May–June 2006

The China Business Review

THE MAGAZINE OF
THE US-CHINA BUSINESS COUNCIL

Special Issue

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Securities Bank Reform Investing in NPLs
Life Insurance Eye on Xi'an US Visas

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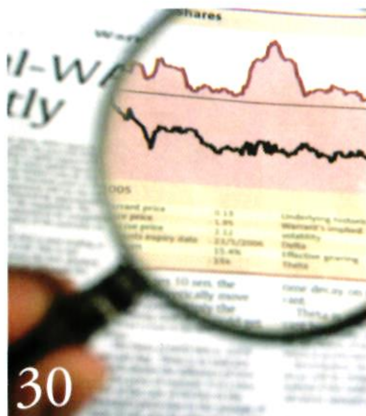

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The *China Business Review* (ISSN 0163-7169) is published bimonthly by the US-China Business Council, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA (Tel: 202-429-0340), a nonprofit organization incorporated under the laws of the District of Columbia. Periodicals postage paid at Washington, DC, and additional mailing offices. Postmaster, please send address changes to the *China Business Review*, 1818 N Street NW, Suite 200, Washington DC 20036-2470, USA.©The US-China Business Council, 2006. All rights reserved.

Annual Subscription Rates: $129 US/Canada and $169 international, print only; $149 US/Canada and $199 international, print and online; $100 online only. Single copy issues: $25, $35 airmail; issues over 1 yr: $15, $20 airmail. DC residents add 5.75% sales tax. Subscriptions to the *China Business Review* are not deductible as charitable contributions for Federal income tax purposes.

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The China Business Review

Letter from the Editor

As China's last World Trade Organization (WTO) commitments in financial services draw near, the focus of this *CBR* special issue is the country's financial sector. In Letter from Beijing, Robert Poole, vice president of China Operations for the US-China Business Council, publisher of the *CBR*, describes the mood in Beijing's financial services community and notes that although China's financial sector has come a long way since the country joined the WTO in 2001, it still has a long way to go to satisfy foreign investors.

Stephen Thomas and Chen Ji follow with an overview of China's bank reforms to date, while Richard Daniel Ewing takes stock of China's life insurance industry. Victor Shih and Louie Huang illuminate the nonperforming loan (NPL) market, revealing due diligence strategies and what it takes to turn a profit on NPLs. Finally, David Strongin looks at the securities sector and offers suggestions on how China can improve it.

Running through all of these articles is a common theme: Although opening China's financial sector fully to foreign companies is obviously in those firms' interest, ultimately China will also benefit greatly from such changes. Not only will opening the sector—in conjunction with other reforms—eventually make the banks stronger, but it will also allow capital, most of which is now stuck in low-interest bank accounts, to be allocated more efficiently. When capital can flow to where it is needed most, Chinese investors, and the economy as a whole, will see higher returns.

After seven years working on the *CBR*, including five years as associate editor, this issue is my first as editor. I am grateful to Catherine Gelb, my predecessor, for her guidance over the years and hope to maintain the high standards she has set for the magazine. In this endeavor, I will, of course, be aided by the magazine's dedicated staff—Associate Editor Paula M. Miller, Assistant Editor Victorien Wu, Business Manager Jesse Marth, and Administrative Assistant Marcia Morrow. Starting in May, we welcome new Assistant Editor Damien Ma to our team. I look forward to working with this team for many issues to come to bring our readers the in-depth, thoughtful articles they expect from the *CBR*.

Virginia Hulme

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Web: www.chinabusinessreview.com
Reprints (minimum 250): The Reprint Outsource, 717-394-7350
Online store: www.uschina.org/store

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Autos

Harley-Davidson, Inc. opened its first dealership in China in April. According to the Milwaukee-based motorcycle company, the dealership, located in Beijing, sells Harley-Davidson motorcycles, parts and accessories, and merchandise and collectibles. The store also plans to sponsor organized rides and provide rider training.

The PRC State Council in late March issued new regulations that require all motorcycle owners to obtain motorcycle accident insurance. Public security authorities may confiscate the motorcycles of riders who fail to comply with this requirement.

In a bid to fight air pollution, the PRC Ministry of Finance (MOF) raised the tax rates on large cars and cut taxes on smaller cars on April 1. Consumer tax on passenger cars with an engine of more than 2 liters rose from 8 percent to 9–20 percent, depending on the engine size, while consumer tax on cars with engines smaller than 1.5 liters dropped from 5 percent to 3 percent.

Taxation

For the first time, MOF imposed consumer taxes of 10 percent on golf equipment and yachts and 20 percent on high-end watches. The move is widely seen as an attempt by the government to demonstrate its commitment to reducing the widening income inequality in China.

MOF also mandated a tax of 5 percent on wooden chopsticks and wooden floor panels to help slow the consumption of timber. According to press reports, China produces more than 45 billion pairs of disposable wooden chopsticks annually, consuming nearly 1.7 million cubic meters of timber, or about 25 million trees.

Environmental Protection

The Beijing Municipal Environmental Protection Bureau (EPB) reported that the water quality in the majority of rivers in the Beijing area fails to meet national standards. Forty-seven of 78 rivers have water quality of level V, the poorest water quality on the I-V scale. The Beijing EPB will regularly publicize the results of its water quality monitoring beginning this year.

