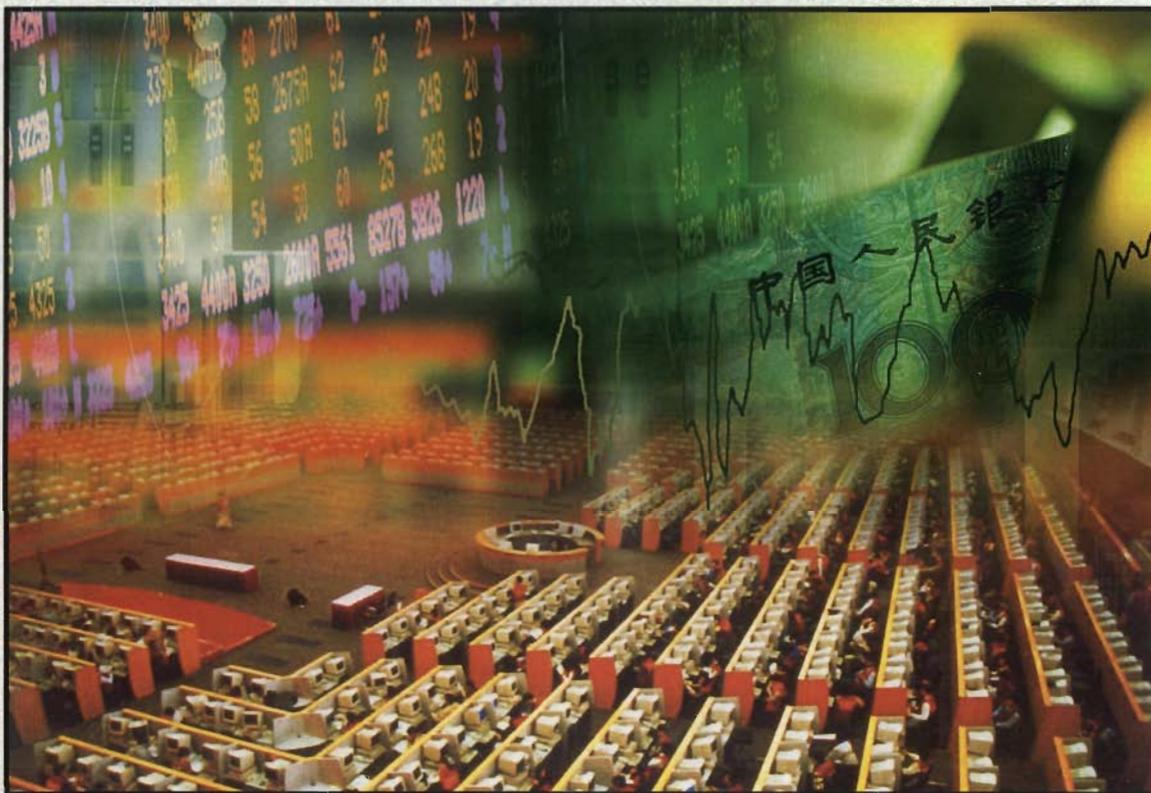


EMERGING INSTITUTIONAL INVESTORS IN CHINA

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ABBREVIATIONS

AIG	American International Group, Inc.
ABS	Asset-Backed Securities
AMCs	Asset Management Companies
BOC	Bank of China
BOCI	Bank of China International
CCB	China Construction Bank
CD	Certificate of Deposit
CIFs	Collective Investment Funds
CIRC	China Insurance Regulatory Commission
CITIC	China International Trust and Investment Corporation
CP	Commercial Paper
CSRC	China Securities Regulatory Commission
EU	European Union
FEFSI	Federation Europeene des Fonds et Societes d'Investissement (European Federation of Investment Funds and Companies)
GDP	Gross Domestic Product
IPOs	Initial Public Offerings
JV	Joint Venture
Ltd.	Limited
M&As	Mergers and Acquisitions
MMF	Money Market Fund
MOF	Ministry of Finance
MOLSS	Ministry of Labor and Social Security
NASD	National Association of Securities Dealers
NBFI	Non-Bank Financial Institution
NPC	National People's Congress
NSSF	National Social Security Fund
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-as-You-Go
PBOC	People's Bank of China
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
SOE	State -Owned Enterprises
TICs	Trust and Investment Companies
US	United States
UK	United Kingdom
WTO	World Trade Organization

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EXECUTIVE SUMMARY

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

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 11 percent of GDP.

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.

The pension system entails a pay-as-you-go (PAYG) first tier, individual defined contribution accounts as a second tier, and a voluntary contribution. In some regions, individual accounts are used to cover shortfalls in the PAYG first tier. Overall, the prospects for significant accumulations in the individual accounts are limited; the odds are better that the voluntary 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.

Closed-end and open-ended investment funds, both offered by fund management companies, are still in their infancy. Closed-end funds used to dominate, since they have been around longer, but open-ended funds, despite their short history, hold high growth potential. Domestic fund management companies have reportedly been prone to irregularities, including collusion and share-price manipulation.

¹ This report—written by Yongbeom Kim (Senior Financial Economist, East Asia and Pacific Region, the World Bank) and Mark St Giles (international consultant, *Cadogan Financial*)—is an abbreviated and updated version of an earlier report titled, “Developing Institutional Investors in the People’s Republic of China.” The main thrust of the earlier report was presented at an international seminar on “Promoting Institutional Investors in China,” held on April 1, 2003, in Beijing. Irene S. M. Ho contributed substantively to the earlier report, while research assistance for this version was provided by Yiping Zhang. The earlier version benefited from valuable comments from David Scott, Dimitri Vittas, Jun Wang, and Xiaoqing Yu. Meanwhile, the findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

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.

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 principals, although some banks have been able to circumvent these restrictions through affiliated firms.

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.

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.

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 of upgrading 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.

Efforts to strengthen the governance and institutional capacity of investment management institutions are not likely to be sufficiently successful as 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, the factors 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.

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.

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 of increasing 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.

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.

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.

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 of 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 among 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 savings² 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 percent of their savings into banks, with only 4 percent invested in the insurance-and-pension sector. In contrast, in the US, the insurance-and-pension sector holds the biggest share with 30 percent, while currency and deposits account for only 15 percent. 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 percent 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 US. Thus the medium-term objective for China would be to increase its non-bank sector, especially its institutional investors sector, to a level on par with Japan's.

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.

² Household deposits stood at RMB 8.04 trillion, or US\$ 971 billion (1 US\$ = 8.28 Yuan), which is 83.8 percent of GDP at end-May 2002, while the total balance of all deposits amounted to RMB 15.33 trillion (160 percent of GDP).

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); 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 4); discusses principles for successful development of institutional investors in China (section 5); and summarizes the conclusions and recommendations (section 6).

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.³ Institutional investors play an instrumental role in capital market development in the 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

³ Major agendas include increasing the supply of quality shares; improving securities regulation; better protecting investors' rights; enhancing market integrity; and reforming corporate governance.

and equity. One of the most distinctive recent changes in financial markets is the 'institutionalization of saving'⁴--a shift away from individuals' holding equity directly toward intermediaries holding it.⁵ 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 the most rapid growth in many countries.⁶ For example, the recent comparative figures from the Organization for Economic Cooperation and Development (OECD)⁷ show that collective investment funds in OECD countries had an average annual growth rate of 20 percent in the years 1991-1998, compared to 13 percent for pension funds and 11 percent 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-

⁴ David and Steil (2001) provide a comprehensive economic assessment of this important shift.

⁵ Individual ownership of equity has fallen in the United States from 79 percent in 1966 to around 50 percent in 1993, while corresponding numbers in Japan were 53 percent in 1953 and about 20 percent in 1993 (Allen and Gale, 2001, p. 58-67).

⁶ Fernando et al. (2003) provides an excellent survey of the global growth of collective investment funds.

⁷ OECD (2002).

participant entry, and pursuing better clearing and settlement. In the US, 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 the 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 scheme⁸, 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

⁸ 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 US 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 energizing the capital market. See Holzmann (1997).

structure can either stimulate or impede development of institutional investors, especially collective investment funds (CIFs). As argued by Vittas (1998), 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 1998). These observations support the conclusion that simply increasing the size of institutionalized assets does not automatically lead to development of capital markets.

3 TODAY’S INSTITUTIONAL LANDSCAPE

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.

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 percent⁹ of total bank assets and 66 percent¹⁰ of total local currency loans.

⁹ Economist Intelligence Unit (2002).

¹⁰ As of December 31, 2002: PBC website, bank annual reports.

22. Second-tier nationwide commercial banks¹¹ 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.¹² 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 institutions¹³. Prior to this ban, which is contained in the Commercial Banking Law of 1995, the four largest state-owned banks had involved themselves in

¹¹ 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).

¹² 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.

¹³ 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 prohibited. 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.

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.

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 of 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 bonds¹⁴. The risk-free characteristics of these securities, coupled with stringent restrictions on foreign investments, has caused this portfolio to swell over time. 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 PBOC and CSRC in November 2002, China Everbright Bank and China Merchants Bank also entered the market.

Pension Funds

29. In developed countries that have funded pension schemes,¹⁵ 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, US pension assets posted 47.5 percent of all institutional assets.¹⁶ In the UK, in the same period, pension assets accounted for nearly 50 percent of all institutional assets.¹⁷ 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 percent 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 them—very costly to fulfill.

31. After years of experimenting with municipal pooling and individual accounts, China's government introduced a nationwide basic pension system in July 1997.¹⁸ Under the new system, which

¹⁴ Offered by China Development Bank and the Export-Import Bank of China.

¹⁵ 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.

¹⁶ The Conference Board (2000).

¹⁷ UK Office of National Statistics.

