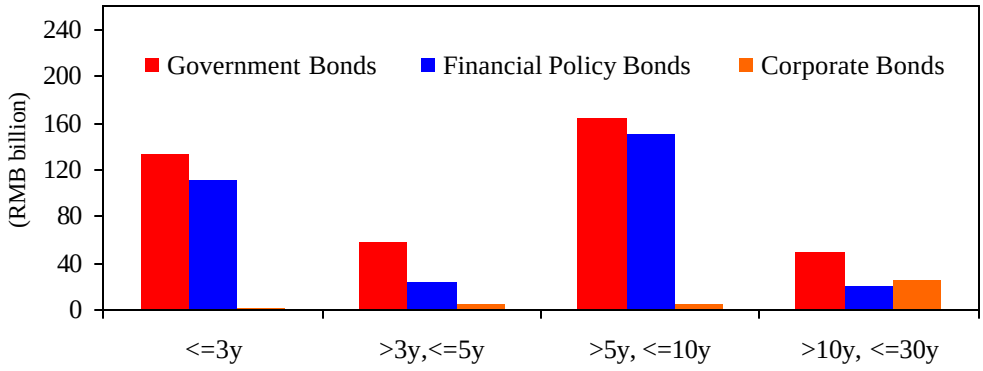
Source: Asian Development Bank (2001)

115. In 2002, the maturity profile of marketable bonds continued to be skewed towards the medium- to long-term. Traditionally, China's Ministry of Finance (MOF) prefers issuing Government bonds (T-bonds) of medium- to long-term maturity to take full advantage of the low interest-rate environment, resulting from the central bank's tight interest control regime, as well as the Ministry's restrictive borrowing authority[75]. Thus, the supply of short-term Government bonds is limited, while Treasury bills (T-bills) are

[75] The National People's Congress approves the MOF's annual borrowing programme during its March assembly. Issuance of long-term government securities avoids frequent NPC refinancing applications.

lacking altogether. At the same time, policy bank and corporate issuances were also tilted towards the longer-term to take advantage of the favorable interest rate environment (see Figure 6).

Figure 6: Maturity Profile of Marketable Bonds New Issue in 2002



116. Meanwhile, the government taps retail investors with a short- to medium-term time horizons by issuing non-marketable savings certificates on a large scale. These certificates are sold to retail investors at commercial bank outlets. Savings certificates have a zero-coupon structure, with maturities of 2, 3 or 5 years, but investors have an option to redeem their certificates before maturity with modest penalties. Savings certificates' share of annual government borrowings dropped from 50% in 1999 to 28% in 2002, and the outstanding stock of savings certificates currently accounts for approximately 30% of outstanding national debt.

117. Several factors contributed to this declining trend. First, commercial banks have become wary of the significant risks posed by the early redemption feature of the savings certificates. According to a MOF regulation, the liquidity risk must be borne by the banks, not by the budget. Second, MOF realizes that savings certificates are a relatively costly form of funding: MOF usually remits some 1% to the banks as administrative fees for distributing savings certificates. Still, savings certificates remain one of the most popular investment instruments with retail investors. It is also considered politically important that households be given adequate access to government securities.

118. In sum, the needs of short- to medium-term investors are met with non-marketable savings certificates, while marketable T-bonds are issued mainly with longer-term maturities.

119. A micro-structure unique to China's bond market impedes investors' easy access to fixed-income instruments. Specifically, the organized bond market has been split in two: an inter-bank market (IBM) and a stock exchange market (SEM). The IBM is

available to a broad representation of banks and selected NBFIs[76], while the SEM is open to all but banks. This separation resulted when the PBOC prohibited banks from trading (spot and repo) in Government bonds on the stock exchanges in June 1997 (PBOC's notice No. 240). The decision to pull banks out of the SEM was mainly motivated by concerns over excessive speculation in the equity market, fueled by Government bond repos between banks and securities companies.

120. Market separation is not confined to the secondary market: bonds are issued separately in each primary market, and until late 2002 bonds issued in one primary market were not eligible for listing on the other secondary market.[77] The extent of primary market segregation in 2002 is summarized in the table below (Table 1):

Table 1: Breakdown of 2002 Primary Issuance and Secondary Trading by Marketplace

<table>
<tr><th>Type of Issue</th><th>SEM</th><th>IBM</th><th>Bank Counters</th><th>Bank Counters and Postal System (Savings Certificates)</th></tr>
<tr><td rowspan="3">Government Bonds</td><td rowspan="2">86.4 (19%)</td><td>253.6[78] (58%)</td><td>n.a.</td><td rowspan="3">147.3</td></tr>
<tr><td colspan="2">46 (10%)</td></tr>
<tr><td colspan="3">60.0 (13%)</td></tr>
<tr><td>Financial Policy Bonds</td><td>n.a.</td><td>307.5</td><td>n.a.</td><td>n.a.</td></tr>
<tr><td>Corporate Bonds[79]</td><td>32.5 (88%)</td><td>4.5 (12%)</td><td>n.a.</td><td>n.a.</td></tr>
<tr><td>Central Bank Bills</td><td>n.a.</td><td>193.8</td><td>n.a.</td><td>n.a.</td></tr>
</table>

121. In 2002, over 50% of marketable Government bonds were issued in the IBM, while the balance were offered to stock exchange and retail investors through the SEM, bank counters and savings certificate distribution network. Meanwhile, financial policy bonds and central bank bills were exclusively issued in the IBM, and thus are not directly

[76] As of December 31, 2002, participants in the IBM include: 185 commercial banks; 488 rural credit cooperatives; 16 foreign banks; 25 finance companies; 2 leasing companies; 17 insurance companies; 64 securities companies; 71 securities investment funds; and 37 other non-bank financial institutions.

[77] In early December, 2002, MOF first issued government bonds (7-year) that are offered on and can be transferred between the IBM and the SEM.

[78] The RMB 36.8 billion 2.3% issue due 2004 is not marketable.

[79] All corporate bonds (except CITIC, see below) were distributed by underwriting syndicates in the primary market with a view to subsequent stock exchange listings (which require approvals from CSRC and the stock exchanges) for secondary trading. However, the approval process is lengthy: only 2 out of the 17 corporate issues completed in 2002 have obtained listing approvals in the same year, and 5 other approvals were granted in the first 4 months of 2003. Unlisted corporate bonds are not marketable otherwise. So far CITIC RMB 4.5 billion 4.08% due 2017 is the only corporate bond that is offered and traded in the IBM.

available to individuals and corporate investors.[80] In sum, as shown in Table 2, only 9.6% of bonds outstanding are freely available to the investing public on the SEM.

Table 2: Basic Statistics of PRC Bond Markets (as of November 30, 2002)

Unit: RMB Billion

Type	Outstanding Volume	SEM		IBM		Nontradable	
		Volume	%	Volume	%	Volume	%
Government bonds	2234	303	13.5%	1,061	47.5%	870	39.0%
Financial bonds	946			946	100.0%		
Central bank bills	184			184	100.0%		
Corporate bonds	80	27.7	34.6%	8	10.0%	44.3	55.4%
Total	3,444	330.7	9.6%	2199	63.9%	897.4	26.5%

Source: www.chinabond.com, CDC,Shanghai Stock Exchange, World Bank.
Note: Non-tradable government bonds include savings certificates, several privately placed issues and the RMB 270 billion bank recapitalization bond.

122. Despite the dominance of government and financial policy bonds in the primary market, as far as the secondary market is concerned, the IBM is characterized as a repo-driven money market rather than a bond market anchored by cash transactions. During 2002, turnover ratio (cash transactions/total marketable bonds) on the IBM was 20% (see Table 2) while repo transactions were over 20 times cash transactions. Correspondingly, the numbers for the SEM were 193% and three and a half fold, respectively.

Table 3: Trading Statistics in IBM and SEM during 2002 (as at November 30, 2002)

Unit: RMB billion

	Outstanding Volume# (A)	Cash Transactions (B)	Repo Transactions (C)	B/A (%)	C/A(%)	C/B(%)
IBM	2,199	441	10,188	20	463	2,310
SEM	331	638	2,242	193	677	351

Source: www.Chinabond.com, CDC and Shanghai Stock Exchange.
Note: Excludes insignificant turnover in the Shenzhen Stock Exchange.

123. The primary reason for poor spot trading on the IBM is the lack of market-making capability and incentives on the part of the banks. Although the IBM is engaged in expanding its membership to NBFIs, in terms of absorption capacity, it is dominated by large banks, especially the four state-owned commercial banks. With limited lending

[80] Commercial banks absorb most of financial policy bonds issued by the policy banks. This financing pattern by a long-term development bank is quite different from that of their equivalents in Japan (former Industrial Bank of Japan and Long Term Credit Bank of Japan) and Korea (Korea Development Bank). In both countries, specialized policy banks mobilize funds through issuing medium-term debentures that are predominantly absorbed by NBFIs and retail investors.

opportunities and a strong inflow of deposits, they buy-and-hold the lion's share of T-bonds and financial policy bonds on the IBM.[81] In July 2001, PBOC appointed 9 market makers[82] to provide continuous two-way quotes on specific government bonds. Market-making activities have been substantially inhibited, however, by strong banking sector liquidity (and hence the desire for commercial banks to be buy-and-hold investors), the absence of hedging and securities borrowing facilities, and delivery versus payment infrastructure. In June 2002, PBOC also allowed the four state-owned commercial banks to offer over-the-counter bonds to retail investors, attempting to create more diverse demand for government bonds in the IBM. In order to facilitate IBM access by non-members, PBOC further approved 39 commercial banks in September 2002 to set up Government bond sales desks to service their corporate clients.

124. In contrast, the liquidity of the SEM is much greater, since it consists of participants who have heterogeneous expectations, especially individuals and corporations. Table 3 shows that the cash transactions turnover ratio of the SEM is nine-fold that of the IBM. Historically, bonds are traded at higher prices on the SEM, providing ample arbitrage opportunities,[83] though recent efforts by the MOF to issue the same bonds in both markets have largely removed such market inefficiencies. Hence, the yield curve on the SEM has become more representative than in earlier years, although large IPOs will still cause repo rates to fluctuate substantially.

125. Meanwhile, the SEM is based on a centralized cross-matching system in which dealers and end-users trade directly with each other, i.e., without intermediation.[84] Currently, the SEM is not dominated by large dealers but by end-investors, namely individuals and corporations. So long as the market is dominated by end-investors, a centralized matching system will work fine. In 2002, both the Shanghai and Shenzhen stock exchanges introduced new trading mechanisms for block trades in order to facilitate wholesale trading by institutional investors.

126. The publicly listed corporate bond market consists of a limited number of issues by SOEs, mainly used to finance infrastructure investments. In 2002, all new corporate bonds were guaranteed by SCBs, other SOEs, or project-specific fiscal subsidies. These include bonds issued by the central government enterprises[85] and by large municipalities[86] to finance infrastructure investments.[87] Information disclosure, even by the largest and most prosperous issuers, is very limited. Investors, on the other hand, apparently routinely view these bonds as being guaranteed by the government.

---

[81] As a proportion of the assets of commercial banks, bonds increased from 5% in 1997 to around 13% in 2002.
[82] These are the four state-owned commercial banks, China Everbright Bank and four city commercial banks.
[83] The average interest rate of bonds in the same class is fifty basis points lower when issued at the SEM than at the IBM.
[84] In fact, the Securities Law (Article 33) bans OTC trading of bonds listed on a SEM. Further, the law requires that the trading rule be centralized competitive pricing.
[85] Such as Ministry of Railway, State Power Corporation, China Mobile and Three Gorges Corporation.
[86] Such as Shanghai, Chongqing and Jiangsu.
[87] Often issued by Urban Development Investment Corporations owned by the municipalities.

127. Corporate bonds[88] are subject to repressive legal and regulatory treatment in China.[89] First, from 1993 to 1999, issuance of corporate bonds was subject to special approval by PBOC and the State Development and Planning Commission[90] (SDPC).[91] After the 1993 regulations were revoked in 1999, SDPC assumed all responsibilities with respect to the screening of applications and the drafting of replacement regulations. In this process, SDPC has favored SOEs over the private sector. Furthermore, SDPC occasionally grants special approvals (with State Council clearance) to individual cases.[92]

128. Second, in addition to SDPC's conservative stance on the issuance of corporate bonds, a more fundamental constraint in corporate bond market development lies with the Company Law of 1995. The PRC Company Law adopted the European Civil law tradition and establishes a very rigid capital structure.[93] Further, the Company Law does not allow bonds with warrants (BW) or option-linked bonds.

129. Third, according to Article 18 of the 1993 regulations, interest rates on corporate bonds could not be higher than 140% of the interest rate on banks' fixed savings deposits of the same term. Should any corporate bonds be issued with interest rate above this ceiling, PBOC will order the firm concerned to correct it accordingly and will impose a fine up to 5% of the raised capital (Article 28).

130. To-date, the much anticipated replacement regulations have yet to be agreed upon by state legislators. It appears that the following themes will be incorporated into the new regulations (though they may be difficult to implement in practice):

(a) A merit system to replace the "approval" system;
(b) More flexibility in setting interest rates;
(c) Non-discriminatory, common market admission criterion; and

---

[88] In this note, we use corporate bonds and enterprise bonds interchangeably.

[89] During late 1980s, enterprises rushed to issue bonds, capitalizing on investors' newly found interest in securities and a regulatory vacuum. Later many bond-issuers failed to honour their debts, putting serious socio-political pressure on the government. Given the poor credit culture in corporate China, regulators tend to think they are mandated to check viability of a firm on behalf of unsophisticated investors. Hence there has been a repressive regime for corporate bonds since 1993.

[90] SDPC was renamed the National Development and Reform Commission (NDRC) in April 2003.

[91] Before 1999, " Regulations on the Management of Enterprise Bonds" , which came into effect in 1993, were jointly administered by SDPC and PBOC (the latter was the lead regulator in practice). In 1999, the regulations were suspended; thereafter, new issue applications are approved by the State Council on a case-by-case basis through the SDPC. CSRC' role on the corporate bonds market is limited: it only examines and approves bond listing applications..

[92] While 17 enterprises were allowed to issue bonds in 1999, the numbers of corporate bonds issued dropped to 6 in both 2000 and 2001 (refer to Appendix 1 for a list of bonds issued).