In mid-March, the Guangdong provincial government announced plans to organize a mass swim across the Pearl River in August to demonstrate its resolve to fight water pollution. Guangdong Mayor Zhang Guangning said that the city has spent ¥9.5 billion ($1.2 billion) on antipollution measures for the Pearl River since the late 1990s when the river began to smell and could no longer support fish. The last mass crossing of the Pearl River occurred in the 1970s, according to Xinhua News Agency.

Trade

Citing rising costs for manufacturing inputs, most Chinese exporters are likely to raise their prices over the coming year, according to a Global Sources China supplier survey, which polled roughly 1,100 enterprises. More than 60 percent of respondents said they will raise their prices over the next 12 months, with most expecting an increase of 5 to 15 percent. The exporters said that their top two challenges are price competition and rising raw material costs.

In March, Zambia joined Australia, Iceland, New Zealand, and South Korea to become the 53rd country to grant China market economy status. None of China's top three trading partners, the European Union, United States, and Japan, has yet recognized China as a market economy.

Telecom

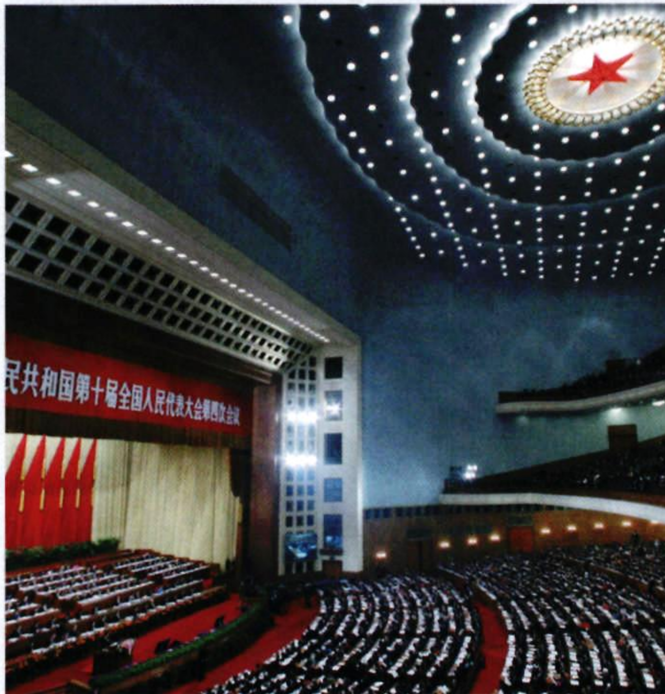
China will not issue voice-over-internet-protocol licenses until 2008, according to Tom Online Inc., a Chinese Internet portal company that has formed a joint venture with Skype Technologies SA. Domestic fixed-line operators are reportedly concerned that allowing calls between computers and telephones would undermine their core business.

Standards

The International Organization for Standardization (ISO) in March rejected China's request that its wireless local area networks (WLAN) encryption technology, WLAN Authentication and Privacy Infrastructure, be adopted as an international standard. ISO voted to adopt IEEE 802.11i instead. China plans to appeal the vote at a June ballot review meeting in Prague.

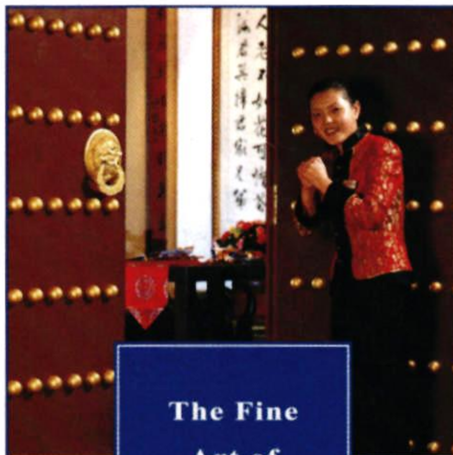
National People's Congress

At its annual meeting in March, the PRC National People's Congress (NPC) approved China's 11th Five-Year Plan (FYP, 2006–10), the centerpiece of which is the goal of building a "new socialist countryside." The central and local governments will boost spending to improve rural infrastructure, make compulsory education affordable, and expand medical services in rural areas.

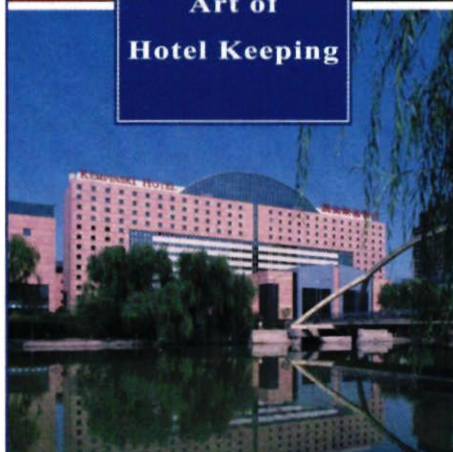


China will also attempt to raise its "self-innovation capacity" during the 11th FYP period. The government plans to enact policies that cover loan support, tax incentives, government procurement, and enhanced intellectual property rights protection to encourage research and development, particularly in biotech and information technology.

The NPC also approved the Government Work Report delivered by Premier Wen Jiabao. The report sets the goals for this year of GDP growth of 8 percent, 9 million new jobs in urban areas, and inflation of less than 3 percent. Perhaps most eye-catching is the goal of lowering energy consumption per unit of GDP by 4 percent by the end of this year.