¹⁸ The State Council's Document No. 26: "Decision on Developing Unified Basic Old Age Pension

combines social pooling with individual accounts, local governments, not SOEs, assume responsibility for pension administration. This two-tiered single-pillar system was intended to settle into the following pattern:

(a) **Basic pension benefit (social pool):**

A pay-as-you-go (PAYG) defined benefit system, operated at the provincial level, which will provide 20 percent of the workers' average wages in respective localities from the previous year as a subsistence-level defined benefit.¹⁹

(b) **Individual account benefit:** A mandatory defined contribution scheme with contributions directed toward 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.

32. Contribution rates vary by provinces and municipalities. In general, the enterprise contribution rate to the social pool is 20 percent of total wages. However, enterprises must contribute additional social security costs of some 14 percent 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 percent of wages, with individual employee contributions starting at 4 percent of wages and gradually rising by one

System for Enterprise Employees," promulgated in 1997.

¹⁹ 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.

²⁰ These include: unemployment (2 percent), medical (6 percent), and housing (6 percent) at minimum.

percentage point every two years up to an 8 percent ceiling. The enterprise's contribution rate will gradually decrease from 7 percent to 3 percent of wages.

33. 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 58.5 percent for the average employee. Those who retired before the reforms were implemented will continue to receive pensions at approximately 79 percent of replacement rate (see Table 1).

Table 1. Combination of Social Pooling with Individual Account

Composition	Contributor	Contribution Rate	Target Replacement Rate (based on local average wages)
Basic Pension Benefit	employer/enterprise	20% of total payroll	20%
Individual Account Benefit	employer & employee	11% of the wages, (6% by employer, 5% by employee)	38.5%
Transitory Pension	employer (rates vary across regions)		approximately 20%

Source: Sun (2004)

34. In terms of account administration, the current pension system remains highly fragmented, managed by some 5,000 local social insurance agencies. The local social insurance agencies administer and manage both social pooling and individual accounts schemes in-house, including collection²¹, record keeping and reserve management. For disbursement, four state commercial

²¹ 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.

banks and the Postal Savings Bureau are entrusted.

35. According to the State Council's Document 26 of 1997, individual accounts were to be funded at 11 percent, with employee contributions to start at 4 percent of wages (in 1997) and rise by one percentage point every two years up to the 8 percent target. The remaining balance is to be funded by enterprise contributions.²² In theory, individual accounts could have opened a new chapter of funded pension schemes in China. In practice, however, individual account accumulations have been widely used to pay retirees and to support the unfunded liabilities of the PAYG pensions, preventing any real accumulation of funds in most provinces. Some municipalities accumulate reserves but in most jurisdictions, individual accounts are "empty" with no separate funding. In this sense, the overall public pension system, consisting of social pooling and individual accounts, is currently running on a *de facto* PAYG basis.

36. Document No. 26 also envisaged pooling the redistributive basic pension benefit contributions at the provincial level first, and then at the national level. By the end of 2001, all provinces have reportedly either put in place pooling mechanisms²³ or established adjustment funds to level out surpluses and deficits across cities/counties.²⁴ The outcome of actual

²² When the system first started in 1997, individuals contributed 4 percent of the average wage, with enterprises picking up 7 percent to make it 11 percent. Currently average individual contribution rate stands around 6 percent, lowering enterprise contributions to individual accounts to about 5 percent.

²³ Notably a portion (5 percent to 10 percent) of such funds at the city/county level is elevated to the provincial social insurance agencies to level out surpluses and deficits across cities/counties.

²⁴ MOLSS Development Statistical Report (2001).

implementation remains a source of skepticism, however. Evidently because of low compliance and transitional costs, many local pension pools are still running deficits even after contributions to individual accounts are diverted to supplement the deficits in the PAYG first tier,²⁵ requiring subsidies from the governments—provincial and central alike.

37. 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 48 billion (0.4 percent of GDP)²⁶ in 2003 to finance the pension gap at the national level (Table 2).²⁷

Table 2. Government Subsidy to the Basic Pension System (RMB billion)

1998	1999	2000	2001	2002	2003
10	20	30	40	48	48

Source: Sun (2004)

38. In 2001, State Council Document No. 42 introduced a pilot program in Liaoning, one of the most financially burdened provinces in northeast China. One salient feature of the program involves the separation of the individual accounts from the rest of the system and their mandatory full funding with 8 percent individual contributions. Similarly, the management of individual accounts is required to be separated from the administration of the PAYG system. The resulting deficits in the

²⁵ In 2001, 28 out of 31 provinces registered deficit.

²⁶ MOLSS Development Statistical Report (2002).

²⁷ 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.

PAYG system will be covered by improved compliance efforts, within-province fund reallocation, and most importantly, fund transfers from the national budget.

39. The *Liaoning pilot*²⁸ represents a general policy direction toward eventually building a new multi-pillar pension system under which government's excess burden in the generous PAYG first pillar is alleviated, while the funded second pillar (individual accounts) and the voluntary third pillar (particularly corporate pensions) play a bigger role. The new system envisages that the central government will provide minimum benefits to all covered urban enterprise members nationwide, while local governments will provide their own supplementary public schemes that are subject to the same contribution ratio nationwide, but linked to local income levels. Given the great disparity in income levels across the country, the ultimate pension package will also vary greatly under the new scheme. Specifically, the combined level of benefits offered by both the central and local governments would not exceed 40 percent of average wage at retirement (see Table 3).

Table 3. Multi-Pillar Pension System in the Making

Composition	Contributor	Contribution Rates	Target Replacement Rate
Basic Pension Benefit	employer/enterprise	30% of total payroll/tax exempt	30%
Local Pension Fund	local government	to be determined by local government in the future	0-10%
Individual Account	employee	8% of wages/tax exempt	0-20%
Corporate Pension Fund	employer & employee	minimum 8% of total wages/4% tax deferral, other 4% tax deferral in the future	0-25%

Source: Sun (2004).

40. The prospects for the second and third pillar pension funds, however, will largely depend on the means by which the state covers the pension shortfall. Aside from the historical pension deficit of up to RMB 3 trillion in the PAYG pillar, "empty" individual accounts make up RMB 600 billion, with annual increments of RMB 100 billion.²⁹ 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 new multi-pillar system, 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.

41. In an effort to address the medium to long-term issue of unfunded pension

²⁸ It is scheduled to be expanded to the neighbouring Jilin and Heilongjiang provinces.

²⁹ Sun (2004). The historical pension deficit could decrease substantially should the government reduce the target replacement rates of the PAYG system as envisaged.

liabilities, the Chinese government established the National Social Security Fund (NSSF)³⁰ in September 2000. 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.

42. 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. 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 percent 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.

43. Another important objective of the NSSF is to participate in the development of the institutional investment sector in China. Since its inception, the NSSF has grown to a value of RMB 132 billion (1.17 percent of GDP) as of December 2003. Although the regulations³¹ would permit up to 40 percent of NSSF's assets to be invested in equities, the NSSF Council in the past opted out of

³⁰ 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.

³¹ "Provisional Regulations on the Management of Investment by Social Security Fund" issued by the Ministry of Finance and the Ministry of Labor and Social Security.

portfolio equity investment, owing to the volatility of the equity market and to the low share quality of some of its listed companies. In January 2003, the Council awarded 11 equities and fixed-income portfolio management mandates to six qualified³² 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. As a result, the NSSF has managed to build a balanced portfolio of bonds (47.7 percent), bank deposits (41 percent), and equities (11 percent) as of July 2004.³³

44. In June 2003, the State Council decided to transfer some SOE equities directly into the NSSF for funding purposes. China's government holds two-thirds of listed SOE shares and hundreds of those non-listed.³⁴ The first to be expectedly

³² 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 of 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.

³³ In December 2002, the corresponding numbers were: bank deposits (76 percent), government bonds (22 percent), and equities (2 percent).

³⁴ In terms of share ownership of state-owned enterprises (SOE), three different types of shares are issued in China: individual, legal person, and state. Legal person shares are held by domestic institutions (joint stock companies, NBFIs, and SOEs with at least one non-state owner). The ultimate owner of the state shares is the State Council. Unlike the norm in equity markets elsewhere, state shares and legal person shares, which account for roughly 65 percent of the total number of shares issued, remain non-tradable, in principle, even after a company is listed. State shares can only be transferred to other institutions via private negotiations, and legal person shares used to be only transferable via private placements.

transferred are those drawn from the 187 central government enterprise groups which include the nation's best known utilities and infrastructure firms (e.g., steel, petrochemical, telecommunication, and power). Beyond that, it is still unclear which type of assets would be covered by the framework (e.g., listed vs. unlisted, central government vs. local government enterprises, etc.).

45. On balance, the NSSF holds great potential to amass huge reserves,³⁵ 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.

46. Further, the unique funding source of the NSSF would somewhat limit its net impact on the stock market. Unlike typical funded pension schemes elsewhere that collect contributions from participants, China's NSSF would be funded mainly through state share sales proceeds, i.e., the potential supply of a portion of such shares to the local equity markets.³⁶ 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 would be partially offset, or in some extreme cases be outweighed, by supply pressure in the equity market.

47. Clearly, the second and third pillar schemes are potentially substantial sources

³⁵ Sun (2004) estimates the NSSF to grow up to RMB 1 trillion in five years.

³⁶ 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.

for regular investment flows into the capital market in China. Some municipalities are running considerable surpluses.³⁷ Total reserve accumulation of individual accounts is estimated at 0.8 percent of GDP.³⁸ 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. Selected regions along China's prosperous east coast, e.g., Guangdong province and Shanghai municipality, will witness robust growth of individual accounts.³⁹ 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.