[93] To issue corporate bonds, a company must meet the following conditions (Article 161): (a) for a joint stock company, its minimum net asset value must be RMB 30 million, and for a limited liability company, RMB 60 million; (b) the cumulative value of the bond issues may not exceed 40% of the company's net asset value; (c) average distributable profit for past three years must be sufficient to cover interest on the company bonds for one year; and (d) the interest rate for the bonds must not exceed the State Council set ceiling.

(d) The use of proceeds will no longer be restricted to greenfield projects or fixed asset formation, i.e., funds can be used for general corporate purposes such as refinancing and acquisition finance.

4.2. Money Markets

131. The money market, having few instruments available, remains underdeveloped. As Table 4 shows, repos[94] are the mainstay of the money markets, followed next by call loan/money. In the inter-bank market, bond repos are backed by both government and financial policy bonds, and on the stock exchange markets, by government bond and corporate bonds[95]. After the inter-bank market opened its membership to non-bank financial institutions in 2000, repo trading in the inter-bank markets picked up remarkably, surpassing that of the stock exchange markets (see Table 3 & 4).

Table 4: Trading Activities in the PRC Money Markets

Unit: RMB billion

Year	Inter-bank lending and borrowing	Inter-bank bond repo	T-bond repo on stock exchanges	Total volume of transactions
1997	829.8	30.7	1,287.6	2,148.1
1998	197.8	102.1	1,626.3	1,926.2
1999	329.1	394.9	1,278.8	2,002.8
2000	672.8	1,578.2	1,473.4	3,724.4

Source: Li and Peng (2002) Table 1 (part). Li and Peng relied on PBOC's *Statistics of China's Financial Markets* and *Statistical Quarterly of the Peoples' Bank of China.*

132. Regarding the flow of funds (see Tables 5 & 6) in the money markets, non-bank financial institutions — especially securities companies[96] — and securities investment funds are net borrowers from both the inter-bank call and repo markets. Borrowing activities of securities companies and securities investment funds are closely linked to equity market conditions, especially the timing of major IPOs. Li and Peng (2002) observed that the changes in borrowing and repo by securities and securities investment funds preceded by one month the changes in stock market index.

133. Commercial banks net borrowed from the repo market and lent money in the inter-bank market to securities companies and securities investment funds, profiting from the spread between repo and call rates (see Figure 7).

134. Foreign financial institutions currently possess a limited number of outlets to take RMB deposits. As a result, they have conveniently mobilized wholesale RMB funds from the inter-bank market to provide RMB loans to foreign-funded enterprises and

[94] Repo is defined in China as secured borrowing.
[95] Corporate bond repos debuted on the stock exchanges in late 2002.
[96] Securities companies are not allowed to practise proprietary trading with borrowed funds (Article 133 of the Securities Law).

foreign residents in Shanghai, Shenzhen and neighboring provinces. This practice is believed to have contributed to "cherry picking" of quality clients — i.e., foreign-funded enterprises — by foreign banks, leading PBOC to issue regulations in 2002 limiting foreign banks' inter-bank borrowing to 40% of their total RMB liabilities.

Table 5: Flow of Funds in the Inter-bank Market

Unit: RMB billion

Year	State-owned banks	Commercial banks	Securities co. & funds	Foreign institutions	Other financial inst.	Finance centers
1997	-29.17	-57.30	-	-0.50	1.73	95.30
1998	0.59	-0.34	-	0.10	-0.20	-0.13
1999	24.72	-39.32	-	0.55	140.60	-
2000	-98.67	-224.17	287.50	8.88	16.40	-

Source: Li and Peng (2002) Table 2.

Table 6: Flows of Funds in the Inter-bank Repo Market

Unit: RMB billion

Year	State-owned Banks	Commercial banks	Securities companies & funds	Insurance companies	Foreign institutions	Other financial institutions
1997	7.10	-7.10	-	-	-	-
1998	-7.36	25.58	-	-	0.01	-18.23
1999	-59.15	15.14	-	-	0.15	43.86
2000	-409.46	325.27	101.60	102.35	0.27	-32.50

Source: Li and Peng (2002), Table 3.

135. Concerning the maturity of money market transactions, there is a trend toward shortening of terms of trading (Table 7). In 2002, over 80% of repo trading were shorter than seven days. The inter-bank call market also exhibited a similar maturity profile. As far as repo and inter-bank call loan/money are concerned, this trend toward shorter maturities could be interpreted as the PRC money markets truly serving market participants as an effective means for cash management, thereby stopping the markets' old practice as an unduly quasi-capital market for raising long-term funds for growth.

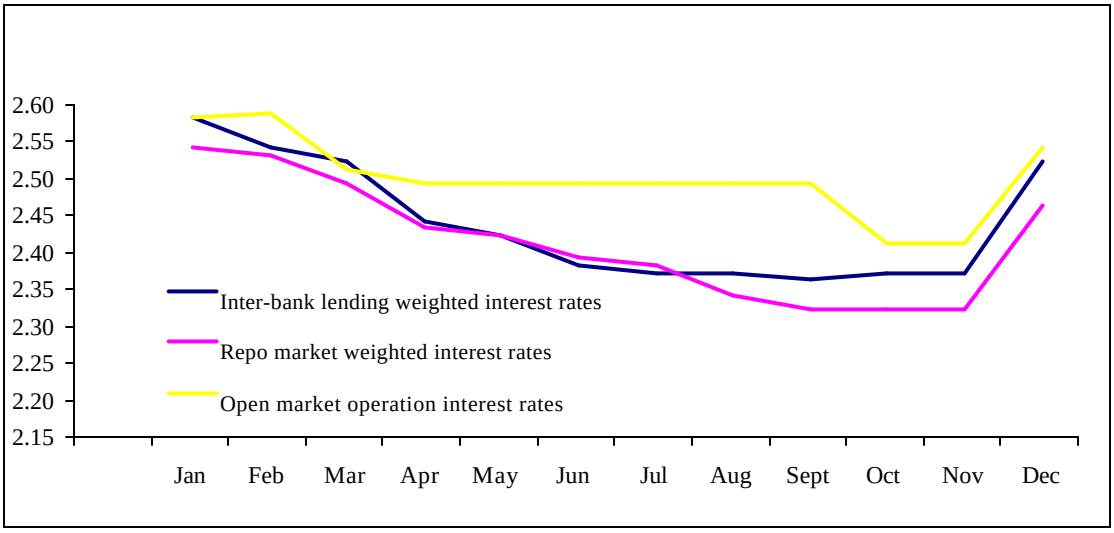
Table 7: Term Structure of the Inter-bank Repo Market (%)

Year	Overnight	below 7 days	8-20 days	21-30 days	31-60 days	61-90 days	91-120 days
1997	6.5	26.15	10.63	13.74	23.14	12.91	6.93
1998	6	22.5	14.5	22.6	18.3	10.5	5.6
1999	10.9	28.6	7.4	21.2	27.9	3.3	0.7
2000	7.7	63.7	12	4.9	9.2	2.3	0.1
2001	12.85	69.38	11.55	4.37	1.16	0.58	0.11
2002	16.6	70.4	8.3	2.4	0.90	0.39	1

Source: PBOC

136. Interest rates in the money markets are freely determined by the supply and demand of funds, representing a rare exception to the strict interest-rate-control regime. Not surprisingly, freely determined money-market interest rates are higher than government-fixed deposit rates. For instance, 1-year deposit rates were kept at 2.25% throughout 2000, while money market interest rates fluctuated, the spread ranging from 6 to 32 basis points in 2000 (Figure 7). Meanwhile, interest rates for inter-bank lending and repo have shown a high level of synchronization. Regarding the relationship between open-market operation rates and money-market interest rates, the gap is closing as the fourth quarter movement in the Figure 7 illustrates. This indicates that money markets provide meaningful information for the central bank to conduct monetary policy.

Figure 7: Money Market Interest Rates and Open Market Operation Interest Rates (2000)



Source: Li and Peng (2002), Figure 6.

137. With the exception of bond repos, PRC money markets suffer from a shortage of short-term marketable instruments which are suitable for active secondary trading, and which make up the longer end in the money-market yield curve, especially from 91-day to 180-day. Historically, short-term (91-day and 180-day) bills issued by China Development Bank (CDB) are one of the few tradable money-market instruments available. In 2002, CDB issued RMB 50 billion of 6-month bills, accounting for 20% of annual bond issuance. China Eximbank also issued RMB 8 billion of 3-month bills out of its 2002 funding program of RMB 57.5 billion.

138. Regarding T-bills, the MOF currently lacks a clear legal basis for issuing such. Moreover, outdated government cash management practices are not conducive to systematic issuance of short-term T-bills. Since the MOF does not have a reliable forecasting of cash positions, it cannot help but keep sufficient reserves in the PBOC. With large balances of idle funds deposited with the PBOC, the MOF has little incentive to issue T-bills and to incur additional interest costs. Nevertheless, the catalytic role of

T-bills to the development of the domestic capital market is well acknowledged by the MOF.

139. Meanwhile, PBOC is constrained by insufficient government securities holdings (less than RMB 300 billion) for open-market operations. As such, the central bank increasingly sees the use of central bank bills as an effective means to address the increasing money supply from the external sector. In fact, in the second half of 2002, PBOC swapped RMB 193.8 billion worth of repo-collateralized government bonds with central bank bills of the same maturities. In 2003, to 8 May, PBOC has systematically offered three central bank bill issues to the market and absorbed RMB 25 billion in market liquidity. At present, given that T-bills are not in issue, the issuance of central bank bills will not lead to market segmentation or competition with similar products.[97] Interest costs of the PBOC bills are expected to remain low, provided the current level of interest rates continues, enabling PBOC to adopt market-based rates. In addition to the primary objective of monetary control, PBOC bills will provide much needed short-term instruments to financial institutions, especially banks, helping them balance their portfolios.

140. In the early 1990s, CDs[98] were popular because they were not subject to interest-rate control. In fact, many counterfeit CDs were circulating at that time. Once PBOC tightened its grip on CD interest rates, these instruments lost favor. In 1996, such activities were banned altogether.

141. On CP, the 1995 Act on Bills explicitly requires that commercial bills be issued against real transactions, effectively prohibiting corporations from issuing commercial paper for financing purposes. Meanwhile, as far as commercial bills or bills of exchange are concerned, banks provide working capital to issuing firms through discounting such bills. Commercial banks in turn receive rediscount of bills from the PBOC. However, commercial bills are not tradable in the secondary money markets, making them unavailable to other investors holding idle cash. Nevertheless, commercial bills are fast becoming a major source of financing for medium to small enterprises. Table 7 shows the strong growth in commercial bills issuance and discounting activities. In February 2002, PBOC cut its lending rate to commercial banks by an average 0.54% while leaving the re-discount rate unchanged at 2.97%. As a result, 2002 saw a dramatic decline in rediscounting activities with third quarter outstanding at a mere RMB 1.2 billion.

[97] Should the MOF significantly improve its cash management systems before readying itself to issue T-bills, the MOF and PBOC will then be advised to coordinate closely to minimize market segmentation. One effective means used in many countries is to add on central bank bills to T-bills; as such, only T-bills are issued even though the central bank normally incurs the interest costs associated with add-ons. In addition, the MOF respects the central bank's decision regarding when and how much add-ons need to be issued.

[98] Pursuant to PBOC circular on Regulatory Measures on Transferable Certificates of Deposit dated May 22, 1989.

Table 8: Size of PRC Commercial Bill Market

Unit: RMB billion

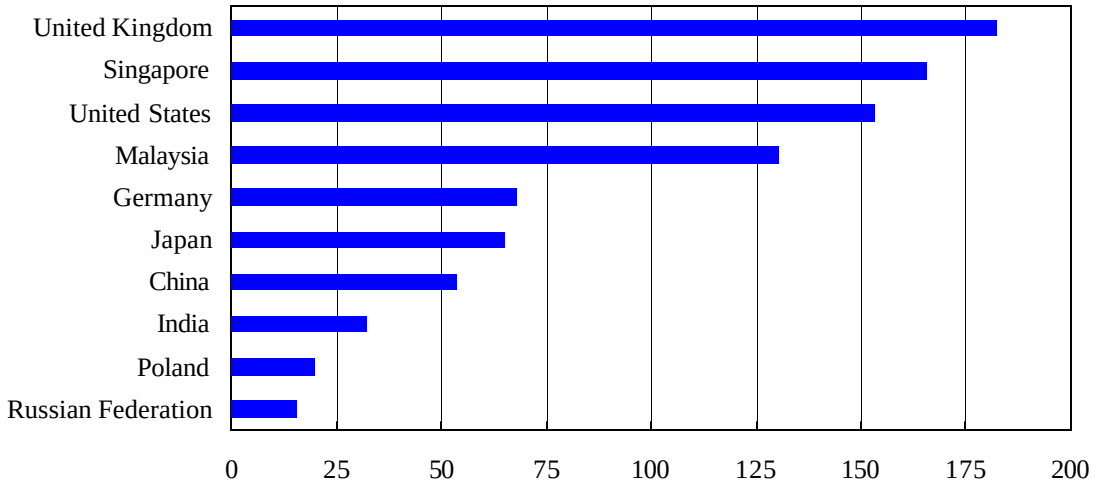
Year	Commercial Bills Issuance	Commercial Banks Discounting	PBOC Re-discounting
1998	348	265	120
1999	508	250	115
2000	745	645	267
2001	1,284	1,555	278
2002	1,614	2,307	n.a.

Source: PBOC

4.3. *Equity Markets*

142. The Shanghai Securities Exchange and the Shenzhen Securities Exchange formally commenced operations in December 1990 and July 1991, respectively. Since then, China's two bourses have been among the fastest growing equity markets in the world. As of end 2002, a total of 1,310 firms were listed on the two exchanges with market capitalization of RMB 3.8 trillion. However, against the backdrop of a fast growing economy and an ironically declining share market, this ratio declined from 54% in 2000 to 37% in 2002. (see Figure 8).

Figure 8: Equity Market Capitalization as Ratio of GDP (2000)



Source: World Bank (2002b).

143. As in the bond market, the equity market mainly serves the state sector, notably the key state-owned enterprises. The vast majority of listed companies are SOEs, with a mere 200 counters (around 15%) associated with private investors.