The Fine Art of Hotel Keeping



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WTO

In late March, the United States and European Union launched a World Trade Organization (WTO) case against China on its tariff treatment of auto parts. The case is only the second WTO case against China for the United States. The first, which involved PRC tax rebates on semiconductors, was resolved during the consultation phase of the case, before it reached a WTO dispute settlement panel.

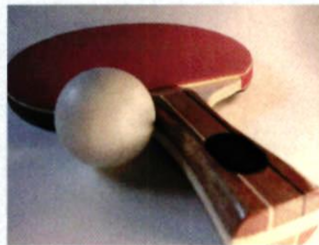
China criticized the United States for imposing unreasonable investment restrictions based on national security and its export controls over sensitive technology during the WTO's review of US trade policy. As the *CBR* went to press, the WTO was expected to urge China to adopt a more flexible exchange rate policy and strengthen its protection of intellectual property rights during its review of PRC trade policy.

Rail

The PRC Ministry of Railways approved in March the construction of a Beijing-Shanghai high-speed railway. More than 70 percent of the railway's components will be sourced from within China, said Vice Minister of Railways Sun Yongfu.

US-China Relations

Following their widely anticipated visit to China, Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) announced that they will postpone until September 29 a vote on their bill, which would impose tariffs of 27.5 percent on imports from China unless Beijing allows the renminbi to appreciate significantly. The two senators said they are convinced that progress will be made on the issue of China's exchange rate policy.



A 25-member US delegation of table tennis officials, coaches, and players visited China in April to commemorate the 35th anniversary of "ping pong diplomacy," which helped pave the way for President Richard Nixon's visit to China in 1972 and the subsequent normalization of bilateral relations. The US delegation included seven members of the original 1971 delegation.

Media, Publishing & Entertainment

The PRC State Administration of Radio, Film, and Television issued a notice in March mandating that TV programming involving contests should reflect a "correct world view" and values. In addition, the attire of contest participants should not be "vulgar" and must be consistent with "the public's view of aesthetics." According to observers, the notice is aimed at reining in TV shows such as "The Mongolian Cow Sour Yogurt Supergirl Contest," a knock-off of "American Idol" that attracted more than 400 million Chinese viewers last year.

Warner Bros. Entertainment Inc. opened its first store in China in late March. Operated by Hutchison Harbour Ring Ltd., the store is located in Shanghai. Warner Bros. indicated that it plans to open more than 200 stores in the next few years, as the toy market in China is expected to reach $12.5 billion by 2010.

Banking and Finance

The People's Bank of China (PBOC) and National Bureau of Statistics in March unveiled the results of the First Quarter Bankers' Survey Report. The confidence index of respondents reached a historical high of 82 percent, and 81 percent of surveyed bankers indicated that the PBOC's monetary policy was "just right."

The survey also showed that the demand for bank loans remains high, with 62.5 percent of banks indicating growth in loan requests from the fourth quarter of 2005. Loan applications rose at 74 percent of rural commercial banks, 67 percent of state-owned commercial banks, and 51 percent of foreign-invested banks.

Internal auditors account for less than 1 percent of staff in Chinese banks, compared to 2 to 5 percent in foreign banks, according to Ernst & Young International. Analysts say that this may hamper the PRC government's efforts to force domestic banks to enhance internal controls.

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WTO Is Only the Warm-Up

Robert Poole

This year will be a landmark year for financial services in China. We can look back at all that China has achieved in the five years since it joined the World Trade Organization (WTO) and look ahead to what the market will look like once China fulfills its final—and most important—WTO commitments in the fields of banking and insurance, which fall due on December 11, 2006. Specifically, China has agreed to lift all geographic and customer restrictions on foreign banks and eliminate any nonprudential measures that restrict the ownership, operation, and operational form of foreign-invested banks. In insurance, China has agreed to allow wholly foreign-owned subsidiaries in insurance of large-scale commercial risks, brokerage for reinsurance, and brokerage for international marine, aviation, and transport insurance and reinsurance.

China's progress to date can be viewed as truly monumental. Consider the number of new laws and regulations, the birth of new regulatory agencies, and the steady increase of licenses, investments, and staff. Visitors to Chinese bank branches in major cities will notice orderly lines and crisply packaged offerings of new saving and investment products. Insurance and risk management products are slowly but steadily being introduced. Securities companies, although still reeling from four years of heavy losses, have built retail networks in preparation for the advent of proper markets.

The slow pace of reform

Any discussion of financial services in China remains principally centered around reforms, and their pace. Though 2006 may stand out as an especially important year for China's financial sector, it will take many years for the full benefits of market reforms to reach Chinese enterprises and consumers, the ultimate beneficiaries of financial reform.

The pace of China's reforms cannot be as fast as most observers would like. The need to create or reconcile a large body of regulations is most frequently cited as the main reason for the slow pace of change, but equally important is the fact that financial services is a knowledge-based business. The creation of a national market of educated financial consumers in China—and experienced bankers, stockbrokers, and insurance agents to serve them—will inevitably take years. Nevertheless, Chinese consumers and companies are hungry for knowledge and quick to learn, and the pace of learning and change will accelerate every year.

"Financial services" is an umbrella term used comfortably in America that encompasses different industries, each with subsets of products and services, each requiring regulations, prudential supervision, education and training, and introduction to end users. In China, however, the relative newness of these industries has resulted in a vast body of implementing rules, regulations, and laws administered by agencies with authorities that sometimes overlap and that certainly have not yet coalesced as a "financial services industry." Any examination beyond surface depth quickly reveals that there are no easy fixes or ready ways for China's financial markets to be "opened."