48. Voluntary supplementary schemes of various sorts that offer personal pensions or small group pensions for companies are still new in China. Legal and regulatory frameworks for enterprise pensions were, at most, scant until recently. As of end-2003, China had some 20,000 enterprise pension funds with 6.6 million participants, the combined total reaching RMB 30 billion (0.25 percent of GDP). The funds from

³⁷ Guangdong (RMB 10 billion), Liaoning (RMB 10 billion), Jilin and Heilongjiang (RMB 6 to 8 billion each): MOLSS estimation.

³⁸ Mark Dorfman (2002). The ratio would be equal to RMB 93 billion in terms of 2003 GDP.

³⁹ Sun (2004) estimated that the annual increase of the second pillar could amount to around RMB 100 billion, provided that the funds would be no longer diverted to the PAYG pillar, a tall order at the moment.

voluntary schemes are usually invested in bank deposits and government bonds. Voluntary contributions to the plans, up to 4 percent of wages, are tax deductible under the *Liaoning pilot*. Employers are encouraged to match employee contributions. Employers can establish supplementary schemes utilizing in-house expertise. Financial institutions, including life insurance companies, can initiate and manage these schemes. Sponsors of the voluntary funds include large SOEs and foreign joint ventures.

49. The new direction toward reduced government involvement in public pension programs—a likely path considering the limited fiscal ability of the central government—will allow private pensions to play bigger roles.⁴⁰ Along this line, the Ministry of Labor and Social Security, in collaboration with financial regulators, promulgated key regulations⁴¹ on corporate pensions in early 2004 which became effective on May 1, 2004. According to the regulations, corporate pension funds are based on a defined contribution scheme and an individual account. Pension assets are separated from trustees' other assets and kept with a custodian, which is a commercial bank. A licensed institution, usually being either a specialized pension management company or a fund management company, can provide multiple

⁴⁰ This new approach is subject to divergent views within the government: The MOF has held the view that prematurely promoting the third pillar corporate pension funds could be detrimental to the basic pension system, given the poor compliance with Pillars I and II by private sector companies. Also, MOF argued that expanding the *Liaoning Pilot* to other provinces is a higher priority than promoting the corporate pension funds. Along this line, MOF has expressed skepticism about granting tax incentives for corporate pension contributions.

⁴¹ "Provisional Measures on Corporate Pension" and "Provisional Measures on Management of Corporate Pension Fund."

services as a trustee, an investment manager, and a fund administrator, but a custodian business must be separated from other pension-related businesses. Investment restrictions include: bank deposits and money market instruments (minimum 20 percent), fixed income securities (minimum 20 percent, maximum 50 percent), and equity-related products (30 percent).

50. The significant improvement in legal and regulatory frameworks notwithstanding, the development of this sector will remain modest, as the impediments include: 1) a heavy financial burden for enterprises on existing and additional social security contributions, which include unemployment, medical and housing; 2) under-development of the capital markets; and 3) employees' perception that social security is the responsibility of the government, rather than of the employer.⁴² As evidenced in other countries, tax incentives are instrumental to promote the corporate pension fund sector. The current contribution rate of 4 percent to corporate pensions appears to be too low vis-à-vis international experience. The rate should be increased to around 10 percent, while allowing a 50 percent tax deductibility up to that level as a compromise. It is also important to ensure that pension contributions are deductible from social security charges (payroll taxes). Given that the personal income tax is low in China but payroll taxes are high, the latter provision of tax deductibility is of greater importance.

Insurance Companies

51. The role of insurance companies in the development of capital markets in China could be potentially significant. In the US, for example, insurance companies account for nearly 30 percent of the institutional market, while in continental Europe, they

⁴² MOLSS estimates the annual increase to be as big as RMB 50 to 80 billion: Sun (2004).

play an even greater role with nearly 40 percent.

52. As of end-2003, 50 insurance companies (27 life and 23 non-life) are licensed. Of those licensed, 37 are foreign-invested insurance companies operating through joint venture or branch operations. Combined assets of insurers stand at RMB 912 billion (7.8 percent of GDP), making the insurance sector by far the largest institutional investor in China.

53. In 2003, total premium income aggregated RMB 388 billion (life: RMB 301 billion, non-life: RMB 87 billion), up 27 percent over 2002. Insurance premiums have been growing at an average compound rate of 43.5 percent per annum between 1985 and 2000.⁴³ 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 1.5 million 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 percent⁴⁴ of GDP, compared with 11.3 percent in South Korea, 8.6 percent US, 6.9 percent Taiwan and 4.7 percent Hong Kong.⁴⁵ Insurance is predominantly sold as a savings product rather than some protection-form 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 better 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 life 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 percent in 1997 to 1.98 percent 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 regulations⁴⁶ 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:

⁴³ China Statistical Yearbook, 2000.

⁴⁴ It increased to 3.3 percent as of 2003.

⁴⁵ *Swiss Re Economic and Research Consulting.*

⁴⁶ “Regulations for the Administration of Insurance Companies” enacted by the CIRC on January 13, 2000 and subsequent amendments on October 2002.

- (a) In 1999 the CIRC permitted insurance companies to invest 5 percent of their assets, and later up to 10 percent, in investment funds, investing largely in equities. This investment limit was raised in January 2001 to 15 percent for a select group of 6 insurance companies and 12 percent 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 fund management companies licensed by the China Securities Regulatory Commission (CSRC).
- (c) 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.
- (d) 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.
- (e) 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 (53.4 percent), government bonds (18.5 percent) and financial policy bonds (9.6 percent), while investment funds and other investment make up the remainder with 7.1 percent and 11.4

percent, respectively⁴⁷. 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.

59. Further, in China, unlike in other countries, the life insurance business is dominated by one company, China Life, which held a 56.6 percent market share in 2003, followed by Ping An with 23.5 percent. Foreign entrants, focusing mainly on prosperous coastal enclaves, still represent a small proportion of the market with less than 2 percent of total premium income.

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,⁴⁸ 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

⁴⁷ As of end-June, 2004 per CIRC.

⁴⁸ 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, to aggressive growth.

sector, surpassing for the first time the non-life insurance sector in premium income.

62. As early as June 2001, leading life insurance companies started to establish a semi-independent in-house asset management department which was structured as functionally and physically separated from the rest of the business. This was originally conceived as a preparatory move for granting permission to insurance companies to invest directly in equities.

63. In 2003, the debut of the PICC Insurance Asset Management Co., Ltd. heralded a new era of specialized asset management by life insurance companies, which has been expedited by the latest regulatory change regarding corporate pension funds (refer to the previous section). This change allowed insurance companies to manage corporate pension assets only by establishing a separate asset management subsidiary that would specialize in managing not only the parent company's own capital and insurance reserves, but also pension assets. Shortly after the regulations became effective in May 2004, the nation's largest insurance company launched the China Life Insurance Asset Management Co., Ltd.,⁴⁹ while Taiping Life—the only insurer participating in the Liaoning pilot pension program—obtained regulatory approval to establish a specialized pension management company.⁵⁰ Other insurance companies are likely to follow suit in the near future.

⁴⁹ Shareholders of this firm include the newly-listed China Life Insurance Co., Ltd. (60 percent) and its parent China Life Insurance Group (40 percent).

⁵⁰ A specialized pension management company is allowed to become a trustee, a fund manager, and an account administrator for a corporate pension fund, but not a custodian.

64. Substantial revisions in the Law covering insurance⁵¹ 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.⁵² 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.

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

⁵¹ Insurance Law of the People's Republic of China, 1995.

⁵² 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.

66. 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 a 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.

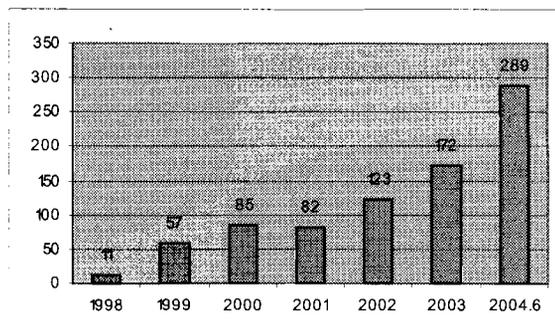
Collective Investment Funds

67. The PRC collective investment fund industry was established in 1997 with the promulgation of the "Provisional Measures on the Supervision of Securities Investment Funds." By the end of 2003, 54 closed-end and 56 open-ended investment funds were established by 49 fund management companies, with aggregate funds under management of RMB 171 billion (1.4 percent of GDP).

68. Since its inception, the industry has seen a steady growth in size and diversity (Figure 1). The growth has been especially prominent since open-ended investment funds were introduced in September 2001. Closed-end funds had dominated the market with a 86 percent share by the end of 2001, but the nascent open-ended fund sector soon became the most popular form, as they are everywhere else:⁵³ By the end of June 2004,

the market size of open-ended funds accounted for 72 percent of the total, eclipsing dormant closed-end funds. Types of fund include equity, bond, mixed, and money market. Also available are index and principal-guaranteed funds, while exchange-traded funds are in the pipeline.

Figure 1. Net Asset Value of Securities Investment Funds (RMB billion)



Source: Mutual Funds Research & Evaluation Center.

69. At present, collective investment funds are distributed through both direct sales (by fund management companies) and third party channel sales via the extensive branch network of commercial banks and securities companies. The breakdown of distribution among the various sales channels is about 70 percent by commercial banks, 10-15 percent by securities companies and 5-10 percent by fund management companies.