144. The predominance of the state sector reflects the founding mandate of the Chinese equity markets—a reform drive to turn SOEs into stockholding companies, and thus to help SOEs mobilize needed funds for restructuring through the capital markets and to improve SOE performance through public listing. But as most of the listed SOEs still

struggle with low profitability and poor corporate governance, the "reform" mandate is arguably an administrative "bail out," in disguise, i.e., utilizing the equity market as a refinancing apparatus for SOEs with questionable commercial prospects.

145. As summarized in Table 9, various classes of shares are issued in China. As a part of foreign exchange control, the government maintains market segmentation among A- , B- and H-shares. In terms of share ownership, three different types of share are issued: state, legal person and individual.

Table 9: Share Classes in China

Type	Description
A-shares	Domestically listed shares, denominated in local currency. Foreign investors many not own these shares.
B-shares	Domestically listed shares of China-incorporated companies, denominated in US$ in Shanghai and HK$ in Shenzhen. Initially reserved for foreign investors and domestic institutions and individuals, these shares now make up the majority of trading.
H-shares	Shares of mainland registered companies listed in Hong Kong, China.
Red-chips	Shares of companies registered overseas and listed abroad (principally in Hong Kong, China), having substantial mainland interests and controlled by affiliates or departments of the Chinese government.
Legal person shares	Roughly a quarter of every listed firm's equity is transferred to domestic institutions (joint stock companies, NBFIs, and SOEs with at least one non-state owner) and cannot be traded.
State shares	More than one-third of equity is transferred to the state (central and local governments, as well as SOEs, which are wholly owned by the state), the ultimate owner being the State Council. Legal person and state shares are not tradable, though they can be transferred with permission from the CSRC. The non-tradable feature of legal person and state shares allows the government to claim that share issuance is not akin to privatization.

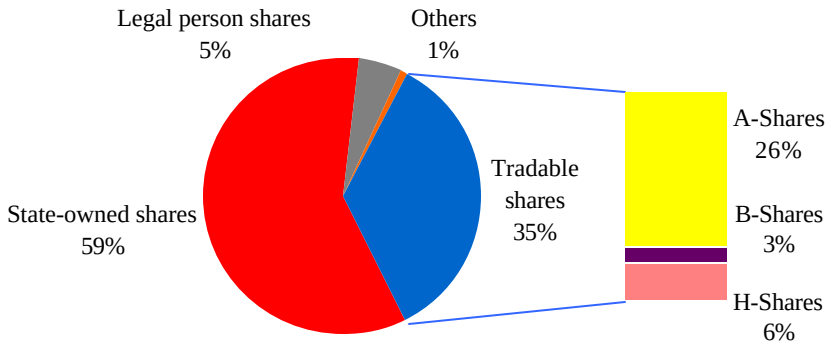
Source: OECD (2002, p. 512). Proportion of legal person shares: author's modification.

146. Unlike the norm in equity markets elsewhere, state shares and legal person shares, which account for 65% of the total number of shares issued as of March 2003 (Figure 9), remain non-tradable, in principle, even after a company is listed.[99] State shares can only

[99] Because two-thirds of the shares issued are non-tradable, the assertion that China's equity market capitalization amounts to a high share of GDP needs to be interpreted with some caution. In a survey of proportion of float shares in major global equity markets by Dow Jones Indexes (as of Jan 31, 2002), the U.S. stood at 93.9%; Europe at 79.7%; Japan at 79.6%; Canada at 82.0%; Australia at 87.8%; Singapore at 51.0%; Hong Kong, SAR at 48.5%: and China at 35%. By the end of 2002, the ratio for China stood at 12.2% on the basis of market capitalization of tradable shares of RMB 1.2 trillion and GDP of RMB 10.2 trillion.

be transferred to other institutions via private negotiations, and legal person shares used to be only transferable via private placements.[100]

Figure 9: Ownership Structure of PRC Listed Companies as of March 2003



Source: CSRC

147. Legal person shares are held by domestic institutions, e.g., industrial enterprises, financial institutions, foundations, funds and research institutes. In terms of their ownership structure, most of those institutions are either directly state-owned or controlled largely by the public sector. Thus, in most cases, the state is directly (through state shares) or indirectly (through legal person shares held by SOEs) in control of listed companies.[101] The high concentration of ownership combined with the non-tradability of more than two-thirds of the shares implies that few listed companies are subject to contestable control, limiting the potential pressure capital markets could exert on the corporate governance of listed companies.

148. In addition to the primary motivation to retain state ownership even after listing, partial tradability of the shares has served another equally important purpose, that of maximizing IPO proceeds. Since only part of the shares are tradable, market supply is suppressed and IPO prices of tradable shares will go up. Because the majority of shares remain non-tradable, tradable shares are believed to carry considerable premiums over non-tradable shares.

149. Rectifying the historical problems of price difference between tradable and non-tradable shares became the subject of heated debate while discussing the ill-fated plan for selling state shares in the PRC during the second half of 2001 into early 2002.[102] Current investors in tradable shares disliked the state's intention to sell the non-tradable shares at

[100] However, since 1998, auction houses have been conducting semi-public auctions for the legal person shares in major cities, predominantly in the Shanghai area. In any case, transfer of legal person shares requires CSRC permission.
[101] Tenev and Zhang (2002), Chapter 4.
[102] Wu (2002) provides a good survey of the historical origin of the problem and a summary of the proposals the CSRC received regarding reduction of state-owned shares.

the secondary market price, while the state worried about potential criticism should it sell state assets at less than market price. Even though the state would have been willing to accept some discount for the non-tradable shares, deciding the appropriate pricing remained a major challenge. Investors generally attribute the persistent stock market weaknesses (Shanghai Composite Stock Index down 32% to April 30, 2003 after peaking at 2,245 on June 14, 2002) to these structural issues. There have been various proposals for resolving the problems of non-tradable shares and mechanisms for further disposals of state shares, though no proposal is acceptable to all stakeholders concerned.

150. Another unique feature of the Chinese equity markets is the predominance of small-cap stocks. As at 30 April 2003, China's top 10 listed companies by market capitalization of tradable shares accounted for only just 6.95% of total market value (see Table 10). Evidently, China's equity market is one of the world's least concentrated (Figure 10). Usually core blue-chip companies that feature high capitalization, low fluctuation, good market liquidity, and dispersed holding lie at the heart of a mature equity market. Thus, 5% of the most capitalized equities easily occupy half the market value in most of the world's equity markets. The corresponding figure for China was as low as 5.2%, less than one-tenth of the 70% average observed in twelve other selected exchanges[103].

Table 10: Ranking of Listed Shares by Market Capitalization of Tradable Shares (31 March 2003)

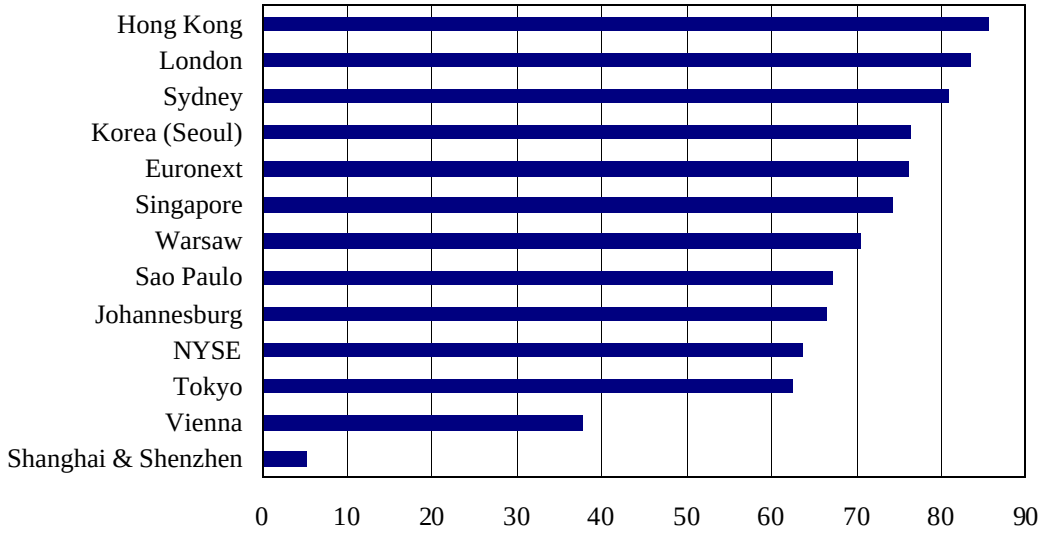
Unit: RMB billion

Ranking	Company	Sector	Market Cap of Tradable Shares	% Total Market Cap
1 (SZ)	Shenzhen Development Bank	Banking	16.6	1.20
2 (SH)	China Merchants Bank	Banking	11.0	0.80
3 (SH)	China Petroleum & Chemical Corp.	Petrochem	10.1	0.73
4 (SH)	Shanghai Pudong Development Bank	Banking	10.0	0.72
5 (SH)	Baoshan Iron & Steel	Steel	9.7	0.70
6 (SZ)	Torch Investment	Conglomerate	8.3	0.60
7 (SH)	China Unicom	Telecom	8.1	0.59
8 (SH)	Harbin Pharmaceutical Group	Pharmaceutical	8.0	0.58
9 (SH)	Shanghai Automotive	Automotive	7.1	0.51
10 (SZ)	Guangdong Electric Power	Power	7.1	0.51
	Total Market Cap – Top 10		96.0	6.95
	Total Market Cap – Tradable Shares		1,380.7	

Source: Shanghai Stock Exchange, Shenzhen Stock Exchange

[103] Gao (2002).

Figure 10: Concentration of the Market Value Measured by top 5% of Companies (2001)



Source: World Federation of Exchanges (2002) and Gao (2002) for China statistics.

151. A shortage of tradable shares - only 35% of total equities - coupled with the predominance of small-cap stocks render the equity markets vulnerable to short-term speculation and share price manipulation. In addition, the lack of core blue-chip companies and the multitude of different share classes (A, B, and H-shares) makes it hard to construct a satisfactory index benchmark against which performance can be measured.

152. Although less than half the China's listed companies register decent profitability, share prices generally remain over-valued, with price/earnings ratios of around 40 times; in comparison, P/E ratios are less than half that for shares traded in Hong Kong, Taiwan and Singapore. Often blamed for the ills of China's volatile equity markets are large numbers of speculative retail investors. However, institutions - securities companies, privately placed funds, and even some licensed investment managers - are also exhibiting short-term oriented investment behaviors no different from retail investors.

153. In a bid to allow equity markets to fulfill the aim of promoting SOE restructuring, the CSRC has recently taken measures to sanction false disclosure and market malpractices and to require all listed companies to meet international audit standards. Further, tougher rules on de-listing were put into effect in early 2001[104]. Now, firms that register losses for three consecutive years will immediately be suspended from trading. If such a firm fails to show financial recovery within six months, de-listing will automatically follow.[105] De-listing of SOEs would send a strong signal to corporate executives and investors alike that the PRC equity market no longer serves as a refinancing apparatus for SOEs with questionable commercial prospects.

[104] " Suspending and Terminating the Listings of Loss-making Listed Companies Implementing Procedures" (CSRC, February 22, 2001).
[105] The first de-listing came in April 2001 when washing machine maker Shanghai Narcissus Electronics was forced off the Shanghai Securities Exchange.

154. Meanwhile, effective 1 December 2002, the long-waited Qualifying Foreign Institutional Investor program, better known as QFII, offered foreign investors access to the A-share market for the first time. This signals a significant step toward capital market opening in the PRC. As Box 1 summarizes, the QFII scheme is subject to strict qualification requirements and tight curbs on early repatriation. Strict investment criteria aside, overvaluation of stocks, price differences between tradable and non-tradable shares, and weak corporate governance in listed companies would lead to limited foreign portfolio investment to the PRC capital markets over the short term. However, the introduction of QFII program will likely have a positive impact on the development of PRC capital market over the medium to long-term, and eventually on the method by which PRC listed companies handle corporate governance issues.

155. Positive developments have taken place since the QFII program was launched in December 2002. In January 2003, the CSRC and PBC approved 7 domestic and 3 foreign banks as QFII custodians[106]. Evidently both local and foreign banks are interested in building expertise in this business area, citing strong growth potential and the considerable fee-based income from scale operations.

156. On May 27, 2003, the CSRC licensed UBS Warburg and Nomura Securities as the first batch of QFIIs[107]. The CSRC also commented that more applications will be approved if they meet with the required criteria.

[106] These banks are Industrial and Commercial Bank of China, Bank of China, China Merchants Bank, China Construction Bank, Agricultural Bank of China, China Merchants Bank, Bank of Communications, HSBC, Standard Chartered and Citibank.

[107] All licensing requirements must be fulfilled subject to final application with SAFE for foreign exchange investment quotas.

Box 1: The Qualifying Foreign Institutional Investor Scheme

Eligible QFIIs. Fund managers, insurance companies, securities companies, and commercial banks who meet the following requirements:

- Fund managers: minimum 5 years operational experience; assets under management not less than USD $10 billion in the last accounting year.
- Insurance companies: minimum 30 years operational experience; securities assets not less than USD $1 billion in the last year; revenues exceeding USD $1 billion.
- Securities companies: minimum 30 years operational experience; securities assets not less than USD $1 billion in the last year; revenues exceeding USD $1 billion.
- Commercial banks: Securities assets not less than USD $10 billion in the last year; total assets ranked among the world's top 100 banks.

Eligible instruments. Any of the following RMB-denominated financial instruments: (1) shares; (2) listed T-bonds; (3) listed convertible bonds and corporate bonds; (4) any other financial instruments approved by the CSRC.

Investment limits. Investment by a single QFII in a single listed company must not exceed 10% of the total shares of that listed company; the total percentage of shares held by all QFIIs in a single listed company must not exceed 20% of the total shares of that listed company. In terms of investment amount, QFIIs must invest USD $50 million to USD $800 million each.

Lock-in periods. In general, QFIIs must keep their capital within the PRC for at least one year. For closed-end funds, the minimum period is three years. During the lock-in periods, the funds remitted into China by the QFIIs must be held by custodians in a special purpose RMB account.

Custodian services: A custodian bank must have (i) a specific fund custody department; (ii) paid in capital of no less than RMB 8 billion; (iii) sufficient professionals familiar with custody; (iv) the ability to manage the entire assets of the fund safely; (v) qualifications to conduct foreign exchange and RMB business; and (vi) no material breach of foreign exchange regulations in the past three years. Approvals from PBOC, CSRC and SAFE are required for custodian status.