As a result, it is easy to sense mutual distrust and suspicion in Beijing. PRC regulators fear that American companies will dominate service sectors because of their advanced management, superior information systems, and access to capital, while foreign players worry that PRC regulators will allow reform and opening measures only when they have the means to protect domestic companies from foreign competition. There may be some grounds for both of these fears. China's financial regulators are walking an uncomfortably fine line, trying to balance the need for reform and opening with the need for stable domestic markets. Of course, the ultimate goal for both PRC regulators and foreign industry is to create Chinese markets that function as transparently and efficiently as major world markets. However, China also considers the creation of strong, internationally competitive domestic financial services companies equally important. At the same time, China's fear of domination by American financial institutions appears misplaced; self-imposed risk limits and prudent growth strategies will prevent them from attaining outsized market shares.

The fundamental question of opening financial markets remains contentious in some circles in China, and PRC regulators rightly observe that US markets sometimes have problems—the savings and loan crisis, the dotcom bubble, and the exposures of asbestos liability or tort claims are all examples they can cite. But the US system enables us to weather those crises and to rely upon markets and prudential supervision to make improvements. One day, the same will be true in China.

Letter from Beijing

China's financial system reform will be difficult and will require years of effort—the WTO commitments due this year are just a warm-up.

In the long run, embracing international financial institutions and systems (likely with some Chinese characteristics) will greatly benefit China's consumers and companies by introducing better financial products, efficient markets, and educated practitioners. Chinese financial institutions will also benefit—competition will make them stronger, not weaker. Though China's regulators on occasion may slip into a protectionist frame of mind while trying to build a mature, market-based system, such protectionism will ultimately prolong the weaknesses in the system.

Beyond WTO

In Beijing, the arrival of December 11, 2006 and the fulfillment of China's WTO commitments in this area will be an important milestone, and China has much work to do before then. But the talk among western financial companies in Beijing is less of WTO and more of the many implementing rules and regulations that will need to be rectified or removed to allow truly open markets. Foreign companies are already looking beyond the commitments due in December. Though China should honor its commitments, a narrow focus on the "letter" of China's WTO commitments in these sectors risks overlooking the equally important "spirit" of the WTO—allowing free, fair, and transparent competition among companies regardless of national origin or ownership. How readily, and to what extent, China's financial regulators adopt this "spirit" will be vital in determining the speed at which China's financial markets and institutions will mature and integrate with the world financial system.

China's financial system reform will be difficult and will require years of effort—the WTO commitments due this year are just a warm-up. The American financial companies that understand China best are well prepared to act as partners in this tremendous endeavor, on which much of the country's economic future depends. 完

Robert Poole *is vice president, China Operations, at the US-China Business Council in Beijing.*

Dennis Chen

Beijing's Financial Street

Event Wrap-Up

US Chamber of Commerce

PRC Vice Minister of Commerce Ma Xiuhong and USCBC President John Frisbie in Washington

US Chamber of Commerce

Ma, Frisbie, Josh Mikesell of Chevron, Robert McDonald of Emerson, and Dinesh C. Paliwal of ABB Inc.

WASHINGTON

March

Luncheon with Senior PRC Officials
Co-sponsored by USCBC and the US Chamber of Commerce, the luncheon featured PRC Vice Minister of Commerce (MOFCOM) Ma Xiuhong and a delegation of MOFCOM officials.

Roundtable Discussion on Business Diplomacy in China
Featured Christian Murck, CEO of APCO Asia

Issues Luncheon: Preparations for the Joint Commission on Commerce and Trade (JCCT)
Featured Deputy Assistant Secretary of Commerce for Asia Hank Levine

April

Discussion on China's Draft Labor Contract Law
Featured Andreas Lauffs, principal with Baker & McKenzie in Hong Kong

JCCT Debriefing with Tim Stratford and Hank Levine
Co-sponsored by USCBC and the US Chamber of Commerce, the debriefing featured Assistant US Trade Representative (USTR) Tim Stratford and Levine.

Dinner in Honor of PRC President Hu Jintao
The USCBC, National Committee on US-China Relations, US Chamber of Commerce, and other organizations co-hosted a reception and dinner in honor of PRC President Hu Jintao.

BEIJING

March

Luncheon with USTR Officials
Featured USTR General Counsel James Mendenhall and Stratford

Luncheon with National Development and Reform Commission (NDRC) Officials
Featured Deputy Director of NDRC's Department of Development Planning Tian Jinchen and NDRC International Cooperation Center Director Zhang Xiaochong

Breakfast with Secretary of Commerce Gutierrez
Co-sponsored by USCBC and the American Chamber of Commerce-Beijing, the breakfast featured US Secretary of Commerce Carlos M. Gutierrez.

April

JCCT Debriefing with US Embassy
Co-sponsored by USCBC and the American Chamber of Commerce-China, the briefing featured US Embassy Minister Counselor for Commercial Affairs Craig Allen, Minister Counselor for Economic Affairs Rob Luke, and Trade Facilitation Office Director Ira Belkin.

China Operations Conference
Featured discussions on China's economy, financial system, tax reform, and distribution rights; speakers also provided a legal update and tips on managing government relations.