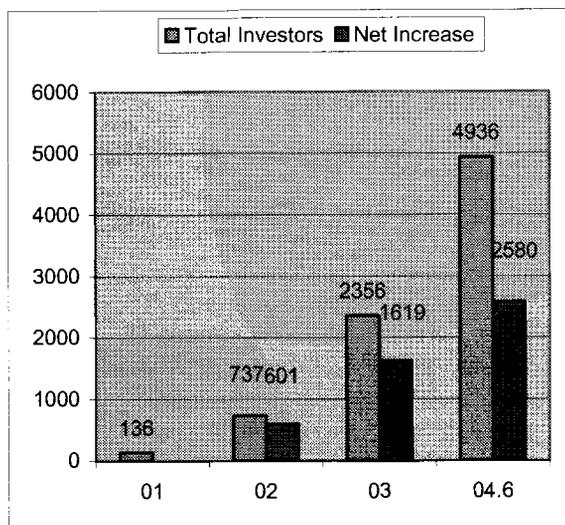
70. Investors are mainly retail customers from concentrated metropolitan cities: Shanghai, Shenzhen, and Beijing. Figure 2 shows the rapid penetration of open-ended funds to retail investors.⁵⁴ Participation by institutional clients, e.g. insurance companies, is on the rise as well.

⁵³ In the US, closed-end funds account for less than 2 percent of the total value of investment funds, while in the UK they account for some 25 percent (the reason 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.

⁵⁴ Numbers are based on initial subscription.

**Figure 2. Number of Fund Investors
(Thousand)**



Source: *Mutual Funds Research & Evaluation Center.*

71. Since the promulgation of the “Provisional Measures on the Supervision of Securities Investment Funds” in 1997, there have been major developments in the regulatory landscape. Most notably, the “Securities Investment Fund Law”⁵⁵ was enacted to further enhance the legal basis of the investment fund industry in 2003, and went into effect in June 2004. Thereafter various rules and regulations for implementing the Law have been promulgated to facilitate the transparency and market-based operations of the industry.

⁵⁵ The scope of the draft law has 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.

(a) Regulations on Management of Information Disclosure of Securities Investment Funds (June 2004);

(b) Regulations on Sales of Securities Investment Funds (June 2004);

(c) Regulations on Operation of Securities Investment Funds (July 2004).

72. The new regulations on the marketing and sale of securities investment funds are of particular significance, as fund management companies and their sales agents tend to be short on ensuring the truthfulness of the content of promotional documents distributed to the investing public, while being long on making ungrounded commitments as to guaranteed returns or the safety of the fund investments, especially at this early stage in the development of collective investment funds. The CSRC regulations prohibit fund managers and their sales agents from engaging in malicious competition by lowering fees to abnormal standards, or offering commissions or gifts.

73. Originally, only securities companies and trust and investment companies were allowed to establish fund management companies.⁵⁶ The current view of the CSRC is that any institution that has good credit standing and that is operating legally is a qualified shareholder.⁵⁷ Nonetheless, banks and insurance companies are banned from investing in fund management companies by the Banking Law and the Insurance Law, respectively. Each securities company and trust and investment company cannot invest in more than two fund management companies in China, and can be in a

⁵⁶ “Provisional Administrative Regulations on Securities Investment Funds.”

⁵⁷ “Notice on Several Issues Regarding Establishment of Fund Management Companies” (CSRC, 2001).

controlling position in only one of them (so-called the “1+1” rule).

74. With open-ended investment funds introduced, more local securities companies have been scrambling to establish fund management companies. Meanwhile, a highly positive development has been the publication of the long-awaited regulations on joint ventures between domestic and foreign asset managers in 2002, which permit the foreign partner initially to take up a maximum stake of 33 percent in the joint venture; the ceiling will then rise to 49 percent after three years, i.e., 2004. Some concerns have been expressed about the large amount of initial capital (RMB 300 million) that the foreign partner will need to provide, 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. All in all, new entrants surged during 2002-2003, registering 7 and 28, respectively, which increased the number of fund management companies from 14 in 2001 to 49 by the end of 2003, of which 9 are joint venture firms.

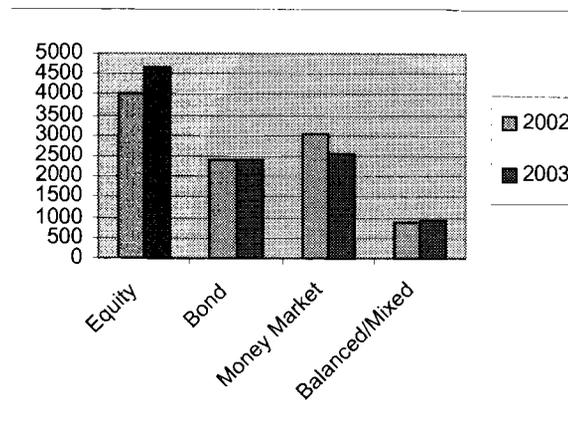
75. Both open- and closed-end funds invest largely in equities, apart from the mandatory 20 percent in government bonds, which was rescinded in July 2004 by the “Regulations on Operation of Securities Investment Funds.” The fact that no fixed-income fund existed until recently⁵⁸ may be indicative of the management companies’ views of demand—or lack of such demand—in the market for bond funds. The prolonged bearish performance of the equity market has caused an increase in asset allocation to bonds exceeding the 20 percent floor requirement; in fact, the ratio exceeded 50 percent for select portfolios. As of June

⁵⁸ Huaxia Fixed Income Investment Fund, first of its kind, was only launched in October 2002. =

2004, the type of fund distribution looked as follows: equity (51 percent), mixed (30 percent), fixed-income (14 percent), money-market (5 percent). The global picture is represented in Figure 3.

Figure 3. Worldwide Assets of Mutual Funds

(Billions euros, end of year)



Source: FEFSI.

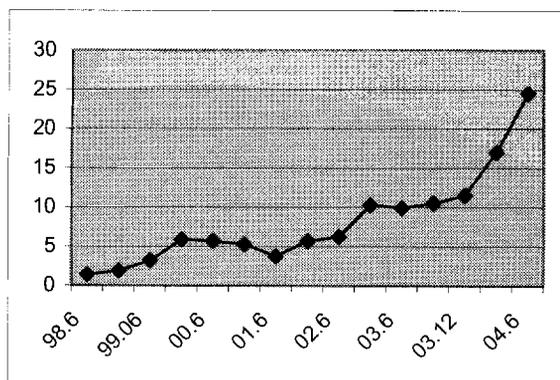
76. It is unusual that during a period of falling interest rates, and consequently rising bond prices and falling equity prices, there has not been a greater supply of fixed-income funds in China. In other countries whose equity markets have suffered during the global bear market since early 2000, fund 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.

77. 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).

78. The rapid growth of a fund industry whose main form of investment vehicle remains equity has helped domestic stock markets to reorganize in recent years around a host of large blue chips. Institutional investors are increasingly purchasing free floats of select blue chips whose availability is limited, because much of the existing shares remain non-tradable. Other institutional investors, such as the qualified foreign institutional investors, contributed to nurturing the value investment culture, but the most notable players have been securities investment funds whose total assets⁵⁹ represented 25 percent of the stock market's free floats as of end-June 2004, which was more than two times the number (11 percent) recorded in end-2002 (see Figure 4). Meanwhile, the average number of stocks held by investment funds decreased from 89 in 2002 to 48 in 2003, another sign of concentration into blue chips.

Figure 4. Fund Assets Ratio to Market Capitalization of Floating Shares



Source: Mutual Funds Research & Evaluation Center.

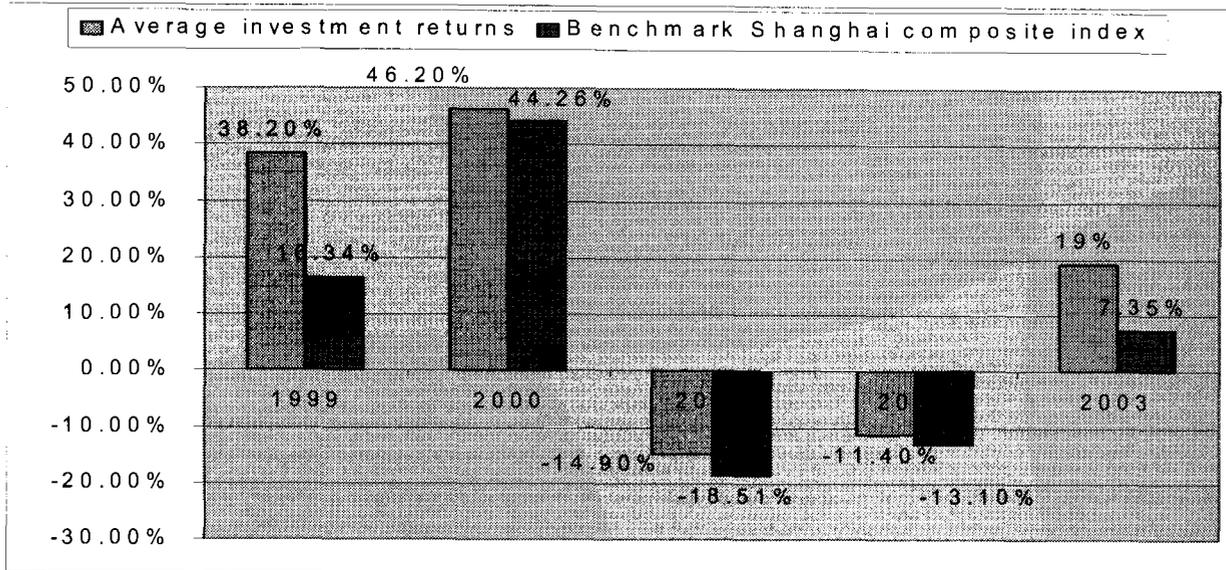
⁵⁹ Similar to common international regulations, CSRC regulations prohibit a securities investment fund from owning more than 10 percent of shares of a single company, or a fund management company from placing more than 10 percent of total assets of all the funds it manages into a single company.