157. In the equity market, recent regulatory developments have created more merger and acquisition opportunities for foreign investors in Chinese companies, especially in State-owned companies. Among the most significant developments are:

(a) The "Notice Regarding the Transfer of State Shares and Legal Person Shares of Listed Companies to Foreign Parties" jointly issued by the CSRC, MOF and SETC, effective November 4, 2002;

(b) The "Tentative Provisions on the Use of Foreign Investment to Restructure State Owned Enterprises" jointly issued by the SETC, the MOF, SAIC and SAFE, effective January 1, 2003; and

(c) The "Measures for Acquisition of Domestic Companies' Shares and Assets by Foreign Companies" prepared by MOFTEC.

158. Specifically, the "Notice Regarding the Transfer of State Shares and Legal Person Shares of Listed Companies to Foreign Parties" now permits the purchase of state shares and legal person shares of PRC-listed companies by foreign investors, lifting a ban imposed in 1995. The Notice also allows foreign investors to purchase state shares and legal person shares by converting them into "foreign capital shares", subject to certain conditions, including compliance with the takeover rules. These regulations are widely expected to provide the "missing link" in the PRC regime for foreign acquisition of interests in pure domestic entities and to fill the gaps of a legal regime that traditionally has been directed predominantly at regulating foreign investments in "green field" projects.

5 CHANGES IN THE INSTITUTIONAL ASSET MANAGEMENT SCENE

159. Several projects involving drafting, amending or rewriting existing laws, including the new Law on Securities Investment Funds (also under review in the National People's Congress), are in progress. This activity shows the importance the government places on the development of investment institutions.

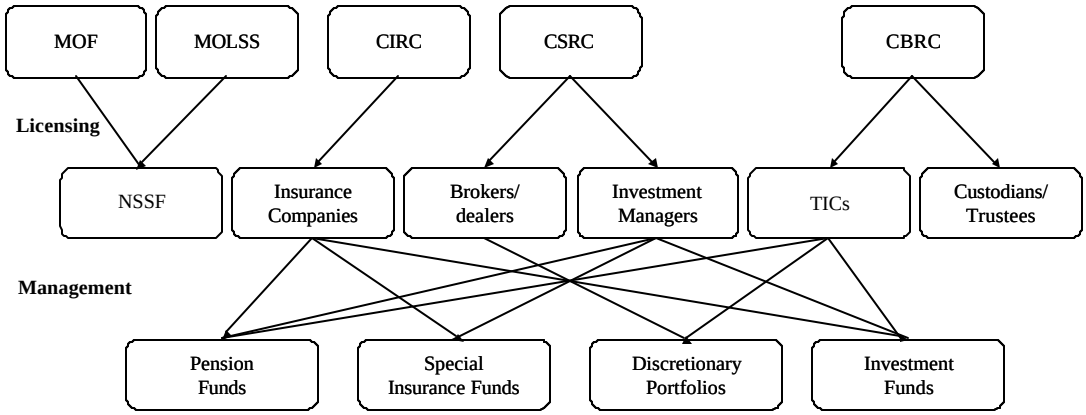
160. The following table summarizes the current situation of various financial institutions and the likely future changes to their roles:

Table 11: Changing Scene of the Asset Management Business

Institution	Regulator	Current restrictions	Changes in progress or expected
Banks	CBRC	Limited participation in managing NBFIs. Custodian for fund managers.	Owning NBFIs through financial holding companies.
NSSF	MOLSS, MOF	Minimum exposure to capital markets. In-house management of investment portfolios.	Invest up to 40% of NSSF's assets in equities. Appoint qualified institutions to manage the NSSF investment.
Insurance companies	CIRC	Limited range of assets permitted.	Relaxation of asset restrictions. Ability to manage third party portfolios.
Fund management companies	CSRC	Regulated by two temporary regulations.	New law will liberalize investment possibilities and clarify structure.
Securities companies	CSRC	Discretionary asset management under strict supervision.	Less restrictive regulatory supervision over discretionary asset management activities.
Trust and investment companies	CBRC	Lack of clear regulation and supervision.	To be more strictly licensed by CBRC. Engage in various trust businesses apart from capital trusts.

161. The table below highlights the fact that, if all the above changes are made, then asset management will be carried out by a broad array of institutions including banks, securities companies, insurance companies, trust companies and investment fund managers. At the same time, the regulatory landscape will become increasing complex, as shown in Figure 11[108].

Figure 11: Regulatory Structure of Asset Management Activities



162. Indeed, if banks are allowed to participate in a wider range of activities, either as holding companies or as owners of NBFIs, the situation will be even more complicated.

[108] Acknowledgement to Leckie and Zhang (2001) for the concept of the chart, originally prepared by the CSRC.

163. Notwithstanding the principle of formal legal separation of the banking, securities and insurance businesses, financial and mixed conglomerates exist in China in at least two sectors through holding company structures.[109] For example, CITIC Holdings[110] and China Everbright (Group), Ltd., offer commercial banking, investment banking and insurance products both in mainland and Hong Kong SAR through financial subsidiaries. In March 2002, BOC International China Limited (BOCI China) was established in Shanghai as a 49% subsidiary of BOC International Holdings Ltd which is incorporated in Hong Kong[111]. The "backdoor" establishment of BOCI China has therefore given it effective access to the securities industry not enjoyed by most peers[112].

164. The emergence of mixed conglomerates is also noteworthy, and the Haier Group provides a good example. The Group's main activity is the manufacture of home appliances, especially refrigerators. However, the Group has a substantial stake in financial institutions via various Haier Group related companies. For example, Group holds 66% of Qingdao City Commercial Bank, and also acquired a 20% controlling stake in Anshan Trust and Investment and a 20% stake in Changjiang Securities through its subsidiaries. Other domestic businesses — Orient Group Industry and Shandong Electric Power Group — also provide integrated financial services through subsidiaries/affiliates.

165. The opening up of the financial sector under WTO will heighten foreign competition. Table 12 is based on concessions made by China under WTO accession in December 2001. While foreign retail banks will enjoy national treatment by 2007, China's WTO concessions in the securities sector are much more limited. With China's WTO membership, foreign firms are allowed to acquire up to a 33% stake (with the ceiling to rise to 49% after three years) in joint-venture fund management companies and a 50% stake in joint-venture life insurance companies. For non-life, China will first allow branching or 51% foreign ownership, with wholly-owned subsidiaries permitted in two years after WTO entry (i.e., no restriction on the form of enterprise establishment). Also, reinsurance will be fully liberalized. In the securities industry, China will allow 33% foreign investment within three years after the accession and 49% afterwards.

---

[109] For more information, refer to a Background Note by World Bank (2002a).

[110] In March 2002, the CITIC obtained permission from the State Council to establish a financial holding company, CITIC Holding Corp. CITIC Holding Corp will control the CITIC Industrial Bank, Hong Kong-based CITIC Ka Wah Bank Ltd., CITIC Securities and CITIC Prudential Life Insurance Co. Ltd.

[111] Other shareholders include China National Petroleum Corporation and Yuxi Hongta Tobacco (Group) Co., Ltd.

[112] With the exception of CITIC Industrial Bank, China Construction Bank, China Everbright Bank, which are members of "de-facto" financial conglomerates.

Table 12: China's WTO Commitments on Financial Services

Banking	Within two years after accession, China will permit foreign banks to provide local currency services to Chinese enterprises. Within five years from accession, China will permit foreign banks to provide local currency business to all Chinese individuals. Within five years after accession, all current unnecessary measures regarding the ownership, operation and establishment of foreign banks, as well as those concerning their branches and restrictions on issuing licenses, will be eliminated (national treatment). Geographical restrictions on local currency business of foreign banks will be phased out in stages. Within five years thereafter all geographical restrictions will be lifted.
Securities	Within three years after accession, foreign investment banks will be permitted to establish joint ventures, with foreign ownership not exceeding 33%, to engage (without a Chinese intermediary) in underwriting domestic shares (A shares) and underwriting and trading in foreign currency denominated securities (B and H shares, government and corporate debts). The shareholding limit will increase to 49% after 3 years of WTO entry. Foreign securities companies may engage directly in B share business. Representative offices of foreign securities companies may become special members of Chinese stock exchanges.
Fund Management	Upon accession, joint venture fund management companies may be established, with foreign ownership not exceeding 33%, to conduct domestic fund management business. Foreign investment shall be increased to 49% after three years.
Insurance	Upon accession, foreign life insurers will be allowed to hold 50% ownership in joint ventures. They may now choose their own joint venture partners. For non-life, China will allow branching or 51% foreign ownership upon accession and wholly owned subsidiaries in two years after the entry (i.e., no restriction on the form of enterprise establishment). Reinsurance is completely open upon accession with no restrictions. All geographic restrictions will be lifted in three years after the entry. Licenses will be granted solely on the basis of prudential criteria with no economic needs test or quantitative limits on the number of licenses granted. Upon accession, foreign life insurers will be permitted to provide individual (non-group) life insurance services. Two years after entry, they will be permitted to provide health insurance, group insurance, pension insurance and annuities to Chinese and foreign customers.

Source: World Bank.

166. On 1 July 2002, the "Regulations on the Establishment of Sino-foreign Joint Venture Securities Companies" and "Regulations on the Establishment of Sino-foreign Joint Venture Fund Management Companies" came into effect.

167. However, strict investment restrictions and intense competition from domestic firms limit major investment banks' interest in forming securities joint venture companies.

Furthermore, the poor financial health and corporate governance of the domestic sector is also a deterring factor in joint venture considerations. Currently, there appears to be no serious interest from top American investment banks, though some European and East Asian investment banks are considering establishing joint-venture securities companies. In May 2003, China Euro Capital Limited became the country's third Sino-foreign joint venture securities company after China International Capital Corporation and BOC International (China) Ltd. The company was formed between Credit Lyonnais Securities (Asia) Ltd. (33%) and Xiangcai Securities Ltd. (67%). BNP Paribas, France's banking group, is also waiting for CSRC approval for joint venture formation between its subsidiary BNP Paribas Peregrine Securities Ltd. and Changjiang Securities Co., Ltd. (the Haier Group is also a major shareholder). As at May 30, 2003, the proposed joint venture between Taiwan-backed Core Pacific-Yamaichi International (HK) Ltd. and Hantang Securities stands to be the last known application with the CSRC.

168. In contrast, despite having to take a minority stake in a joint venture, many foreign fund management companies have an interest in entering the fund management industry, seeing the enormous growth potential for the sector. In the fund management industry, domestic companies are required by CSRC to forge advisory alliances with foreign fund management companies. The prospect of strong sector growth has prompted foreign firms to upgrade their relationship with domestic companies from an advisory role to one of ownership participation.

169. On the other hand, current shareholders of fund management companies — usually a group of securities companies and TICs — are reluctant to sell their profitable equity stakes to foreign investors. Thus, it would seem unlikely for an existing fund management company to transform itself into a joint-venture through divestiture. Rather, foreign investors and domestic securities companies — also TICs to some extent — are expected to establish new joint-venture fund management companies. On October 16, 2002, the CSRC approved the establishment of Guotai Junan Allianz Fund Management Co. between Allianz Dresdner Asset Management (33%), a subsidiary of Germany's Allianz Group, and Guotai Junan Securities Co. Ltd. (33%). With the same objective, Prudential Financial Inc. also signed a letter of intent to form a joint venture fund management company with China Everbright Securities Co., Ltd., in November 2001. In January 2003, China Merchants Fund Management Co., Ltd, a joint venture among ING (30%), China Merchants Securities Co. Ltd. (40%) and three other corporate investors became the first Sino-foreign joint venture fund management company to be put into full operations.

170. At present, the following alliances are in the pipeline:

Table 13: Proposed Fund Management Alliances Between Domestic and Foreign Companies

Foreign Fund Managers	Chinese Partners
HSBC	China Southern Fund Management
JP Morgan Fleming	Hua An Fund Management
Invesco	Penghua Fund Management
ABN-AMRO Asset Management	Chang Sheng Fund Management
Deutsche Bank	Dacheng Fund Management
Bank of Montreal, BNO Investments Inc.	Fullgoal Fund Management
Schroders	China Galaxy Securities
Allianz	Guotai Junan Securities
Fortis Investment Management	Haitong Securities
Commerzbank	China Southern Securities
BNP Paribas	Shenyin Wanguo Securities, IFC
Prudential	China Everbright Securities
ING	Guotong Securities
Bank of New York	Agricultural Bank of China
JP Morgan Chase	Bank of Communications; China Construction Bank
State Street	Industrial and Commercial Bank of China

Source: World Bank

6 THE WAY FORWARD

171. As a nation, China has the good fortune to have a surplus of savings. Individual savers, however, have the misfortune of lacking a sufficient range of suitable outlets for their savings. The distortions of the market itself are partly to blame for this, given the authoritarian control of interest rates and equity markets dominated by issues of relatively unprofitable state owned enterprises. For these reasons, building a range of well capitalized, honest and efficient investment institutions in a rational and balanced way must be considered an important component of China's long-term strategy for capital market and economic development.

172. More specifically, there are at least four priority objectives for developing institutional investors.

173. One priority objective is to increase demand for longer-term government bonds. This will expand the investor base for government bonds beyond the SCBs, who are the major investors in that market segment to date and who are increasingly reluctant to assume the interest rate risk associated with long-term investments. The SCB's inability to take on increased levels of interest rate risk presents an urgent challenge for government debt management by the MOF.

174. A second priority objective is to create demand for infrastructure bonds, by their nature longer-term instruments. There are substantial potential synergies, currently unrealized, between the strategy to develop institutional investors and the strategy to urgently develop new financing mechanisms for infrastructure investments.[113]

175. A third priority objective is to strengthen the professional capacity of institutional investors to manage investments in equity securities with a longer-term investment horizon and to create greater investment demand for equities. Traditionally, the short-term investment style of PRC equity investors contributed to market volatility and provoked abusive practices. Strengthening professional management capacity will lay the foundation for tapping the potentially huge pent-up demand for equity investment in China. This cannot be achieved so long as small investors are not comfortable placing their savings with equity issuers and market intermediaries. Tapping into this demand will also improve the prospects of an orderly disposal of state shares.