SHANGHAI

March

Luncheon on Implementing Distribution Rights in China Operations
Featured David Du of Praxair, Inc. and Stephens Lee of PricewaterhouseCoopers

Upcoming Events

WASHINGTON

Issues Luncheons
May 18, 2006
June 15, 2006
July 20, 2006

June 5, 2006
33rd Annual Membership Meeting and Evening Reception for Incoming USCBC Chair W. James (Jim) McNerney Jr., Chairman, President, and CEO of the Boeing Company
For more information, see p.19

Jim Boyce

USTR General Counsel James Mendenhall in Beijing

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Letter from US Treasury Secretary John W. Snow

The Treasury Department has participated in an ongoing and productive dialogue with our Chinese counterparts on the importance of fostering deeper financial markets and a greater range of financial services products. Financial sector development is in China's interest. It would result in increased domestic spending in China, and together with a more flexible exchange rate, help encourage more balanced growth.

Financial sector reform will also improve the quality and efficiency of China's domestic investment. The development of a greater array of insurance and savings products, including those for retirement, will provide for greater income security, encourage increased consumption, and improve standards of living. In order to achieve these important reforms, China must further open its financial sector to competition, establish risk-based supervision and improved risk management, and broaden opportunities for private sector companies.

Real progress has been made on these issues through senior-level participation in important forums like the US-China Joint Economic Committee and the recently launched Sino-US Financial Sector Working Group. These groups bring together senior officials and staff from all US and Chinese financial regulators to discuss key prudential, market development, and market access issues.

While we proceed down this path of continued financial sector reform, the US-China Business Council will remain an integral partner in these efforts.

美国财政部部长约翰·斯诺的信

美国财政部正在与中国有关部门进行卓有成效的对话，讨论完善金融市场和扩展金融服务产品的重要性。金融业的发展符合中国的利益。它将带来中国国内消费的增加，并与更灵活的汇率一起，促进经济的均衡增长。

金融业改革还将改善中国国内投资的质量和效率。开发更丰富的保险和储蓄产品，包括为退休员工服务的产品，可以增加收入保障，促进消费增长，改善生活水平。为了实现这些重要的改革，中国必须进一步开放金融业的竞争，建立基于风险的监管方式，改进风险管理，并给予私营企业更多的机会。

通过由两国高层参与的重要对话机制，诸如美中经济联委会和最近启动的中美金融工作组，美中双方已经在这些问题上取得了实质性的进展。这些会议将美中两国金融监管部门的高级官员及工作人员带到一起，共同探讨金融市场审慎监管，市场发展，以及市场准入方面的关键性议题。

在我们致力于推进这一金融改革的进程中，美中贸易全国委员会将会一直是我们不可缺少的合作伙伴。

A Message from US Securities and Exchange Commission Chairman Christopher Cox

China's vast population and its very name—the Peoples' Republic of China—are constant reminders of the importance of placing people first. From America's earliest days, our Founding Fathers understood the value of thinking of the people first. That's why they announced their intentions to the world by starting the Preamble of our Constitution with the words "We the People."

It is for this reason that the first responsibility of our capital market regulators is to the people. We are charged with protecting investors. The investor is at the heart of what we do. The Securities and Exchange Commission (SEC) and the China Securities Regulatory Commission (CSRC) have a strong interest in working together to protect investors in our capital markets.

China's emergence as a participant in the global economy is transforming international finance. The CSRC and the SEC have a key role in facilitating this evolution, through rules that promote high-quality disclosure, fair and orderly markets, and efficient capital formation. Together with vigilant enforcement, this will help ensure that investors get the information they need to make sound decisions.

As China focuses on the establishment of improved corporate governance, strengthened accounting standards, and investor confidence, America and the SEC stand ready to help. Already, we have trained hundreds of Chinese securities regulators and other officials in Beijing and in Washington in subjects ranging from money laundering to insider trading to market manipulation.

The 19th century French liberal thinker Frederic Bastiat observed that commerce between nations is the best assurance that their relations will be harmonious. Our commerce is already great, but we can do much more to enhance harmony. Three key areas, which are critical to well-functioning capital markets, are shareholder democracy; access to material information; and tough, independent regulation. In my view, our two nations have but one wise course, and that is to work together to ensure that these three ingredients help nourish our markets and protect our investors.

美国证券交易委员会主席克里斯托弗·考克斯致辞

中国众多的人口及其国名“中华人民共和国”，不断提醒我们将人民放在首位的重要性。在美国历史的早期，我们的开国领袖就已意识到优先为民众考虑的重要性。因此，他们在美国宪法的导言中，以“我们——人民”作为开头，向全世界表明了他们的用意。

也正是因此，向公众负责是我们资本市场监管人员的首要职责。我们被赋予了保护投资者的责任。投资者就是我们工作的重心。美国证券交易委员会和中国证券监督管理委员会应该携手合作，共同保护我们资本市场中的投资者。

中国成为全球经济共同体中一员的事实，正在改变着国际金融市场。美国证交会和中国证监会在促进这一演变的过程中，通过制定法规促进高水平的信息披露、公平有序的资本市场及高效率的资本筹集，将能够发挥关键性的作用。严谨地执行这些法规，将有助于确保投资者获得必要信息，作出正确决策。

当前中国正关注于改善公司治理机制，提高会计标准，增强投资者信心。对此，美国和美国证交会愿意助一臂之力。我们已经在北京和华盛顿为中国培训了数百名证券监管人员及相关官员，培训课题包括反洗钱、反内幕交易和市场操纵。

十九世纪法国自由派思想家弗雷德里克·巴斯蒂亚特(Frederic Bastiat)洞察到，国与国之间的商贸往来是它们和谐关系的最佳保证。我们两国之间的商贸往来已经开展良好，但是我们完全可以做得更好，来增进两国的和谐。对于一个运作良好的资本市场而言，以下三个领域至关重要，那就是股东的民主权益，获取信息的通畅渠道，以及严格而独立的市场监管。我认为，我们两国只有一条明智的道路，那就是携手合作，共同确保这三大要素促进资本市场的繁荣并保护投资者的权益。

China Conference Calendar

China-related events near you

May–June 2006

Please confirm dates and venues with organizer prior to attending events. To include your event in our next issue, send your event announcements to Jesse Marth at jmarth@uschina.org.