79. 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 has been one of the most important aspects 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

80. As shown in Figure 5, the closed-end only investment funds outperformed the composite market index during 1999-2000, largely thanks to the government's policy of preferentially allocating IPO shares to the funds, which were substantially reduced in 2001.⁶⁰ The prolonged market doldrums since July 2001 sent average returns of the funds into negative territory for 2001-2002, yet still better than the market benchmark. With the emergence of mixed funds, average returns of the funds not only bounced back into positive territory, but they also registered a sizable spread over the composite market index in 2003. In fact, historical performances of China's investment funds have not fared badly vis-à-vis international experience, e.g., average performance of all US large cap growth mutual funds against the Dow Jones Industrial Average (Figure 6). One important caveat exists, however: the Dow Jones Index captures the main board's blue chips, while the Benchmark Shanghai Composite Index is much more broadly based.

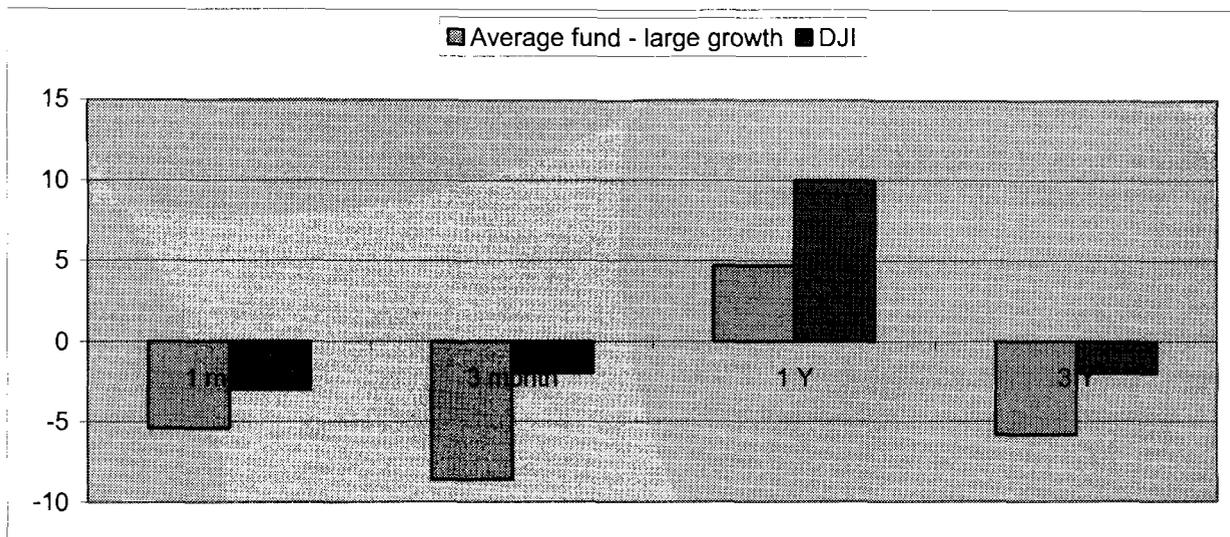
⁶⁰ Now funds' subscriptions to any particular IPO should be less than 5 percent.

Figure 5. Historical Performance of China's Investment Funds



Source: Mutual Funds Research & Evaluation Center.

Figure 6. Average Performance of all US Large Cap Growth Mutual Funds



Source: Morningstar and Tradetrek.

81. 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 “reputation regulation,” is a valuable addition to the supervision of the securities regulator and

82. means that the pressure to produce good results is driven by both commercial and legal considerations.

83. 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, accompanied by detailed regulations and effective enforcement, could be a milestone for boosting the healthy development of the sector, while curbing irregularities in the business.

84. 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.

85. Investment funds in China have grown rapidly reaching more than \$36 billion in value as at June 2004. In absolute terms this is slightly less in total value than mutual funds in Greece.⁶¹ If measured as a percentage of household savings deposits, in China (\$1,375 billion) they represent only .02 percent as compared with the US, where holdings of money market mutual funds alone accounted for 25 percent of total household time and savings deposits⁶² and where total value of mutual fund shares held by households (including money market funds) exceeded that held in household deposits.

86. So investment funds in China are still in their infancy and have a long way to

go to reach full maturity. To some extent their development has been held back by the rather disappointing performance of China's stock markets, with which retail investors are feeling quite disillusioned. Also some well-publicized scandals concerning investment funds and the perceived instability of many securities companies, the main sponsors of investment funds, have left an impression of relatively lax supervision and enforcement. Life insurance is proving to be a strong competitor in the rush to gather savings, since it pays higher commissions and is sold more aggressively.

87. The passage of the Law on Securities Investment Funds, which came into force in June 2004, should considerably assist the future development of investment funds by providing a firmer legal base. The steady development of detailed regulations and improved supervision by the CSRC will reinforce this, and, as the reputation of investment funds for honesty and transparency grows, it would be surprising if investment funds did not enjoy strong growth over the coming years.

Securities Companies

88. As of October 2002, 124 securities companies are operating in China,⁶³ 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.⁶⁴

⁶³ According to the PBOC, as of 9 January 2003, these companies fall into four categories: Comprehensive (18), Brokering (27), Rectifying (25), and Transitional (54).

⁶⁴ 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.

⁶¹ End 2003 Source: FEFSI.

⁶² End 2003 Source: Board of Governors of the Federal Reserve System.

Further, financial institutions, with the exception of securities companies and trust and investment companies, are not permitted to hold shares in securities companies.⁶⁵ CSRC-promulgated “Administrative Rules of Securities Companies” (2002) impose few restrictions on qualification of shareholders except for some financial standards, however.

89. Securities companies have a narrow business scope in China, focusing on brokerage and dealing in equities. Revenues from their investment banking business only account for a marginal proportion.⁶⁶ 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.

90. 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.⁶⁷ 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

Of the 124 existing securities companies, 26 companies have been transformed from the securities business units of TICs.

⁶⁵ “Certain Opinions on Further Strengthening the Administration of Securities Companies” (CSRC, 1999).

⁶⁶ 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 percent) and securities trading (38 percent) in FY 2000.

⁶⁷ Securities Law of the PRC December 1998, Article 142.

from directly managing investment funds (but they can invest in fund management companies).

91. 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.⁶⁸ The market downturn since mid-2001⁶⁹ 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.⁷⁰

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

⁶⁸ This practice has helped 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).

⁶⁹ Shanghai Stock Index was down 32 percent from its peak on June 14, 2001 to May 6, 2003.

⁷⁰ www.chinaonline.com, June 21, 2002.

93. 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,⁷¹ 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 percent 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.

Trust and Investment Companies

94. 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

⁷¹ 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.

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.

95. 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.

96. 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 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 malpractice.
- (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.

97. 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.⁷² TICs

⁷² According to Article 4 of the “Administrative Rules on Management of Trust and Investment Companies” by the PBOC (2001), trust business

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.

98. 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 regulations. The latest numbers show that 50 TICs offered 250 trust products during 2003, raising US\$2.7 billion.⁷³

99. During this process, some important laws and regulations were enacted. At present, China has put in place the

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).

⁷³ Far Eastern Economic Review, “China—A Complete Lack of Trust: In their search for decent returns, Chinese investors have taken some big risks,” July 2004.

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 went into effect on January 12, 2001 and was subsequently renewed on May 9, 2002.

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

101. First, establishing a TIC is subject to PBOC examination and approval (these functions are now assumed by the newly-established China Banking and Regulatory Commission,⁷⁴ 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.

102. 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.

103. 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.

104. 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 50,000.⁷⁵ Further, TICs must also observe specific asset and liability ratios in their business operations.

105. 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).

106. Despite recent efforts by PBOC (and the newly created CBRC), regulation of the TIC sector still needs much improvement, especially in the area of "capital trusts." When the "Provisional Measures on Administration of Capital Trust for Trust and Investment Companies" became effective on July 18, 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

⁷⁴ CBRC was officially established in April 2003.

⁷⁵ Article 45, the Administrative Rules on Management of Trust and Investment Companies.

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 February 10, 2003, over RMB 5 billion was raised from 39 collective capital trusts.⁷⁶

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

108. 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.⁷⁷ 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.

109. 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.

⁷⁶ Per Jun Ze Jun Law Offices, such schemes were offered by 23 TICs.

⁷⁷ Clients of Bank of Communications, the nation's fifth biggest bank, held a sit-in early July 2004 at the institution's main branch in Shanghai after a trust marketed by the bank on behalf of Jinsin Trust Co. of north-western Xinjiang province expired and they were unable to collect either the US\$10.4 million in principal or the promised 5.2 percent interest due on their one-year investment. The trust company took in an average of US\$54,400 each from 191 investors. The sit-in highlighted not only lax supervision and poor disclosure of trust products, but also unclear regulations about what potential liability banks would face when they channel risky products into the marketplace. Far Eastern Economic Review, *Ibid.*

Underground Funds

110. The so-called underground funds⁷⁸ 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.

111. 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 funds⁷⁹ indicates that the total value of assets managed may be as high as RMB 700 billion, or 7.3 percent of GDP (compared to RMB 123 billion and 1.2 percent of 2002 GDP for licensed securities investment funds), but the fact that the funds are not licensed and recorded indicates such data is thin and largely inferred.

112. 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.

113. 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

⁷⁸ 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.

⁷⁹ Xia (2001).

all companies with business operations falling under this law to be registered.

114. 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).

115. 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.

116. 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 as long-term investors. The research suggests virtually 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.

117. 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.

118. 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.