176. The fourth priority objective is to build a significant and independent constituency for improved disclosure, corporate governance and minority shareholder protection by equity-issuing firms. The actions of professional institutional equity managers can be leveraged as an important complement to regulatory efforts in this regard.

177. The policy options that follow underlie the successful development of institutional investors elsewhere. In general it appears that the existing structure of capital markets in China is not yet in line with these principles, which may account in part for the slow and uneven development of institutional investors.

6.1 Consolidation of Asset Management and Applicable Standards

178. The approach in China of "experiment first, regulate later" has resulted in a complex set of structures. Issuing regulations prior to passing laws is seen as having the advantage of allowing markets the flexibility to develop without being bound by laws. The disadvantage, however, is exemplified by constant changes in regulations. It is commonplace for inconsistencies to exist among institutional investor-related regulations issued by different regulators.

179. One agency should be the lead regulator for any activity that involves securities or management of portfolios of securities, by whatever organization. The concept of a lead regulator is well understood in countries that do not have consolidated supervision of the whole financial sector. It may be seen as regulation by function, rather than by institution.

180. The necessary professional skills common to all institutional investors are investment analysis and portfolio management. While the objectives and time horizons of a pension fund and a collective investment fund may be different, the techniques for portfolio management in a way that meets the objectives of the investors are the same for all portfolio classes.

---

[113] Two key weaknesses of current infrastructure financing structures are that they are excessively dependent on bank loans; and that they involve excessive use of government guarantees and thus give rise to excessive contingent fiscal liabilities.

181. While one can appreciate the need for different prudential standards to be applied to pension funds and insurance companies, particularly if there are guarantees involved, it may be unnecessary to create a special breed of investment managers to manage each type of portfolio. Many countries have made the mistake of believing that the management of a pension fund portfolio is so different from the management of any other type of portfolio that it must be done by a company specifically licensed to do only that, and cannot be done by another licensed asset management company. This has the effect of diffusing valuable professional talent, which is, in any case, in short supply in China.

182. In more advanced economies, it is becoming increasingly hard to categorize non-bank activity among mutual funds, insurance and pensions. The mutual fund model is increasingly used to express an individual participant's ultimate pension and life insurance benefits. This contrasts with the guarantees given to participants by traditional life insurance products and defined benefit pension schemes, where the life insurance company or the plan sponsor stand as guarantors between the participant and market risk. Also, even in jurisdictions where life insurance companies and banks are physically separate and separately regulated, the linkages between banks and life insurance companies are close. Such linkages are evidenced by i) cross-ownership (common in Germany), ii) the two forming part of the same group, or iii)an ultimate holding company or subsidiary ownership.

183. Unit-linked life insurance uses premiums received to make a series of contractual purchases of free-standing mutual funds (often those managed by the life insurance company itself or its banking affiliate) or of a series of internally managed funds (not legally constituted as mutual funds but are operated in almost the same way). In either case, market risk is transferred from the life company as guarantor to the participant. The life insurance company's role becomes increasingly that of asset manager, providing only a minimal life insurance parcel (death benefit), which is often required for tax reasons[114].

184. Pension funds too are moving away from being guarantors of a lump sum or an annuity upon retirement and want to transfer market risks to pension plan participants. A fund that transfers market risk is generically known as a *defined contribution scheme.* The regular contractual payments made by the employer and/or the employee are invested in mutual-fund-type instruments or internal funds which are operated as quasi-mutual-funds, not unlike life insurance companies. Such pension schemes are managed by life insurance companies, asset managers or specially constituted structures. There are numerous examples of this type of pension fund. They are, in effect, mutual funds with certain added tax benefits[115] and with the restriction that a participant will incur a penalty if withdrawals are made prior to reaching a certain age or retiring.

185. There is a strong case, therefore, for setting common standards for those wishing to engage in asset management activities within whatever context or parentage. Typically, these standards apply only to those wishing to manage third-party portfolios

[114] The premiums payable attract tax relief;, or the life company ownership of assets provides shelter from capital gains and income taxes; or the proceeds are tax-free on maturity or death.

[115] Contributions may be tax deductible; the funds may be free from capital gains and income taxes and/or the resulting pension payments may be free of tax.

and not to the internal management of insurance or pension portfolios. However, many regulatory regimes require internal managers to adopt most of the standards (competence, conduct of business, avoidance of conflicts of interest, etc.) that would be applied to external managers. Of course, once an insurance company, or indeed a large pension fund with internal management, starts to manage segregated third party portfolios, it will have to comply with all the regulations that apply to independent asset management companies.

186. In China the common standards should apply to all asset management companies that manage investments of others at discretion – insurance companies, pension funds, investment fund managers, trust and investment companies and securities companies.

187. For securities companies, there is a long running argument regarding whether the activity of discretionary management of clients' portfolios should be performed by a separate company, rather than by a department. There is a strong argument for separating the two activities, particularly if the securities company is a broker-dealer and also engages in corporate finance work. There is an inherent conflict of interest and difference of style between brokers and investment managers. The broker lives from commission on transactions and clearly wishes that turnover should be as high as possible to generate maximum commission. Investment managers should have no interest in transactions for their own sake but only on the total return (dividends, interest and capital gains) that the portfolio managed can consistently generate over time. Broker-owned asset management businesses tend to be turnover driven rather than investment driven.

188. Ideally, therefore, securities companies might be required to establish separate asset management subsidiaries, with separate personnel and systems, for the purpose of discretionary management. These subsidiaries should conform to the rules applying to asset management companies generally; they should also be supervised under the same regime – capital adequacy, qualifications of personnel, systems, etc. This will have the effect of harmonizing the regime for asset management generally and create a level playing field between asset management companies under different ownership, i.e., investment fund managers, pension fund managers, insurance companies, trust investment corporations and (possibly in the future) banks.

189. Setting common standards for all investment managers will involve detailed regulations that should cover a number of key areas, including:

(a) Capital adequacy and solvency;
(b) Resources and systems;
(c) Competence and skill of personnel;
(d) Conduct of client business;
(e) Conflicts of interest;
(f) Advertising, marketing and selling; and
(g) Transparency, disclosure and reporting.

6.2 Level Playing Field

190. In China, the terms for obtaining permission to enter and to continue to perform any business are sufficiently unclear as to place considerable power in the hands of those who grant the licenses.

191. While this holds some advantages in allowing the state regulators to keep out undesirable applicants, who may qualify to be granted a license on all counts except their perceived fitness and propriety, it has many disadvantages too:

(a) It tends to perpetuate monopolies, favoring existing large players and well known domestic enterprises, while excluding new entrepreneurial entrants, domestic and foreign alike (some of which may be low profile yet highly reputable institutions);

(b) By limiting access to licensing, it drives businesses underground rather than allowing them to be visible in the formal sector;

(c) By requiring very large sums of capital to be invested in new companies, it goes against smaller entrepreneurial entrants, driving these also underground; and

(d) It provides an opportunity for those with the power to grant licenses potentially to indulge in corrupt practices.

192. The Chinese characteristic of predominant public ownership of banks extends to the NBFI sector too. Most non-bank financial institutions are held by the public sector — outright or through governmental entities or state-owned enterprises — and have weak corporate governance. Appendices 2 and 3 show the ownership structure of leading securities companies and fund management companies, respectively.

193. As a transitional economy, China has an obvious historical background of government ownership of financial institutions. Until the mid-1980s, the banking and insurance businesses, as in many developing countries, remained a state monopoly. And even though the securities business emerged in 1992, after two stock exchanges were established, public ownership of securities companies and fund management companies was common, as a result of a shortage of private capital and a lack of confidence in the security of private sector institutions.

194. Whatever the motives, prolonged public ownership of financial institutions will in the long run involve palpable costs while offering elusive benefits, if any. Publicly owned enterprises are inherently inefficient with low business incentives, little matching the market dynamism and innovative skills of private enterprises. It is not unusual for government-owned companies to sacrifice their commercial interests to serve *ad hoc* public policies. Government ownership is also problematic because it may lead to considerable regulatory forbearance. Further, publicly owned financial institutions enjoy an implicit government guarantee of the products they offer. All in all, predominant

public ownership in the financial sector leads to unfair competitive advantages for publicly supplied financial services, which can stifle the development of vibrant private sector alternatives.

195. To encourage a rapidly expanding private sector where entrepreneurs take the lead in wealth creation and promotion of economic growth, government ownership of financial institutions needs to be reduced going forward. The state should not only allow, but *encourage*, the creation of genuinely private financial institutions, especially in the securities business where innovation is key to success. Even if the government continues to retain partial ownership in certain financial institutions, private owners should have effective control of those institutions' operations, which will facilitate the competent implementation of commercial principles.

196. If new domestic entrants are to enjoy a level playing field with existing players, foreign applicants should be allowed to compete on equal grounds with domestic players too. In the context of China's financial system, the first and most obvious benefit of foreign participation would be access to foreign expertise. This is particularly important in the capital markets where local firms have far less experience than foreign firms. The second order benefit, perhaps more valuable in the long-term, would be developing trust and confidence, the cornerstone of asset management business, for the domestic financial sector. Notably, renowned international financial institutions will conduct their business activities in a highly prudent manner in order to maintain their professional reputation.

197. It is also hoped that foreign participation in the management of investment funds, and possibly in the wider field of asset management for pension and other institutional funds, will usher in advantages for the Chinese financial markets. The large multinational asset management companies, which are known to be interested in forming or have already formed alliances, should be able to introduce and transfer skills, including:

(a) Better investment analysis, asset allocation and stock selection, leading to the training of a new cadre of Chinese investment professionals. This should have useful side effects, such as improving the way in which securities are valued in the market, a better quality of issues, and improved corporate governance;

(b) The technology for mass administration and shareholder servicing systems, which will be needed to keep management costs competitive if many investors are to be attracted; and

(c) Better information to investors through higher quality prospectuses and annual reports, leading to better investor understanding of the potential upsides and downsides of investing.

198. As mentioned in the preceding sections, it is encouraging to see that Chinese regulators are taking swift actions to implement WTO commitments for the financial sector. Earlier than expected, the CSRC issued on June 3, 2002, the rules outlining

foreign participation in fund management and securities business. Notably, the rapid establishment of joint venture securities and fund management companies are respectable boosts to the otherwise tarnished image of the financial services industry.

6.3 Availability of Wider Range of Investment Opportunities and Products

199. One of the constraints on asset management in China today is the inadequate supply of investment instruments. This is especially true of fixed-income securities. In particular, products that are lacking — shorter-term instruments, corporate bonds and financial derivatives — render rational portfolio management and asset allocation difficult.

200. Specifically, the viability of fixed-income investment funds is predicated upon the availability of a wide range of bonds, bills and money market instruments.

201. For the government bond market, future debt management strategy needs to focus on introducing T-bills and shorter-term (one- or two-year) T-bonds. These instruments will be important for supporting government cash management operations and for the development of the money markets.

202. As for the corporate bond market, issuers with good credit quality should be allowed to issue corporate bonds provided they are subjected to a rigorous credit review by competent credit-rating agencies. The post-crisis revival of the Asian domestic bond markets — notably Korea, Singapore and Thailand — reflects corporate Asia's need to safeguard against currency and term-mismatch risks. The same force should also be at play in China, coupled with enabling elements including a high savings rate, low domestic interest rates and low inflation. More importantly, China's massive infrastructure program also calls for an efficient bond market that is capable of mobilizing long-term funds for long-term investment projects.

203. The necessary legal and regulatory framework should be created for introducing asset-backed securities (ABS)[116] and mortgage bonds to the market. Asset securitization could provide an effective means for trading impaired assets held by the four asset management companies (AMCs).

204. One of China's biggest constraints in developing the debt market is the existing pricing restriction on financial assets, i.e., the interest rate control system. It will be very difficult to see significant progress toward a deep and professional debt market if such restrictions are not addressed in an expedient manner. Ideally, the market should offer both risk-free (government issues) and risky (corporate papers of varying credit ratings) fixed-income securities. This will stimulate the development of fixed income funds across the credit spectrum and risk/return continuum.

205. An important yet often overlooked issue is the quality of credit information services. Credit information services are fundamental to fostering diversity and liquidity

[116] PBOC is reportedly working on drafting ABS law.

in the domestic bond market. In China, however, the credit information industry is thwarted by poor issuer transparency and corporate governance. On the demand side, institutional investors have yet to see the value of credit rating services. As a result, credit information service providers find it very difficult to make ends meet, let alone uphold the objectives of independence, professionalism and core competence.

206. Deep liquidity is essential, since active management of fixed-income fund portfolios is necessary for those managers to achieve higher returns than others who simply buy and hold. This will be particularly important in China where the differential in yields between retail bank deposits and government bonds is negligible. A very active management approach will be necessary to give investors value for the fees that will be charged on the investment funds themselves.

207. Along this line, bond market segmentation needs to be addressed and improved. The guiding principles should be broader market access; flexible trading systems; market competition; and effective regulatory coordination.

208. Additional tools are also necessary for the efficient management of fixed-income portfolios. Interest rate futures and options are widely used elsewhere, not only as a means to manage risk but also as a cost effective way to rebalance and alter the maturity of portfolios without incurring high transaction costs. These are not yet available in China.

209. The supply of quality equities should be increased. To this end, the state should proceed with its original plan to sell state-owned shares of listed companies provided that the policy is implemented to minimize disturbance of the equity markets. The authorities need to develop comprehensive divesture plans for SOEs that will combine sales to strategic investors; block sales to private investors; and partial IPOs on the equity markets.[117] A strategic plan covering a large number of different SOEs, with advance information about possible IPOs or sales, would enable long-term institutions to plan their investments on a longer term and rational basis. It may also help eliminate the speculative rush to purchase any IPOs, a characteristic peculiar to the Chinese market.

210. This systematic plan would replace the ill-fated plan, officially scrapped in June 2002 (see section 4.3), of selling 10% of the state shares in IPOs and rights offerings to replenish the NSSF. While many options for re-launching the sale of state shares have been identified, there are no clear-cut solutions. The future mechanisms for selling state shares would have to address the historical problem of substantial price differences between tradable and non-tradable shares of existing listed companies. Across-the-board measures to resolve this discrepancy and to develop mechanisms for further disposals of

[117] In October 2002, the CSRC enacted " Regulation on Listed Company Takeovers." The new measures are expected to facilitate block sales of shares by creating a comprehensive and stable legal basis for the M&A market. Under the new regulation, no limits are placed on the type of entity -- the state, a private firm, or an individual -- that can engage in the takeover of a listed company. As for the means of acquisition, shares and assets swaps are now allowed; previously only large sums of cash could be used. In addition, the new rule allows for applying different prices to tradable and non-tradable shares, i.e., it allows the purchase of non-tradable shares at a substantially discounted price.

state shares may not prove viable. The state may have to accept some price difference and let stakeholders (investors, underwriters, and company executives) collectively decide the valuation on a case-by-case basis.