Western China Airport Summit, May 26–27

China Business Conference

MAY 15–17, 18–19, AND 22–24

This series of events covers the nuts and bolts of preparing a realistic China strategy. Presenters include US Commercial Service officers, private sector specialists, and US exporters.
Location: Houston, TX; Washington, DC; and Cleveland, OH
Organizer: US Commercial Service, US Department of Commerce
Tel: 1-800-USA-TRADE
E-mail: chinabic@mail.doc.gov
www.export.gov/china

National Hardware Show

MAY 9–11

Manufacturers and resellers at this event will explore options for entering the China market.
Location: Las Vegas Convention Center
Organizer: Reed Exhibitions
Tel: 1-888-425-9377
E-mail: inquiry@hardware.reedexpo.com
www.nationalhardwareshow.com

CONEXPO Asia 2006

MAY 15–18

CONEXPO brings together manufacturers of equipment, products, and services related to the construction industry in China and Asia.
Location: Beijing: China National Agricultural Exhibition Center
Organizers: China Chamber of Commerce, PRC Ministry of Communications
Tel: 1-800-867-6060
E-mail: info@conexpoasia.com
www.conexpoasia.com

International Building & Construction Trade Fair 2006

MAY 23–26

Shanghai's largest construction fair, the event highlights everything from engineering and design to importing and exporting.
Location: Shanghai New International Expo Center
Organizer: Worldwide Exhibition Services
E-mail: info@wes-expo.com.cn
www.wes-expo.com.cn

ELE/PT Communications China 2006

MAY 23–26

This event covers advanced information communication technology, including third-generation mobile communication and smart networks.
Location: Shanghai New International Expo Center and Shanghaimart
Organizers: Shanghai International Exhibition Co., China P&T Appliances
Tel: 86-21-6279-7630 x 6245
E-mail: jane.shen@mail.doc.gov
www.siec-ccpit.com

Semiconductor Industry Forum

MAY 24–26

Experts from both the United States and China will explore how best to integrate the Chinese circuit industry with its broader electronics industry.
Location: Guangzhou Yihe Hotel
Organizer: Guangdong Semiconductor Industry Association
Tel: 86-20-8391-8698
E-mail: yisheri@globaleight.com

Western China Airport Summit 2006

MAY 26–27

This event focuses on future development opportunities for Western China's airport industry.
Location: Chengdu, Sichuan
Organizers: Western China International Economy Trade Fair, Global Integrated Solutions
Tel: 86-21-5169-6210
www.westernchinasummit.org/
www.westernchinafair.org

The Fifth Wuhan International Conference on E-Business

MAY 27–28

This year's conference spotlights the management and measurement of performance in enterprise computing environments. Topics include e-business, innovation management, and international finance.
Location: Wuhan Lake View Garden Hotel
Organizers: China University of Geosciences, International Business Interface, Inc.
Tel: 86-27-6788-3357
E-mail: fhuang@alfred.edu
www.whiceb.com

Guangzhou International Lighting Exhibition

JUNE 8–11

Asia's largest lighting and building event of the year explores further expansion into the Chinese market.
Location: Guangzhou International Convention & Exhibition Center
Organizer: Guangzhou Guangya Messe Frankfurt
Tel: 852-2802-7728
E-mail: info@hongkong.messe frankfurt.com
www.light-building.messefrank furt.com

China International Consumer Goods Fair

JUNE 8–12

This export-oriented event will showcase thousands of consumer goods made in China.
Location: Ningbo International Convention & Exhibition Center
Organizer: China International

Consumer Goods Fair Organizing Committee
Tel: 86-21-6279-7630 x 6245
E-mail: jane.shen@mail.doc.gov
www.siec-ccpit.com

All in Print China 2006

JUNE 14–17

All in Print covers the latest trends in global printing technologies, while seeking solutions to integrating printing systems.
Location: Shanghai New International Expo Center
Organizer: Messe Düsseldorf
Tel: 86-21-6279-7338
E-mail: vivian@mdc.com.cn
www.aipchina.com

The 14th International Electronic Equipments & Components (China) Fair

JUNE 19–21

This show features the latest in electronic equipment technology, electronic components, and photo-electronic technology.
Location: Shenzhen: China Hi-Tech Fair Exhibition Center
Organizer: Shenzhen Dowell Industrial Co., Ltd.
Tel: 86-21-6279-7630 x 6245
E-mail: jane.shen@mail.doc.gov
www.e-dowell.com

Medical Equipment Design & Technology Exhibition (MEDTEC) Shanghai

JUNE 21–23

MEDTEC Shanghai features leading medical technologies from global suppliers. The exhibition also includes a conference on the latest quality and manufacturing issues.
Location: Intex Shanghai Exhibition Center
Organizers: Cannon Communications LLC, China Association for Medical Devices Industry
Tel: 86-21-6272-4673
E-mail: medtecshanghai@e21mm.com