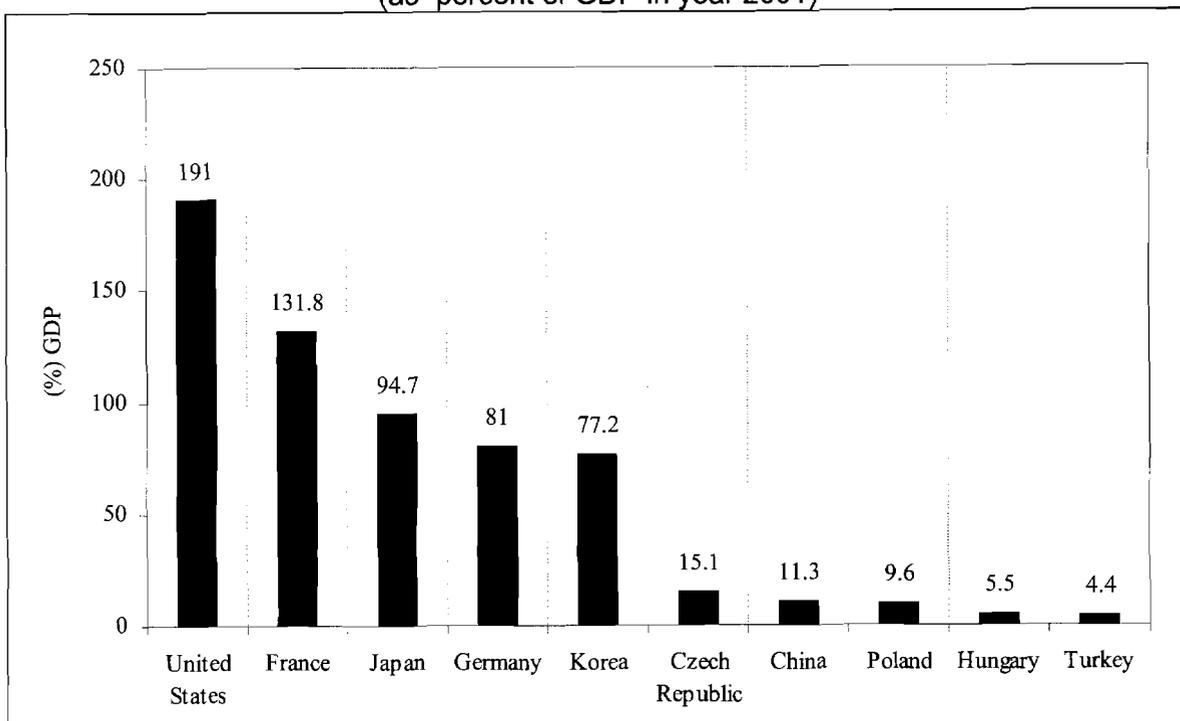
Summary of the Institutional Landscape and International Comparison

119. Given the largely unfunded pension system and fledgling collective investment funds, China's formal institutional assets registered RMB 1,338 billion (11.3 percent of GDP) in 2003, insurance companies RMB 912 billion (7.8 percent of GDP), pension funds RMB 255⁸⁰ billion (2.17 percent of GDP), and collective investment funds RMB 171 billion (1.4 percent of GDP). In addition to this formal institutional investor base, large sums are believed to be managed privately by securities companies, TICs, and unlicensed entities.

120. When compared globally, as Figure 7 illustrates, China certainly has a much smaller institutional base than that of most OECD countries. But institutional investor penetration in China seems not unlike the degree observed in leading transitional economies in Central and Eastern Europe.

⁸⁰ NSSF (RMB 132 billion), individual accounts (93 billion), and corporate pensions (30 billion).

Figure 7. Financial Assets of Institutional Investors
(as percent of GDP in year 2001)



Source: OECD (2004).

Note: China's figure is based on 2003.

4 CHANGES IN THE INSTITUTIONAL ASSET MANAGEMENT SCENE

121. 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. Table 4 summarizes the current situation of various financial institutions and the likely future changes to their roles. It 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

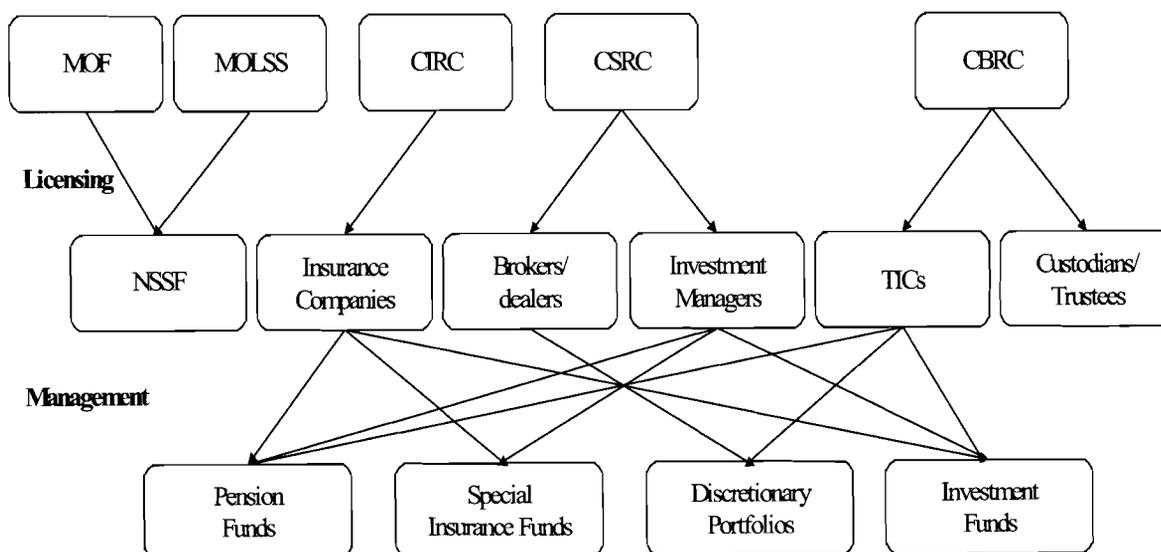
landscape will become increasingly complex, as shown in Figure 8.⁸¹

⁸¹ Acknowledgement to Leckie and Zhang (2001) for the concept of the chart, originally prepared by the CSRC.

Table 4. Changing Scene of the Asset Management Business

Institution	Regulator	Current Restrictions	Changes in Progress or Expected
Banks	CBRC	Limited participation in managing NBFIs. Distributor and custodian for fund managers.	Owning NBFIs through financial holding companies.
NSSF	MOLSS, MOF	Invest up to 40% of its assets in equities. Appoint qualified institutions to manage the NSSF investment.	Overseas investment
Corporate pension funds	MOLSS, CSRC, CIRC, CBRC	Encourage pension management by specialized financial companies. Money market instruments (minimum 20%), fixed income securities (20%-50%), and equities (30%).	Increase tax incentives. "Regulations on Corporate Pension Funds" envisaged by the MOLSS.
Insurance companies	CIRC	Ability to manage third party portfolios through a specialized asset management subsidiary. Limited range of assets permitted.	Relaxation of asset restrictions, including permission to invest directly into equities.
Fund management companies	CSRC	Securities Investment Fund Law liberalizes investment possibilities and clarifies structure.	More Sino-foreign joint ventures are expected to enter the market as foreign ownership rises to 49% by the end of 2004.
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.

Figure 8. Regulatory Structure of Asset Management Activities



122. 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.

123. 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.⁸² For example, CITIC Holdings⁸³ 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 Ltd. (BOCI China) was established in Shanghai as a 49 percent subsidiary of BOC International Holdings, Ltd., which is incorporated in Hong Kong.⁸⁴ The “backdoor” establishment of BOCI China has therefore given it effective access to the securities industry not enjoyed by most peers.⁸⁵

124. 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

⁸² For more information, refer to a Background Note by World Bank (2002a).

⁸³ 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.

⁸⁴ Other shareholders include China National Petroleum Corporation and Yuxi Hongta Tobacco (Group) Co., Ltd.

⁸⁵ With the exception of CITIC Industrial Bank, China Construction Bank, China Everbright Bank, which are members of “de-facto” financial conglomerates.

in financial institutions via various Haier Group related companies. For example, Group holds 66 percent of Qingdao City Commercial Bank, and also acquired a 20 percent controlling stake in Anshan Trust and Investment and a 20 percent 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.

125. The opening up of the financial sector under WTO will heighten foreign competition. Table 5 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 percent stake (with the ceiling to rise to 49 percent after three years) in joint-venture fund management companies and a 50 percent stake in joint-venture life insurance companies. For non-life, China will first allow branching or 51 percent 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 percent foreign investment within three years after the accession and 49 percent afterwards.

126. On July 1, 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.

127. 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, Ltd. 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 percent) and Xiangcai Securities Ltd. (67 percent). 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 of 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.

128. 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.

129. 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. At present, the following alliances are at work or in the pipeline (Table 6).

130. Meanwhile, effective December 1, 2002, the long-awaited Qualifying Foreign Institutional Investor program, better known as QFII, offered foreign investors access to the A-share market for the first time (Box 1). This signals a significant step toward capital market opening in the PRC. As of the end of December 2003, twelve foreign financial institutions were licensed as QFIIs with a total investment quota of US\$ 1.7 billion, and eleven banks (four of them being foreign banks) were licensed as the QFIIs' custodians.⁸⁶ QFIIs portfolios include: bank deposits, shares, government bonds, investment funds, and convertible bonds. At the initial stage, bank deposits used to make up half of the total portfolios, but decreased into one third, while two-thirds of the funds are currently invested in securities.⁸⁷

⁸⁶ 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.

⁸⁷ <http://www.cs.com.cn/01/200407080250.htm>.