211. In addition to sales of non-tradable state shares, the CSRC should open up the stock exchanges to good private companies and reduce its role in the IPO approval process. In 1999, the old quota system for IPOs was replaced with a new merit review system involving the semi-independent Public Offering and Listing Review Committee.[118] This new procedure is considered to be less prone to political influences. Still, the CSRC tightly screens entry to the equity market (Box 2). In addition, firms must obtain approvals from multiple government departments before applying to the CSRC.

[118] The committee is composed of professionals from the CSRC and outside market experts. It has been structured with its members rising to 80 from 34, three-fourths of whom are currently non-CSRC members.

Box 2: Merit Review System for Initial Public Offering in China

Currently initial public offerings (IPO) in China are subject to a strict merit review system by the CSRC. The CSRC holds the key throughout the review process, while the Public Offering and Listing Review Committee plays a supplementary role at the final review stage. The IPO review process consists of the following:

- IPO application is submitted to the IPO department of the CSRC through an underwriter.
- The CSRC then sends the documents to both SDPC and SETC — each ministry still holds veto rights.
- If application is cleared by SDPC and SETC, it undergoes close examination by one to two staff member(s) of the IPO department of the CSRC.
- Usually the review process involves several rounds of comments/revisions.
- If the application passes review by the IPO department, then the accounting and legal departments of the CSRC join the comprehensive review meeting.
- After the comprehensive meeting, the CSRC issues a formal notice to the applicant; this then leads to a second comprehensive meeting whereby a final notice is issued to the underwriter.
- Only at this late stage does the Public Offering and Listing Review Committee become involved. The applicant (via an underwriter) is required to submit nine copies for the Committee review meeting.
- In the past, members of the Committee were given seven days to review the documents; to prevent corruption, members now are not told in advance the identity of the applicant company but are simply requested to attend the review meeting (in reality, though, they know which firm they will review, due to extensive lobbying by the applicant and the underwriter). Committee members are given only a half-day to review the application and then must make a decision that afternoon.

The whole process is quite cumbersome, usually requiring six months to one year. The Committee's involvement permits the CSRC to disapprove an application at the final stage while incurring minimal political burden. The current system is a replacement for the previous quota system that prevailed until 1998. Inefficient as it is, the current system hails improvement on two fronts: no official quotas are imposed and there is no discrimination against private sector firms on the surface.

6.4 Relaxation of Investment Restrictions

212. The regulations on permissible investments for institutional investors need to be improved. China has, in general, a restrictive system of investment options for financial institutions. Typically, different investor groups are subject to different investment restrictions. The list of permissible investments often contains limited options vis-à-vis

international practices, which restricts institutional investors' ability to manage diverse and balanced portfolios.

213. Developments in the insurance sector illustrate how the current system works along a gradualist approach. The Insurance Law of 1995 (Article 104) states that insurance company assets may be invested only in bank deposits, government and financial bonds, and other assets approved by the State Council. The CIRC issued a measure in July 1999 to include as an investment option central-government enterprise bonds with a rating above AA. In August 1999, purchases of bonds in the inter-bank primary market were included as permitted investments. At end-1999, insurance companies were permitted to indirectly invest in equities up to 15% of their total asset through securities investment funds. In October 2000, insurance companies were allowed to engage in secondary bond trading in the inter-bank market. Thus, every expansion of permissible investments required a new authorization from the government. The October 2002 Insurance Law amendments further removed certain specific investment restrictions and authorized the State Council to approve new forms of permitted investments. Accordingly, the CIRC allowed insurance companies to invest up to 20% of funds in corporate paper[119] (up from 10%) in June 2003.

214. Table 14 summarizes permissible investment products by type of institution. Despite continuous efforts by regulators to relax and codify[120] investment restrictions, the current system expressly prohibits investments that are permitted in other markets.

215. As a related issue, it is not always clear what investments are permissible for financial institutions. Similarly, for second and third pillar pension funds, there are as yet nodisclosed investment guidelines although MOLSS claims an investment rule is currently being drafted.

216. Clarity is also lacking with regard to permissible investments for insurance companies with funds raised from unit-linked products. Since there are no investment guidelines specifically addressing unit-linked products, insurance companies applied general investment restrictions for insurance funds to these products. According to a recent report on the CIRC's plan to relax investment restrictions for unit-linked products, the CIRC has reportedly given its consent to three insurers (Ping An, Xinhua and Zhonghong) to invest up to 100% of the unit-linked product funds in securities investment funds.

217. The "restrictive and indicative system" common in China contrasts with the "prudent person" approach to investment portfolio management in countries where the common law is in use, e.g., U.S. and U.K. Under the "prudent person" model, investment options are not specifically restricted; instead, trustees and/or asset managers are expected to apply the rules of appropriateness and suitability taking into consideration a

[119] Insurance companies are no longer limited to investing in only four issuers (ie, China Mobile, State Power, Three Gorges and Ministry of Railway). Rather they can invest in bonds with a domestic rating of AA or above.

[120] Most notably, the enactment of investment guidelines of National Social Security Fund by the Ministry of Finance in December 2001.

portfolio's stated strategic objectives, contractual agreements between clients and asset managers, avoidance of conflicts, and such factors as guarantees.

Table 14: Investment Restrictions at a Glance

Institutions	Permitted	Prohibited
Banks	• Loans • Government Bonds • Discounting Bills • Inter-bank Call Loans • Corporate Bonds[121]	• Equities • Investment Funds • Real Estate
Investment Funds	• Equities • Government Bonds • Corporate Bonds • Cash • Bank Deposits	• Investment Funds (Cross-Investment) • Real Estate
Insurance Companies	• Bank Deposits • Government Bonds • Corporate Bonds (with limitations) • Investment Funds (with limitations)	• Equities • Real Estate • Loans
National Social Security Fund	• Bank Deposits • Government Bonds • Corporate Bonds • Investment Funds • Equities	• Real Estate
Locally Controlled Pension Funds	• Bank Deposits • Government Bonds	• Equities • Investment Funds • Real Estate
Trust and Investment Companies	• Bank Deposits • Equities • Government Bonds • Corporate Bonds • Investment Funds • Real Estate	

218. The means by which standards of investment management practice can be enforced are diverse:

(a) Trustees can be engaged to apply "prudent person" principles over investment management activities. Trustees may be open to personal lawsuits if the beneficiaries can prove damage as a result of the trustees' imprudent actions or negligence.

[121] " Domestic banks are not explicitly prohibited from nor permitted to purchase corporate bonds," Chao and Gounaris (2002, p.5). However, the prohibition against commercial banks opening accounts at the stock exchanges (for custody of listed corporate bonds) is believed to be a technical impediment to such activities .

(b) For failure to observe the terms, or negligent breach, of a contractual agreement between a client and an asset manager, the client, a trustee, corporation or individual may bring an action for damage against the manager.

(c) Regulators too may apply the concept of best advice and suitability of advice given to individuals, trustees or corporations, and take action if they can show that advice given was inappropriate to the needs or circumstances of the client (i.e., involved excessive risk).

(d) Conflicts of interest are usually clearly defined in regulations and understood from legal precedents. However, professional asset managers can often profit from asymmetrical information at the expense of clients. Hence, transparency and disclosure should be further enforced.

219. The "prudent person" approach is useful in that it avoids the need for constant re-categorization of permitted investments as markets become more complex and diverse and as new types of security or other asset classes emerge. Under a restrictive system, the regulators responsible for categorizing permitted investments need to issue ongoing and more detailed updates (as has been the case in China, and as is highlighted for the insurance sector)[122]. However, the "prudent person" approach is not without risks for countries that are unfamiliar with the concept of fiduciary responsibilities. In these jurisdictions, both investment managers and regulators are inexperienced with managing and regulating activities with different investment horizons, while clients demand returns that can only be achieved by significantly raising the level of risks.

220. In the case of China, the giant leap from the current highly restrictive regulatory regime to the fiduciary duty-based "prudent person" approach will create unnecessary risks and therefore cannot be recommended. A gradualist reform approach will more likely to give the desired result. This approach was adopted by the Chilean pension sector,[123] which remains a well-known and successful model for the development of institutional investment.

221. There is no simple answer to which of the two approaches — “prudent person" or "restrictive and indicative" — will yield the better results, although some analyses suggest that the "prudent person" approach yields better results in the long term[124]. In reality, most countries adopt an amalgam approach for different types of investment institutions (pension funds, insurance companies and mutual funds), but at the same time ensure that the less specific prudential rules are in place. These include portfolio diversification requirements; prohibitions against conflicts of interest; limits to market

[122] For an excellent review of the two different regulatory approaches, see Vittas (1998).
[123] In Chile, there was substantial involvement of foreign institutions in pension fund management companies as there were in other Latin American countries that adopted the same model. This is because the specialized pension management companies were set up as free-standing entities and were specially regulated. Local banks were kept out of the pension fund management industry in the early years of its development. In China, as in the European model, insurance companies are making the running in private pension provision. There are so many local and cultural issues surrounding pension generation and distribution that it cannot be said that any particular model is better than any other for a particular country.
[124] Davis (1997).

power and other factors, e.g., investment risk and liquidity; and investment suitability for different types of portfolios.

222. As a way forward, regulators in China are advised to conduct a thorough review of the categories of investments permitted for the different categories of institutional investors. Investment rules should be specific and clearly defined, and should be readily available to institutional investors and applicable to all institutions that fall within the same category, not just to selected favorites.

223. Further, the investment regime needs to be considerably relaxed. In fact, many countries adopted an "indicative system," investments being confined to pre-approved categories of assets. This approach is common in newer markets: the regulator lacks confidence in the managers' ability to adopt sensible and low-risk investment strategies; domestic instruments may be in short supply,; or the government wishes to channel investments in particular directions (e.g., twenty years ago in France, collective investment funds were obliged to hold a percentage in government bonds). Statutory investment restrictions have been subsequently relaxed as local financial intermediaries and capital markets become more transparent and better regulated by appropriate supervisory authorities. So long as a wide range of investment opportunities exists, institutional investors may have little problem under a positive system in meeting multiple objectives, *inter alia*, achieving adequate rates of return, managing risks and matching assets to liabilities.

224. Box 3 summarizes best practices on permissible assets for CIFs and insurance companies in developed markets.

Box 3: Permissible Assets for CIFs and Insurance Companies

Collective Investment Funds (CIFs)

The permissible assets for collective investment funds (CIFs) are generally selected for their characteristics of liquidity and transparency, along with the issuer's soundness.[125] Open-end CIFs are required to limit their investment in illiquid assets to a small ratio, usually a maximum 10% of a portfolio for reasons of liquidity (since they may be obliged to sell assets to meet redemptions) and valuation (since it is important to be able to value the assets at market price regularly and reliably). Permissible assets for CIFs typically include:

- Cash and deposits: deposits with banks, certificates of deposit, commercial paper;
- Bonds: government bonds, municipal bonds, agency bonds, corporate bonds, convertible bonds;
- Equities: listed shares, unlisted shares (limited figure).

Holdings of real estate are usually not permitted to open-end CIFs. Closed-end corporate types of CIFs specialize in investment in real estate (Real Estate Investment Trusts in the U.S. and Property Companies in the U.K.).

Insurance Companies

In advanced markets, insurers have a wider range of permissible assets. EU Insurance Directives, for example, permit the following:

- Investments: a) debt securities, bonds and other money- and capital-market instruments; b) loans; c) shares and other variable-yield participations; d) units in investment funds; e) land, building and immovable property rights;
- Debts and claims: advances against policies, among others;
- Others: tangible fixed-assets apart from land and buildings; cash at banks and on hand; deposits with credit institutions, among others.

In OECD countries, permissible assets include[126]:

- bonds (permitted in all member countries; no minimum floors reported; maximum percentages between 2% (Turkey) ~ 5% (Poland) and 100%);
- shares (permitted in all member countries; no minimum floor reported; maximum percentages between 25% and 100%);
- mortgages (not allowed in Turkey);
- real estate (permitted in all member countries; percentages of 10% (Netherlands) to 100%); loans (permitted in all member countries except Poland); advances against policies in life insurance (except for Japan and the UK); and cash (permitted in all member countries except Mexico).

[125] This paragraph has benefited from Cadogan Financial (2000).
[126] OECD. (2000). See Appendix 5 for detailed limits in each country.

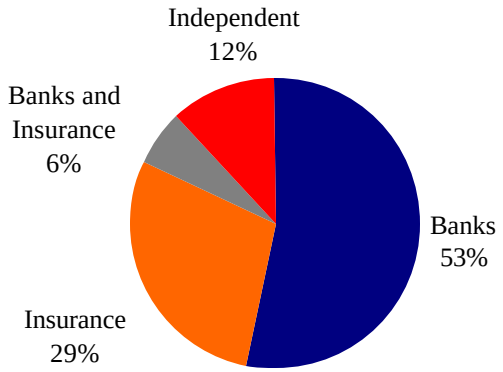
6.5 Increased Role of Banks

225. Examples of bank-based financial systems are common in the larger and more developed countries of the European Union – Germany, France, Italy and Spain for instance. But each of these countries has made considerable efforts to develop itscapital markets. During this process, the ability of banks to undertake a variety of non-bank activities (e.g., asset management, formation and promotion of investment funds and pension funds and life insurance) has accelerated the development of these activities.

226. This may be a useful lesson for China in mobilizing its banking sector for the development of the country's institutional investor base. As the banks in continental Europe did, the Chinese banks hold the bulk of household savings. Thus, they are in a good position to offer alternative investment opportunities to their customers.