WoodBuild China 2006

JUNE 27–30

WoodBuild China 2006 hosts more than 380 exhibiting companies from 12 countries displaying the latest in manufacturing, woodworking, and forestry machinery.
Location: Shanghai New International Expo Center
Organizers: Hong Kong Exhibition Services Ltd., Allworld Exhibitions
Tel: 86-21-6209-5209 x 15
E-mail: Margaret@chinaallworld.com
www.woodbuildchina.net

USCBC 33rd Annual Membership Meeting and Reception for Incoming USCBC Board Chair

June 5, 2006 Washington, DC

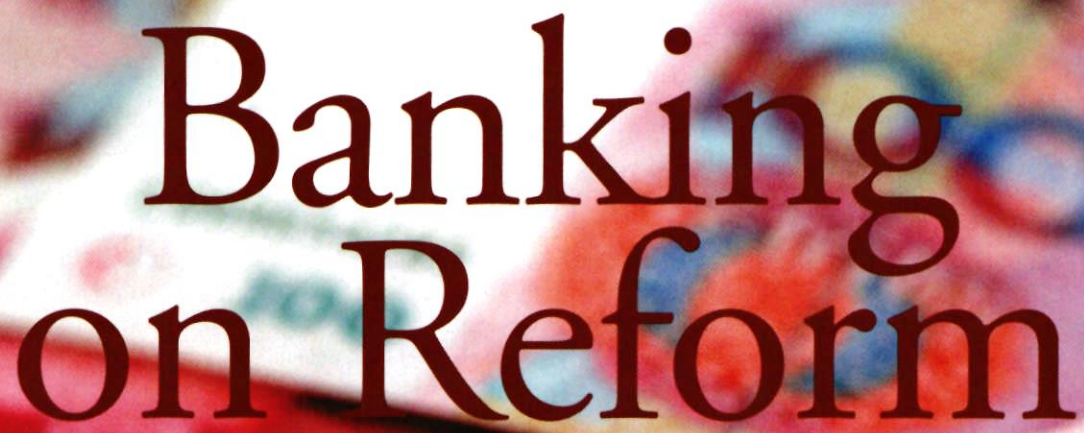
A members-only conference
8:30 am – 2:00 pm
St. Regis Washington

Mid-year update on
- US-China commercial relations
- China trade politics in Washington
- Top operating issues and best practices

Luncheon Keynote
Bilateral Relations after PRC President Hu Jintao's US Visit
Lt. Gen. Brent Scowcroft, USAF (Ret.), President, The Scowcroft Group

Evening reception for incoming USCBC Chair
W. James (Jim) McNerney Jr.,
Chairman, President, and CEO of the Boeing Company
5:30 – 7:00 pm
Sewall-Belmont House and Museum

For more details and registration information, see **www.uschina.org**
Contact: Gloria González-Micklin, USCBC Director of Programs, Tel: 202-429-0340, programs@uschina.org



Banking on Reform

Recent reforms have helped China avoid a banking collapse. But how will its banks hold up when the sector fully opens to foreign competition?

Stephen Thomas and Chen Ji

China's banks have played a crucial role in the country's dramatic economic growth. Since economic reforms began in 1978, they have provided the majority of banking services. Last year, they accounted for about 90 percent of China's financial intermediation—the movement of funds from savers to borrowers. Despite the banking sector's importance to the country's economy, China's four largest commercial banks—the Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), and Agricultural Bank of China (ABC)—known collectively as the Big Four, did not undergo the level of reform carried out in the rest of the economy until 1998.

In the first two decades of the reform era, the Big Four were entirely state owned and controlled and were largely insulated from market forces. Consequently, these banks suffered from severe weaknesses: high levels of nonperforming loans (NPLs); overstaffed and inefficient operations; and untrained and often corrupt managers and staff. By 1998, the NPL ratio of the Big Four was as high as 40 percent, according to foreign observers. China's banks were technically insolvent, and numerous bank officials were tried and convicted of fraud and theft of bank funds. Aware of the banks' problems, the PRC government stepped up solicitation of recommendations from foreign banking experts in 1999. The government then launched several reforms to spark a radical turnaround in the Big Four. Though the reforms benefited the banking industry in many ways, they have not solved all of its problems. Whether the banks will be ready for foreign competition at the end of 2006—when, according to its World Trade Organization (WTO) commitments, China must open its banking sector fully—is open to question.

Motives for reform

PRC political and financial leaders have pursued bold banking reforms since 1999, when the government began to tackle the Big Four's NPL problems through asset management companies (AMCs). Three developments convinced China's leaders of the need to reform:

■ The Asian financial crisis

Though PRC policymakers kept the 1997–98 Asian financial crisis at bay (partly because of the inconvertibility of the Chinese currency) and never devalued the renminbi (RMB), they became acutely aware of the dangers of bank collapses and financial downturns, as well as the costs of a financial crisis to a country's economic and social well-being.

■ China's WTO commitments

As part of its WTO entry package in 2001, China agreed to open its almost wholly state-owned banking sector to foreign competition completely by December 2006. The country has had much to do to prepare for the sector openings.