Table 5. China's WTO Commitments on Financial Services

<p>Banking</p>	<p>Within two years after accession, China will permit foreign banks to provide local currency services to Chinese enterprises.</p> <p>Within five years from accession, China will permit foreign banks to provide local currency business to all Chinese individuals.</p> <p>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).</p> <p>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.</p>
<p>Securities</p>	<p>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.</p> <p>Foreign securities companies may engage directly in B share business.</p> <p>Representative offices of foreign securities companies may become special members of Chinese stock exchanges.</p>
<p>Fund Management</p>	<p>Upon accession, joint venture fund management companies may be established, with foreign ownership not exceeding 33%, to conduct domestic fund management business.</p> <p>Foreign investment shall be increased to 49% after three years.</p>
<p>Insurance</p>	<p>Upon accession, foreign life insurers will be allowed to hold 50% ownership in joint ventures. They may now choose their own joint venture partners.</p> <p>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).</p> <p>Reinsurance is completely open upon accession with no restrictions.</p> <p>All geographic restrictions will be lifted in three years after entry.</p> <p>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.</p> <p>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.</p>

Source: World Bank.

Table 6. Overview of Sino-foreign JV players in December 2003

APPLICANT STATUS FOR SETTING UP FUND MANAGEMENT JV	FOREIGN PARTNER(S)	CHINESE PARTNER(S)	JV FUND MANAGEMENT COMPANY
Approved (Oct 2002)	Societe Generale Asset Management (33%)	Fortune Trust & Investment (67%)	Fortune SGAM Fund Management
Approved (Dec 2002)	Fortis Investment Management (33%)	Haitong Securities (67%)	Fortis Haitong Investment Management
Approved (Dec 2002)	ING Investment Management (30%)	China Electric Financial Affairs (10%) China Huaneng Financial Affairs (10%) China Merchant Securities (40%) COSCO Financial Affairs (10%)	China Merchants Fund Management
Approved (Feb 2003)	Invesco Asia (33%)	China Great Wall Securities (33%) Dalian Shide (17%) Kailuan (17%)	Invesco Great Wall Fund Management
Approved (Mar 2003)	Allianz Dresdner Asset Management (33%)	Guotai Jun'an Securities (67%)	Guotai Jun'an Allianz Fund Management
Approved (May 2003) (via acquisition)	BMO Financial Group (16.7%)	Fujian International Trust & Investment (16.7%) Haitong Securities (16.7%) Hutai Securities (16.7%) Shandong International Trust & Investment (16.7%) Shenyin & Wanguo Securities (16.7%)	Fullgoal Fund Management
Approved (Aug 2003)	Franklin Templeton (33%)	Sealand Securities (67%)	Franklin Templeton Sealand Fund Management
Approved (Aug 2003)	BNP Paribas Asset Management (33%)	Shenyin & Wanguo Securities (67%)	SW BNP Paribas Asset Management
Approved (Sep 2003) (via acquisition)	ABN AMRO (33%)	Xiangcai Securities (37%) Shandong Xinyuan (30%)	Xiangcai Hefeng Fund Management
Preliminary approval	Prumerica Financial (33%)	Everbright Securities (67%)	Everbright-Prumerica Fund Management
Preliminary approval	Merrill Lynch (16.5%) BOC International Holdings (16.5%)	BOC International China (67%)	Bank of China International Fund Management
Pending approval	First State Investments (30%)	Hantang Securities (40%) China Southern Airlines (16%) Nanjing YPC Refining and Chemical (14%)	FSI Hantang Fund Management
Pending approval	AIG Global Investments (33%)	Huatai Securities (33%) Suzhou New District High-Tech Industrial, Jiangsu Communications Holding, and Guohua Energy Investment (34%)	AIG Huatai Fund Management
Pending approval	JP Morgan Fleming Asset Management (33%)	Shanghai International Trust and Investment (67%)	

Source: KPMG.

131. The QFII scheme is subject to strict qualification requirements and tight curbs on early repatriation. In addition, 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.

132. Indeed, the increasing presence of the QFIIs in the A share market has brought

about positive changes in equity investment. First and foremost, share prices started to differentiate according to the quality of shares. QFIIs concentrate on blue chips with high liquidity and good profitability. In the past, shares tended to move in the same direction regardless of their qualities. Second, there are signs that momentum trading practices are slowly giving way to a value-based long-term investment culture. Third, the importance of transparency and disclosure, which remains high on QFIIs' investment criteria, started to permeate into senior executives and controlling shareholders alike.

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 US\$10 billion in the last accounting year.
- Insurance companies: minimum 30 years operational experience; securities assets not less than US\$1 billion in the last year; revenues exceeding US\$1 billion.
- Securities companies: minimum 30 years operational experience; securities assets not less than US\$1 billion in the last year; revenues exceeding US\$1 billion.
- Commercial banks: Securities assets not less than US\$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 percent 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 percent of the total shares of that listed company. In terms of investment amount, QFIIs must invest US\$ 50 million to US\$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.

5 THE WAY FORWARD

133. 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.

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

135. One priority objective is to increase demand for longer-term government bonds. This will expand the investor base for government bonds beyond the state commercial banks, 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.

136. 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.⁸⁸

137. 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.

138. 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.

139. 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

⁸⁸ 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.

part for the slow and uneven development of institutional investors.

Consolidation of Asset Management and Applicable Standards

140. 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.

141. 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.

142. 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.

143. 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.

144. 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.

145. 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 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.⁸⁹

146. 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 benefits⁹⁰ and with the restriction that a participant will incur a penalty if withdrawals are made prior to reaching a certain age or retiring.

147. 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 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.

148. 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.

149. 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.

150. 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

⁸⁹ 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.

⁹⁰ 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.

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.

151. 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.

152. By way of illustration, the marketing and selling of mutual funds has recently been a subject of great debate in leading financial centers. In the United States, sales and distribution of mutual fund shares are governed by the National Association of Securities Dealers (“NASD”), that has an extensive rule book. The charging and commission structure of mutual funds has become increasingly complex in recent years, following the adoption of rule 12b-1 in 1980. Under this rule some distribution expenses (i.e. commissions to sales agents) may be paid out of fund assets subject to certain limitations. Most funds that are sold through brokers are offered with different share classes, each of which has a different fee schedule (Class A shares rely primarily on front-end loads from which commission is paid; class C shares rely more on asset-

based 12b-1 fees, while class B is a hybrid of the two, relying on contingent deferred sales charges, or declining backend loads.). Recently the complexity of the 12b-1 arrangements and their relative opacity have been called into question. The US Securities and Exchange Commission (SEC) in its testimony to the Senate Banking Committee on March 2004 said, “*Over time, rule 12b-1 has come to be used in ways that exceed its original purpose. Consequently, the Commission is seeking comment on whether rule 12b-1 continues to serve the purpose for which it was intended and whether it should be repealed.*”

153. The main principle is that there is equality of treatment—i.e. that a published charging and commission tariff is adhered to so that all customers in the same category pay the same fees and that no intermediary is given special deals.

154. There are other ways in which agents can be remunerated that have recently caught the attention of the SEC. One of these is “directed brokerage,” where the fund manager directs transactions of the fund’s portfolio to brokers who have purchased fund units for their clients.⁹¹

155. In the UK, shares and units of collective investment schemes can only be sold through authorized firms subject to the regulation of the Financial Services Authority (FSA). These firms are mostly remunerated through an initial commission paid by the management company out of the front-end load. There is no limitation on the amount of commission that can be paid, and it must be said that the system is rather messy. Some intermediaries may be offered

⁹¹ For a very full analysis of US mutual fund distribution, see Investment Company Institute Perspective : Vol. 9/No 3 dated July 2003.

special commission deals and their clients offered incentives by way of price discounts. There is a whole range of discount brokers, who are prepared to cede part or all of the commission they receive to the client, thus enabling purchases of load funds at what is effectively no-load.

156. The UK also has multi-share class funds with varying charging structures. Sales agents can be paid both front-end commissions and “trail fees” that are similar to 12b-1 fees in remunerating agents for retaining their clients’ holdings. The difference is that, unlike in the US where the 12b-1 fee is a charge on the fund’s assets (and thus paid by ongoing shareholders), trail fees are paid by management companies out of their own revenues.

157. The main principle in the UK is that an agent must disclose to the client the remuneration that he will receive from any transaction done for that client. (FSA Conduct of Business Rules 5.7.5).

158. In India, most remuneration of agents is by way of trail fees, since front-end loads are not common, except on equity and balanced funds. There has recently been some pressure on agents to cease the practice of retrocession of part, or the entire, trail fee to the client as an incentive to deal with that agent.

159. As the market for collective investment schemes continues to grow in China, the CSRC will have to address all the issues discussed here and perhaps more, which should serve as a benchmark for the other regulators, i.e., the CBRC and the CIRC, to write proper regulatory and supervisory frameworks for similar products offered by trust and investment companies and insurance companies, respectively.

Level Playing Field

160. 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.

161. 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.

162. The Chinese characteristic of predominant public ownership of banks extends to the NBFIs 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 1 and 2 show the ownership structure of leading securities companies and fund management companies, respectively.

163. 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.

164. 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.

165. 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.

166. 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.

167. 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.

168. 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.

Availability of Wider Range of Investment Opportunities and Products

169. 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.

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

171. 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.

172. 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.

173. The necessary legal and regulatory framework should be created for introducing asset-backed securities (ABS)⁹² 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).

174. 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

⁹² PBOC is reportedly working on drafting ABS law.

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.

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

176. 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.

177. 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.

178. 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 re-balance and alter the maturity of portfolios without incurring high transaction costs. These are not yet available in China.

179. 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 divestiture plans for SOEs that will combine sales to strategic investors; block sales to private investors; and partial IPOs on the equity markets.⁹³ 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.

180. This systematic plan would replace the ill-fated plan, officially scrapped in June 2002, of selling 10 percent 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

⁹³ 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.