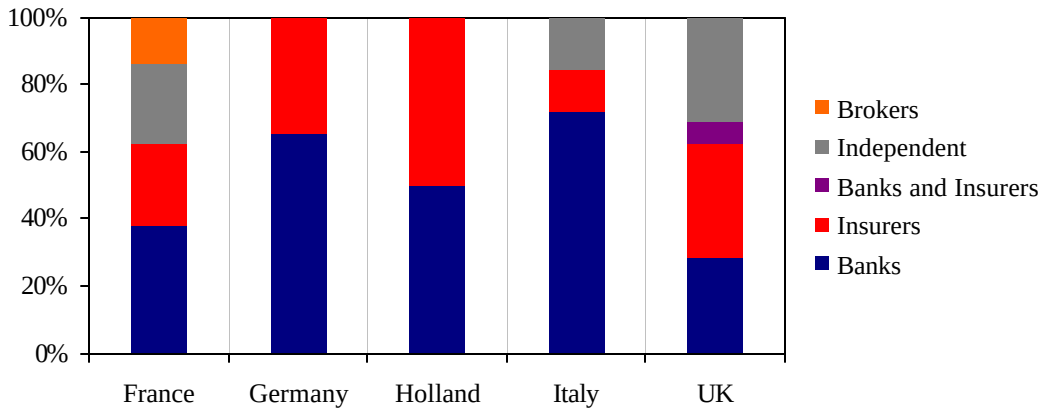
227. The 1990s witnessed the rapid growth of mutual funds throughout Europe (including U.K.). With the exception of the U.K., most European fund management companies are bank-owned. Figures 12 and 13, below, give an impression of the ownership of asset management companies in Europe as a whole and shows different ownership patterns in certain countries of Europe. The data is from 1998, but it is unlikely that there have been substantial changes in ownership patterns since that time. The domination of banks and insurance companies is clear, even in the UK, which is less bank dominated:

Figure 12: Ownership Structure of Fund Management Companies in Europe



Source: Oxford Economic Research Associates Ltd.

Figure 13: Shareholder Profile of Fund Management Companies in Selected Countries



Source: Oxford Economic Research Associates Ltd.

228. The universal banking model[127] is well established in Europe and looks likely to continue to dominate non-bank financial activities. Europe has never had a "Glass-Steagall" type of legal separation of banking from non-banking activity. Even in the U.K., there is clear trend towards the domination of non-bank activity, particularly of mutual fund management and distribution, by banks and insurance companies at the expense of the independent asset management companies. In the U.S. too, with the repeal of Glass-Steagall by the Graham Leach Blighly Act in 1999, there is a developing trend towards bank ownership of asset management companies, although the large independents –- Fidelity and Vanguard, for example -- remain strong for historical reasons. It remains to be seen how far this trend will perpetuate in the US market.

229. Vis-à-vis the world's financial centers, China has one of the most restrictive regimes for permissible banking organization activities. According to a 2001 global survey[128] by the Institute of International Bankers, China was the only country among the 44 surveyed to prohibit banks from practicing securities, insurance, real estate and investments in industrial firms altogether.

230. In China, the role of banks in capital markets is confined to the intermediary business, providing a distribution network as agents. On July 4, 2001, the PBOC issued the "Interim Regulations on Intermediary Business of Commercial Banks" ("Interim Regulations"), which described the definition, scope, and approval procedure for the intermediary businesses. According to the Interim Regulations, intermediary businesses of commercial banks in the capital market include:

[127] In theory, the universal banking model refers to production and distribution of all financial services in a single legal entity. Few if any examples exist internationally. In practice, universal banking refers to production and distribution of commercial banking and investment banking products in a single legal entity, in some cases with insurance products produced and/or distributed via a separate subsidiary.
[128] Appendix 4 illustrates the main findings of the survey for selected countries.

(a) investment funds custodian;
(b) record-keeping, subscription, bid and redemption of all fund types;
(c) securities agent in a very restrictive sense[129]; and
(d) insurance agent.

231. As mentioned in earlier sections, in June 2002, the PBOC allowed the four state-owned commercial banks to offer marketable government bonds to retail investors through designated branches. In September of the same year, the PBOC further approved 39 commercial banks to set up government bond sales desks to serve their corporate clients. In the corporate bond market, Chinese commercial banks are banned from underwriting corporate debt[130], but for customer relationship and fee income generation purposes, some banks acted as guarantors of corporate issues. Again, this highlights the restrictions on commercial banking activities in the capital markets arena.

232. Meanwhile China's separation principle has not served to completely prohibit financial services integration. First, two of the four state-owned commercial banks engage in the securities business via subsidiaries. As previously explained, BOC and CCB are undertaking investment banking and securities brokerage activities indirectly through BOCI International (China) Ltd. and China International Capital Corporation Ltd. respectively.

233. Second, financial conglomerates do exist. They include CITIC Holdings and China Everbright (Group) Ltd., whose businesses reach into every corner of China's financial sector, including the industrial sector (see our discussion on the evolution of financial conglomerates in chapter 4). Both groups were established before 1993, prior to the introduction of the separation principle.

234. Third, to date no specific law directly addresses financial holding companies, (i.e., whether they are permitted and if so, in what form). This lack of clarity renders the holding company structure a feasible vehicle for evading the segregation constraint. The prohibition against banks' investing in non-bank financial institutions is clearly stated; in contrast, however, an industrial corporation is not prohibited from owning both a bank and non-bank financial institution at the same time. Thus, it is possible for a holding company to integrate the different financial segments under one roof with financial subsidiaries and affiliates having access to capital markets.

235. Since the specific exceptions from the separation principle cited above were basically associated with privileges tied to state-owned financial institutions or with historical legacy, there is no guarantee that others — banks and industrial enterprises alike — will be able to obtain government approval to copy the CITIC or the BOCI approach to form a financial holding company. However, amid increasing concerns

[129] For specification on the agent of securities business, the "Notice of Implementing the Interim Regulations on Intermediary Business of Commercial Banks" by PBOC on April 22, 2002, clearly stated that a bank, while acting as an agent of securities business, may not engage in the buying or selling of equity securities.
[130] Apart from China Development Bank, which is allowed to underwrite corporate bonds issued by existing clients.

about stiff competition from foreign financial institutions offering the full line of financial services after China's WTO entry, the government is set to re-examine the current strict segregation principle in order to nurture a more conducive environment for the development of financial conglomerates.

236. The CBRC will likely continue to prohibit banks from engaging in any form of equity-related business due to fears of equity market speculations. In fact, allowing banks to engage in securities dealing and underwriting activities represents a real risk to banks' solvency. It was the collapses of banks in the U.S. Great Depression (1929-1933) that led to the enactment of Glass-Steagall. In Russia, the 1998 banking collapse was caused by the dual impact of the massive sell-off of government bonds, as well as the securities operations of commercial banks. For these reasons, banking regulators in most jurisdictions would prefer to isolate the securities business from banking activities.

237. In order to promote the development of institutional investors in China, however, the government should re-consider commercial ownership of NBFIs. The basic tenet lies in depositors' trust in the country's banking system. As such, the entry of commercial banks into non-bank services might prove a more reliable yet less politically risky avenue for deploying retail savings vis-à-vis securities companies or independent investment managers.

238. Since banks already act as agent-distributors of life insurance and investment products, it would be a fairly short step forward to allow banks to own the originators of the products — investment managers and life insurance companies — or to sell own-branded products managed by other originators which convey the impression to customers that they are the bank's own. Banks will need incentives to develop non-banking activities, since they will be concerned about deposit loss. Small commissions for selling products will not likely be a sufficient incentive to attract banks more deeply into non-bank financial activities.

239. Of greater importance is devising a system that recognizes and minimizes the inherent conflicts of interest among the different activities — commercial banking, investment banking, brokerage and asset management. If banks are permitted to own (in whatever form) life insurance and investment management companies, the amount of capital required should be properly defined[131] and be reflected in the overall capital adequacy requirements of a bank.

6.6 Pension Reform

240. The long-term development of institutional investors depends significantly on pension reform. Not only do pension schemes have long investment horizons, making it possible for them to become significant equity investors, but they are also major investors in longer-term government and corporate bonds, the balance between the two being

[131] Non-bank activities may involve legal, operational and reputational risks. Reputational risk is of particular importance since a major banking institution cannot be seen to fail its customers. If a subsidiary fails, the parent bank may have to subsidise or compensate for it (e.g., Deutsche Bank, when faced with a major scandal in its UK investment management subsidiary, was prepared to pay nearly $700 million).

largely a result of the proportion of contributors to pensioners and of the age profile of participants.

241. Enterprise pension funds have a potential to exhibit the most solid growth pattern in the entire pension sector in China. Of course, in the SOE sector where total employer contribution rates remain exorbitantly high, few companies would afford to establish supplementary pension schemes. However, growing non-SOEs in the private sector would have bigger interests in enterprise pension plans if the government comes up with a less onerous PAYG contribution requirement.[132] In addition, the government needs to provide strong legal and regulatory frameworks for enterprise pension plans along with more attractive tax incentives for contributions by both employers and employees.

242. If funded schemes of any type (i.e. non-PAYG schemes) are to be successful, to win the trust of participants and to fulfill their long term function of providing adequate pensions, their assets should be clearly separated from those of the sponsoring entities and managed professionally. Here international experience may be valuable in understanding the successes and many failures of pension regimes vis-à-vis the legal structures within which pension funds operate and the protection of the interests of participants.

243. Whether second pillar schemes are sponsored by the state and municipalities (including the NSSF), or third pillar schemes are sponsored by enterprises for their employees or result from contributions by individuals, it is particularly important that any new guidelines for both mandatory and voluntary pension funds include the following principles:

(a) The assets of the pension fund must be clearly distinguished from the assets of the sponsor (an enterprise or an insurance company offering individual schemes) and held in trust in such a way that the fund cannot be construed to be part of the assets of a bankrupt entity;

(b) Pension fund discretionary management must be undertaken only by properly regulated and qualified managers;

(c) Rights to parts of the pool attributed to individuals in the case of defined contribution schemes must be clearly distinguished so that an individual may be able to determine at any time the current market value of accumulated contributions, and so as to facilitate transfers in the event of a change of career;

(d) Investment guidelines must be clear and specific in order to ensure diversification among asset classes, and so as to eliminate the possibility that

[132] Under the current system, non-state companies are reluctant to take part in social security system because they think their contributions will be used to subsidize pension liabilities of SOEs, leaving little set aside for their young employees. As a result, non-state companies are either completely out of public pension schemes (outright evading) or are making at best perfunctory contributions by reporting artificially low wages.

pension funds could be used to finance sponsoring enterprises (possibly as far as a ban on investment in the securities issued by the sponsor).

7 CONCLUSION

244. There is a tendency among policymakers, and not just in China, to look at specific parts of the institutional investment sectors in isolation from one another. Thus pensions are regarded as an issue separate from collective investment funds or life insurance. This is often a function of the fragmentation of responsibility at the ministerial or government level.

245. Misunderstanding of desirable policy objectives is also due to viewing the scene through the wrong end of the telescope; governments tend to consider this landscape from a macro-economic perspective, given their concerns about their fiscal deficits, funding pensions and financing industry and commerce, whether in the public or private sectors.

246. Clearly the structure and operation of the Chinese capital markets is distorted at two levels. At one level the legislation lacks clear definition of key concepts and, as a consequence, the roles and responsibilities of different institutions are indistinct. At the other level, consumers are offered an inadequate and ill-defined range of savings choices. The results of this are that the long-term value of the vast pool of savings is not maximized, to the detriment of both the national interest and investors.

247. However desirable the macroeconomic objectives in building institutions may be, this goal cannot be achieved without establishing a rational and precise regulatory framework, designed to ensure good governance and prudent management of the institutions that will serve the public saver and investor. Fair and prompt enforcement, without favoritism, is the next step, since drafting laws and regulations will not, in itself, produce an honest and fair market.

248. A brief summary of the issues that might be addressed to develop sound institutional investment sectors is as follows:

(a) Pensions are, as always, the central issue. China's existing pension system is facing considerable trouble. The second pillar defined contribution schemes are used to cover the deficits in the first pillar PAYG schemes and are not expected to contribute much to market development in the short term. There is a good chance, however, that the voluntary third pillar schemes can begin to make a significant contribution and that the NSSF, which is starting to accumulate substantial reserves, may become a major market participant.

(b) At the same time, insurance companies have a significant part to play in offering secure low risk products. Insurance companies need also to broaden their scope to better offer more innovative products. Insurance companies are the largest repositories of savings outside banks and are

enjoying strong growth in premium income. But they too are suffering from uncertainty about the permitted scope of their investment portfolios and the range of products that they may offer. The role of insurance companies across a broad front needs to be defined with appropriate regulations to support their activities.

(c) Asset management needs to become more professional, and the licensing and professional qualifications of asset managers consolidated across different sectors of institutional investment. The management, administration and distribution of collective investment funds needs improvement, particularly when faced with the challenges of open-end funds and a more competitive market environment. The range of products needs to be broadened; at the same time, the degree of risk investors assume and the returns they can reasonably expect should be clearly disclosed. More efficient administration and order processing should lead to a significant reduction in annual operational costs, which are too high in such a low return environment.

(d) Institutional investors need to have their investment powers more clearly defined. The restrictions placed on the scope and structure of their investment portfolios need to be slowly eased once they have proved that they can behave in a prudent and responsible way. A level playing field for all institutions of a similar nature must be established.

(e) The role of banks needs to be considered carefully. Banks have the largest pool of customers and hold the key to wide product distribution. It seems logical to allow them to offer a much wider range of products to their retail customers, as banks increasingly do in other countries. Whether banks are allowed to engage in non-bank financial activities by means of a holding company structure or through directly owned subsidiaries is not a crucial issue.

249. Very few governments take a holistic and long-term view of the means by which savings are mobilized and channeled, preferring to tinker with tax or other incentives and to allow market forces to determine the structure of long-term investment institutions. The outcome thus is largely determined by the restrictions[133] placed on some and the incentives[134] given to others. In developed countries, there are also powerful sectional interests which lobby for retention or granting of regulatory and fiscal privileges. So market forces are highly distorted by the nature of the playing field, which is constantly being tilted one way or another. This is a less than efficient way of directing the flow of funds that finance not only industry and commerce but also government. China is no exception.

[133] Interest-rate control regimes and a strict merit review system for securities issuance, among others.
[134] For example, tax exemptions for government bonds.

250. China now has a good opportunity to learn from the mistakes of others and to lay a solid foundation for its institutional investors. Accomplishing such can serve well the interests both of the nation and its citizens in a rational and planned way and ensure that market forces drive development towards the most desirable objectives.

APPENDIX 1—CORPORATE BONDS ISSUANCE IN CHINA FOR 2000-2002

Corporate Issuer	Amount (RMB billion)	Maturity (Years)	Interest Rate (%)
Year 2000			
Three Gorges Corporation	3.00	10	D+1.75%
Shanghai Lujiazui Co. Ltd.	0.20	3	3.65%
	0.60	5	4.00%
Shanghai Urban Development Investment Co.	0.50	5	4.00%
Zhejiang Highway Co. Ltd.	0.20	3	3.78%
Jiangsu Highway Group Co. Ltd.	0.20	3	3.78%
	0.15	5	4.32%
Shanghai Baosteel Group Company	2.00	5	4.00%
2000 Sub-total	***4.85***		
Year 2001			
Three Gorges Corporation	2.00	10	D+1.75%
	3.00	15	5.21%
China Mobile (Guangdong) Co. Ltd.	5.00	10	D+1.75%
Inner Mongolia Bao Steel Co. Ltd.	0.40	5	3.78%
China International Trust & Investment Company	3.50	10	4.12%
China Guangdong Nuclear Group	2.50	7	3.98%
Ministry of Railway	1.50	15	5.10%
2001 Sub-total	***17.90***		
Year 2002			
China Jinmou (Group) Co. Ltd.	1.00	10	4.22%
Capital Highway Development Co.	1.50	10	4.32%
China Aviation Technology Import and Export Co.	0.50	3	3.50%
	0.50	7	4.05%
State Power Corporation	0.50	3	3.50%
	3.50	15	4.86%
Shenhua Group Co.	1.00	3	3.51%
China Ocean Shipping (Group) Co.	2.00	15	4.58%
Three Gorges Corporation	5.00	20	4.76%
China International Trust & Investment Company	4.50	15	4.08%
China Mobile (Guangdong) Co. Ltd.	3.00	5	3.50%
	5.00	15	4.50%
Wuhang Steel Group Co.	0.50	3	3.50%
	1.50	5	4.02%
China Guangdong Nuclear Group	4.00	15	4.50%
Jiangsu Transportation Holding Co. Ltd.	1.50	15	4.51%

Chongqing Urban Development Investment Co.	1.50	**10**	**4.32%**
2002 Sub-total	***37.00***		
2000-2002 Total	***59.75***		

Source: SDPC, World Bank

APPENDIX 2—MAJOR OWNERS OF TEN LARGEST SECURITIES COMPANIES OF CHINA

	Company name	Capital (RMB billion)	Major Owners and their shares
1	China Galaxy Securities	4.5	MOF 100%
2	Guo Tai Jun An Securities	3.7	Shanghai State-owned Asset Administration Company 16.38%, Shenzhen Investment Management Company 15.74%, National Electric Company 5.37%, China First Automobile Group 4.02%, Shenzhen Power Group 3.22%
3	Shen Yin & Wan Guo Securities	4.2	China Everbright Group 16.41%, Shanghai Jiushi Company 14.47%, Shanghai International Group 13.28%, Shanghai State-owned Asset Administration Company 5.65%, Shen Neng Group 4.74%
4	Hai Tong Securities	4	Shanghai Shangshi Group 16.49%, Shanghai Electronics Group 14.12%, Shen Neng Group 12.16%, Jiangsu Sunshine Group 6.86%, Shanghai Lansheng Corporation 6.61%
5	China Southern Securities	1.5	Shenzhen Investment Management Company 19.01%, National Development Investment Company 11.3%, Wuhan Chengcheng Cultural Investment Group 5%, Shenzhen Jiabei Investment Development Company 4.84% , Bank of Communications 4.04%
6	China Securities	1	Beijing State-owned Asset Administration Company 40.79%, National Development Investment Company 12.55%, China Travel Service Group 5.28%, China National Petroleum Corporation 5%, China Steel Industry and Trade Group 4%
7	Guang Fa Securities	2	Liaoning Chengda Corporation 20%, Zhongshan Utility Group 15%, Jilin Aodong Medicine Group 13.75%, Guangdong Zhujiang Investment Company 10%, Guangdong Meiyan Group 8.4%
8	CITIC Securities	2	CITIC 38.21%, YaGeer Group 9.7%, CITIC Guoan Group 9.7%, Nanjing Yangzi Petrochemical Company 6.06%, China National Cereals, Oils & Foodstuffs Imp. & Exp. Corporation 4.85%
9	China Communication Securities	2.4	China Merchants Shipping Corporation 12.98%, Qinghuangdao Port Authority 10.16%, China Port Construction Company 9.01%, Guangzhou Shipping Group 8.47%, China Merchants Shekou Industrial Zone Co., Ltd. 8%
10	China Everbright Securities.	2.6	China Everbright Group 51%, China Everbright Limited 49%

Source: CSRC

APPENDIX 3—OWNERS OF FIVE LARGEST FUND MANAGEMENT COMPANIES OF CHINA

	Company name	Registered capital (RMB Million)	Owners and their shares
1	Hua An Fund Management Co., LTD	150	Shanghai ITIC 30%, Shandong Securities 20%, Shen Yin & Wan Guo Securities 20%, Orient Securities 20%, Zhejiang Securities 10%
2	China Asset Management Co., LTD	138	China Securities 30%, Beijing Securities 20%, Southwest Securities 15.55%, Huatai Securities 15.45%, Xingye Securities 15.45%, China Sci-Tech ITIC 3.55%
3	China Southern Fun Management Co., LTD	100	China Southern Securities 30%, Shanxi ITIC 10%, Xiamen ITIC 10%, Hai Tong Securities 10%, Great Wall Securities 10%, Hua Tai Securities 10%, Hua Xi Securities 10%, Xing Ye Securities 10%
4	Bo Shi Fund Management Co., LTD	100	China Great Wall TIC 25%, Everbright Securities 25%, Jinhua TIC 25%, China Merchants Securities 25%
5	Da Cheng Fund Management Co., LTD	100	China Galaxy Securities 25%, Everbright Securities 25%, China Eagle Securities 25%, Guang Dong Securities 25%

Source: China Galaxy Securities Company

APPENDIX 4—PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS IN VARIOUS FINANCIAL CENTERS

Country	Securities	Insurance	Real Es tate	Bank Investment in Industrial Firms	Industrial Firm Investment in Banks
Australia	Permitted	Permitted through subsidiaries	Limited	Permitted with limits	Permitted with regulatory approval (more than 15%)
Brazil	Permitted through subsidiaries	Permitted through subsidiaries	Limited to holding bank premises	Limited to suppliers to the bank	Permitted
China	Not Permitted	Not Permitted	Not Permitted	Not Permitted	Not Permitted
EU	Not Applicable	Not Applicable	Not Applicable	Permitted with limits	No general restrictions
Germany	Permitted	Permitted through subsidiaries	Limited; Unlimited through subsidiaries	Permitted with limits	Permitted, subject to regulatory consent (suitability of the shareholder)
Japan	Some services (selling of government bonds, investment trusts)	Some services (selling insurance policies in connection with housing loans)	Generally limited to holding of bank premises	Limited to holding 5% interest	Permitted
Korea	Permitted through affiliates	Permitted through affiliates	Limited to 60% of bank capital	Prior approval for investments in excess of 15%	Permitted, subject to regulatory consent (suitability of the shareholder)
Poland	Partially permitted	Permitted	Permitted	Permitted up to 25% of bank capital	Permitted
Russia	Permitted	Not permitted	Not permitted	Permitted, but not more than one group	Permitted with regulatory approval (more than 25%)
Singapore	Permitted with MAS approval	Permitted with MAS approval	Limited to 20% of bank's capital	Permitted with regulatory approval	Permitted with regulatory approval (5%, 12%, and 20% or more)
United States	Permitted, but underwriting and dealing in corporate securities must be done through: 1) a nonbank subsidiary of a bank holding company; 2) a nonbank subsidiary of a financial holding company; 3) a financial subsidiary of a national bank	Insurance underwriting and sales are permissible for nonbank subsidiaries of financial holding companies. National banks and their subsidiaries are generally restricted to agency sales activities	Generally limited to holding bank premises	Permitted to hold up to 5% of voting shares through bank holding company	Permitted to make non-controlling investments up to 25% of the voting shares

Source: Institute of International Bankers, *Global Survey 2001*, http://www.iib.org/global/2001/GS2001.pdf

APPENDIX 5—DOMESTIC LIMITS ON INVESTMENT REPRESENTING TECHNICAL PROVISIONS – LIFE INSURANCE COMPANIES

Country	*Bonds* Corporate Bonds	Gov't Bonds	*Shares*	*Mortgage*	*Real Estate*	*Loans*	*Cash*	*Derivatives*	*Unit Trust*
Australia	100	100	100	100	100	100	100	100	100
Belgium	100	100	100	100	100	5	100	5	100
Czech Republic	NA	NA	10	20	25	N	NA	N	10
Denmark	40	100	40	N	N	Y	Y	N	40
Finland	50	100	50	40	40	Y	3	N	N
France	65	100	65	10	40	10	N	N	NA
Germany	50	50	30	50	25	50	N	N	30
Hungary	NA	NA	NA	NA	NA	NA	NA	N	N
Iceland	Y	N	Y	Y	Y	Y	Y	N	N
Italy	100	100	35	10	40	Y	15	N	Y
Japan	10	100	30	N	20	10	N	N	N
Korea	100	100	40	100	15	100	100	5	100
Luxembourg	40	100	25	N	40	10	20	N	25
Mé xico	60	100	30	5	25	5	NA	30	NA
Netherlands	N	N	N	N	10	8	3	N	N
Norway	30	100	35	30	100	1	100	NA	30
Poland	5	100	30	5	25	N	100	N	30
Portugal	60	60	50	25	45	25	20	N	20
Spain	100	100	100	45	45	5	3	NA	Y
Sweden	50	100	25	25	25	N	3	N	N
Switzerland	N	N	30	N	N	N			
United Kingdom	N	N	N	N	N	N	3	N	N
Turkey	2	N	25	N	15	5	3	N	10
United States									
EC	VAR	VAR	VAR	N	N	VAR	3	NA	VAR

Source: OECD (2000).

REFERENCES

Allen, Franklin, and Douglas Gale. 2001. *Comparing Financial Systems.* Cambridge: The MIT Press.

Asian Development Bank. 2001. *Government Bond Market Development in Asia.*

Cadogan Financial. 2000. *Managing Collective Investment Funds*.

Calatan, Mario; Impavido, Gregorio; and Alberto R. Musalem. 2000. "Contractual Savings and Stock Market Development: Which Leads?" Social Protection Discussion Paper Series. World Bank.

China Statistical Yearbook. 2000.

Chao, Howard, and Nestor Gounaris. 2002. "Capital Flows within China and the Creation of Chinese Institutional Investors." *Topics in Chinese Law (May).* O'Melveny & Myers LLP.

China's Ministry of Labor and Social Security. 2000. *Social Insurance in China*.

Conference Board. 2001. *Institutional Investment Report – Financial Assets and Equity Holdings 4 (1,* November).

Davis, E. Phillip. 1997. *Private Pensions in OECD Countries.* Paris: OECD.

Davis, E. Philip, and Benn Steil. 2001. *Institutional Investors*. Cambridge: The MIT Press.

Dorfman, Mark, C. 2002. "Public Pension Reserve Management in China: A Process Just Beginning." World Bank. Processed.

Economic Intelligence Unit. 2002. *Country Finance China.*

Fernando, Deepthi; Klapper, Leora; Sulla, Victor; and Dimitri Vittas. 2003. "The Global Growth of Mutual Funds." World Bank. Processed.

Gao, Chaosheng. 2002. "Understanding the Myth of the Stock Market." www.chinaonline.com (June 20).

Gillan, Stuart L., and Laura T. Starks. 2002. "Institutional Investors, Corporate Ownership, and Corporate Governance: Global Perspective."

Guo, Richard Qiang. 2001. "A Look at China's New Trust Law." www.chinaonline.com (August 17).

Holzmann, Robert. 1997. "Pension Reform, Financial Market Development and Economic Growth: Preliminary Evidence From Chile." IMF Staff Papers.

Impavido, Gregorio; Musalem, Alberto R.; and Thierry Tressel. 2003. "The Impact of Contractual Savings Institutions on Securities Markets." World Bank Policy Research Working Paper 2948.

Institute of International Bankers. 2001. *Global Survey 2001*.

Leckie, Stuart H. 2000. "Pension Funds in China."

Leckie, Stuart, and Tony Zhang. 2001. *Investment Funds in China*.

Li, Yang, and Peng Xianyun. 2002. "The Money Market in China: Theory and Practice." *China and World Economy Number 3.*

Ma, Jun, and Fan Zhai. 2001. "Financing China's Pension Reform." Paper presented at the Conference on Financial Sector Reform in China, September 11-13.

McKinsey & Company, Inc.. 2002. "Filling China's Pension Gap." *The McKinsey Quarterly Number 2.*

Naughton, Barry. 2002. "Selling Down the State Share: Contested Policy, New Rules." *China Leadership Monitor No. 1, Part 2.*

OECD. 2000. "Investment Regulation of Insurance Companies and Pension Funds: Issues for Discussion."

--------. 2002a. *Institutional Investors Statistical Yearbook 2001*.

--------. 2002b. "Priorities For Development of China's Capital Markets." *China in the World Economy: The Domestic Policy Challenges.*

Sun, Jianyong. 2001. "Supervision and Regulation of China's Occupation Pension." Room Document No. 19, Private Pensions Conference, April 23-26, 2001. OECD.

Tenev, Stoyan, and Zhang Chunlin. 2002. *Corporate Governance and Enterprise Reform in China*. Washington, D.C.: World Bank and International Finance Corporation.

Vittas, Dimitri. 1998a. "Institutional Investors and Securities Markets: Which Comes First?" World Bank. Processed.

----------. 1998b. "Regulatory Controversies of Private Pension Funds." World Bank. Processed.

World Bank. 2002a. "Background Note: Financial Services Integration in China."

----------. 2002b. *World Development Indicators.*

World Federation of Exchanges. 2002. *Statistics.* http://www.world-exchanges.org/index.asp?resolutionX=1024&resolutionY=768.

Wu, Jianglian. 2002. "An Alternative Proposal to Reduce State-owned Shares." www.chinaonline.com (January 21, 2002).

Xia, Bin. 2001. "Report on China's Privately Placed Funds."