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 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.

181. 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. The IPO system has improved, i.e., from the old quota system to an IPO review committee (1999)⁹⁴ to the latest “sponsorship system (2004)” under which the registered sponsors will be held responsible for the behavior of each sponsored firm for a post-IPO period of two years. The new and tougher IPO rules could send a signal to corporate executives and investors alike that the PRC equity market no longer would serve as a convenient refinancing apparatus for SOEs with questionable commercial prospects.

Relaxation of Investment Restrictions

182. 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.

183. 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 percent 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 percent of funds in corporate paper⁹⁵ (up from 10 percent) in June 2003.

184. Table 7 summarizes permissible investment products by type of institution. Despite continuous efforts by regulators to

⁹⁴ The committee was composed of professionals from the CSRC and outside market experts. It had been structured with its members rising to 80 from 34, three-fourths of whom were currently non-CSRC members.

⁹⁵ Insurance companies are no longer limited to investing in only four issuers (i.e., China Mobile, State Power, Three Gorges and Ministry of Railway). Rather they can invest in bonds with a domestic rating of AA or above.

relax and codify⁹⁶ investment restrictions, the current system expressly prohibits investments that are permitted in other markets. As a related issue, it is not always clear what investments are permissible for financial institutions.

185. 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 percent of the unit-linked product funds in securities investment funds.

⁹⁶ Most notably, the enactment of investment guidelines of National Social Security Fund by the Ministry of Finance in December 2001.

Table 7. Investment Restrictions at a Glance

Institutions	Permitted	Prohibited
Banks	<ul style="list-style-type: none"> • Loans • Government Bonds • Discounting Bills • Inter-bank Call Loans • Corporate Bonds⁹⁷ 	<ul style="list-style-type: none"> • Equities • Investment Funds • Real Estate
Investment Funds	<ul style="list-style-type: none"> • Equities • Government Bonds • Corporate Bonds • Cash • Bank Deposits 	<ul style="list-style-type: none"> • Investment Funds (Cross-Investment) • Real Estate
Insurance Companies	<ul style="list-style-type: none"> • Bank Deposits • Government Bonds • Corporate Bonds (with limitations) • Investment Funds (with limitations) 	<ul style="list-style-type: none"> • Equities • Real Estate • Loans • Overseas Investment
National Social Security Fund	<ul style="list-style-type: none"> • Bank Deposits • Government Bonds • Corporate Bonds • Investment Funds • Equities 	<ul style="list-style-type: none"> • Real Estate • Overseas Investment
Corporate Pension Funds	<ul style="list-style-type: none"> • Bank Deposits and Money Market Instruments • Fixed-income Securities • Equities 	<ul style="list-style-type: none"> • Real Estate
Trust and Investment Companies	<ul style="list-style-type: none"> • Bank Deposits • Equities • Government Bonds • Corporate Bonds • Investment Funds • Real Estate 	

Source: World Bank.

⁹⁷ “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.

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

187. 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.
- (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.

188. 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).⁹⁸ 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.

189. 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 be more likely to give the desired result. This approach was adopted by the Chilean pension sector,⁹⁹ which remains a well-

⁹⁸ For an excellent review of the two different regulatory approaches, see Vittas (1998).

⁹⁹ 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

known and successful model for the development of institutional investment.

190. 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.¹⁰⁰ 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 power and other factors, e.g., investment risk and liquidity; and investment suitability for different types of portfolios.

191. 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.

192. Further, the investment regime needs to be considerably relaxed. In fact, many countries adopted an “indicative system,”

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.

¹⁰⁰ Davis (1997).

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. As 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. Box 2 summarizes best practices on permissible assets for CIFs and insurance companies in developed markets.

Box 2: 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.¹⁰¹ Open-end CIFs are required to limit their investment in illiquid assets to a small ratio, usually a maximum 10 percent 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 US and Property Companies in the UK).

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:¹⁰²

- 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).

¹⁰¹ This paragraph has benefited from Cadogan Financial (2000).

¹⁰² OECD (2000). See Appendix 4 for detailed limits in each country.

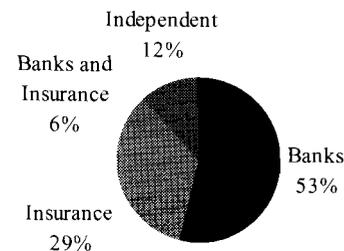
Increased Role of Banks

193. 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 its capital 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.

194. 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.

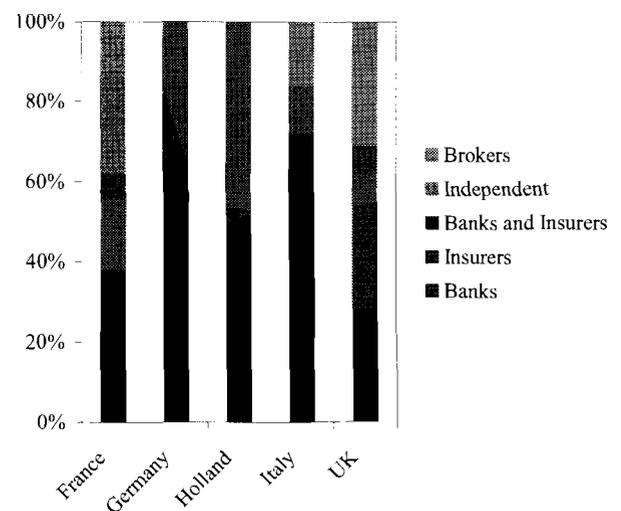
195. The 1990s witnessed the rapid growth of mutual funds throughout Europe (including UK). With the exception of the UK, most European fund management companies are bank-owned. Figures 9 and 10 below give an impression of the ownership of asset management companies in Europe as a whole and shows different 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 9. Ownership Structure of Fund Management Companies in Europe



Source: Oxford Economic Research Associates Ltd.

Figure 10. Shareholder Profile of Fund Management Companies in Selected Countries



Source: Oxford Economic Research Associates, Ltd.

196. The universal banking model¹⁰³ is well established in Europe and looks likely to continue to dominate non-bank financial

¹⁰³ 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.

activities. Europe has never had a “Glass-Steagall” type of legal separation of banking from non-banking activity. Even in the UK, there is a clear trend toward 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 US too, with the repeal of Glass-Steagall by the Graham-Leach-Blighly Act in 1999, there is a developing trend toward 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 persist in the US market.

197. Vis-à-vis the world’s financial centers, China has one of the most restrictive regimes for permissible banking organization activities. According to a 2003 global survey¹⁰⁴ 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.

198. 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:

- (a) investment funds custodian;

¹⁰⁴ Appendix 3 illustrates the main findings of the survey for selected countries.

- (b) record-keeping, subscription, bid and redemption of all fund types;
- (c) securities agent in a very restrictive sense;¹⁰⁵ and
- (d) insurance agent.

199. 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,¹⁰⁶ 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.

200. 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.

¹⁰⁵ 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.

¹⁰⁶ Apart from China Development Bank, which is allowed to underwrite corporate bonds issued by existing clients.

201. 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.

202. 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.

203. 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 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.

204. 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 collapse of banks in the US 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.

205. 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.

206. 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.

207. 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 defined¹⁰⁷ and be reflected in the overall capital adequacy requirements of a bank.

Pension Reform

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

209. Corporate 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.¹⁰⁸ In addition, the government needs to provide strong legal and regulatory frameworks for corporate pension plans, along with more attractive tax incentives for contributions by both employers and employees.

210. 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.

211. 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

¹⁰⁷ 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 subsidize 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 US\$700 million).

¹⁰⁸ 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.

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

6 CONCLUSION

212. 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.

213. 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.

214. 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.

215. 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.

216. 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 defined contribution individual accounts 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. 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.

217. 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 restrictions¹⁰⁹ placed on some and the incentives¹¹⁰ 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 finances not only industry and commerce, but also government. China is no exception.

218. China now has a good opportunity to learn from the mistakes of others and to lay a solid foundation for its institutional investors. Accomplishing this 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 toward the most desirable objectives.

¹⁰⁹ Interest-rate control regimes and a strict merit review system for securities issuance, among others.

¹¹⁰ For example, tax exemptions for government bonds.

APPENDIX 1—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 Meiyuan 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 ZoneCo., Ltd. 8%
10	China Everbright Securities.	2.6	China Everbright Group 51%, China Everbright Limited 49%

Source: CSRC.

Note: As of June 2002.

APPENDIX 2—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.

Note: As of June 2002.

APPENDIX 3—PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS IN VARIOUS FINANCIAL CENTERS

Country	Securities	Insurance	Real Estate	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	Generally limited to holding bank premises	Limited to suppliers to the bank	Permitted
China	Not Permitted	Not Permitted	Not Permitted	Not Permitted	Not Permitted
Germany	Permitted	Permitted, but only through insurance subsidiaries	Permitted	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, provided total investment does not exceed investing firm's capital or net assets
Korea	Permitted through affiliates	Permitted through affiliates	Generally limited to 60% of bank capital	Permitted, limited to 15% of total shares of non-financial companies	Permitted, up to 10% of the bank's capital, subject to regulatory consent (suitability of the shareholder)
Russia	Permitted	Not permitted	Not permitted	Permitted, but not more than in one financial-industrial group	Permitted with regulatory approval (more than 25%)
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 2003.*

APPENDIX 4—DOMESTIC LIMITS ON INVESTMENT REPRESENTING TECHNICAL PROVISIONS - LIFE INSURANCE COMPANIES

Country	Bonds		Shares	Mortgage	Real Estate	Loans	Cash	Derivatives	Unit Trust
	Corporate Bonds	Gov't Bonds							
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
México	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									

Source: OECD (2000).

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