■ Limitations of China's financial intermediation process

By 1998, PRC officials had established some of the more conventional methods for financial intermediation—such as stock markets, bond markets, and an insurance industry—in addition to banking (see the *CBR*, January–February 2005, p.30 and January–February 2003, p.36). In 2001, however, plans to float previously nontradable state-owned shares spooked the stock markets, which began a five-year slump; China's commercial bond market was put on hold because of defaults; and China's insurance industry was still in its infancy. Consequently, by the end of 2005, China's banks accounted for the intermediation of up to 90 percent of China's growing capital pool, excluding government bonds. Most of the capital was deposited by the country's prodigious savers, who have saved about 40 percent of their income, accumulating ¥14.7 trillion ($1.8 trillion) in savings. This level of intermediation is somewhat higher than that of other developing economies in Asia, and much higher than those of most developed capital markets, such as the United States. The Big Four together granted roughly three-quarters of China's commercial loans and held just over half of China's total banking assets at the end of 2005. In contrast, US banks hold about 15 percent of assets.

As the need for reforms grew, particularly in the Big Four banks, the PRC government began to launch legal, prudential, corporate governance, and operational reforms.

Legal reforms

The government embarked on a series of bank reforms in the 1980s and 1990s (see Figure). After China's 2001 WTO entry, these reforms accelerated to move the banking sector closer to international best practices. In late 2003, China amended the PRC Law on the People's Bank of China (PBOC) and the PRC Commercial Banking Law to establish the China Banking Regulatory Commission (CBRC) to oversee the banking industry.

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The authors wish to acknowledge support for this research from the Institute for International Business, University of Colorado at Denver and Health Sciences Center.

Figure: Key Events in China's Banking Reform

1983–84	The PRC government spins off four major state-owned banks (the Big Four)—the Bank of China, Industrial and Commercial Bank of China, China Construction Bank (CCB), and Agricultural Bank of China—from the People's Bank of China (PBOC).
1994	China reorganizes the Big Four into commercial banks to be operated on a profit-and-loss basis.
	China also establishes three policy banks—China Development Bank, Export-Import Bank of China, and China Agricultural Development Bank—to perform policy-lending functions.
1995	The PRC Law on the PBOC allows PBOC to act only as a central bank, overseeing China's monetary policy and regulating the entire financial sector, rather than carrying on commercial banking functions.
	The PRC Commercial Banking Law establishes the Big Four banks as joint-stock companies and removes insurance and securities regulatory functions from PBOC.
1996	China permits the establishment of Minsheng Bank, China's first publicly traded, largely private bank.
1999	China sets up four asset management companies, one for each of the Big Four, to relieve them of some of their nonperforming loans.
2001	China joins the World Trade Organization (WTO) and promises to open its banking sector gradually to foreign firms.
2003	China amends the PRC Law on the PBOC and the PRC Commercial Banking Law to establish the China Banking Regulatory Commission (CBRC) to oversee and regulate the banking industry.
	China establishes Central Huijin Investment Co., Ltd. to funnel foreign exchange from the State Administration of Foreign Exchange to large state-owned banks.
2004	Revisions to China's banking laws further separate PBOC and CBRC and allow the Big Four to carry out commercial banking activities.
2005	CCB lists on the Hong Kong Stock Exchange, marking the largest initial public offering in the history of that stock exchange.
2006	Under China's WTO commitments, the country is scheduled to fully open its banking sector to foreign banks by December 11.

The government also issued regulations to permit and regulate foreign investment in China's banks. According to these regulations, a foreign investor may hold a stake of up to 20 percent in any one bank; total foreign ownership of any one bank is capped at 25 percent.

Further revisions to China's banking laws took effect in February 2004. Changes to the PRC Law on the PBOC strengthened the central bank's responsibility for monetary policy and stated that it would no longer regulate financial institutions. Revisions to the Administrative Measures on the Supervision of the Banking Industry assigned CBRC responsibility for regulating all banks and other depository institutions and incorporated international norms for banking supervision to improve risk management. In addition, changes to the PRC Commercial Banking Law freed the Big Four from the requirement to provide loans to State Council-approved projects and permitted them to carry out commercial banking activities—such as trading government bonds, dealing in foreign exchange, and offering credit card services.

These legal reforms moved China's banks to a system more closely modeled on modern banking operations, with institutional structures and practices comparable to those of commercial banking systems in developed countries.

Prudential reforms

China also began bringing its banking sector up to internationally accepted financial standards. PRC banks had been burdened by high levels of NPLs, a result of policy loans to large state-owned enterprises. The loans had been based on government-mandated quotas, rather than on profitability analyses and credit evaluations. Fixing these money-losing lending patterns would require a series of changes in business practices.

The PRC government's most immediate goal was to recast the Big Four banks as functioning commercial banks rather than as extensions of the government treasury. After the government turned the Big Four into commercial banks in 1994, it gave bank managers a measure of independence from the government and charged them with developing a credit culture (making loans based on creditworthiness rather than on personal connections or government directives), setting up accountability systems for their performance, developing new products and services, and providing bank directors and managers incentives based on financial performance.

Even with these new structures and regulations, change in actual banking practices was slow in the 1990s. Banks continued to suffer from a large NPL burden, the lack of a credit culture, and corporate governance that was not based on international best practices. In addition, government ownership helped maintain an old "state bank" mentality, meaning that banks were driven by government directives rather than by profits.

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Reducing NPL levels and infusing new capital

To redress some of the financial damage done to the banks during their days of policy-driven lending, in 1999 the government set up an AMC for each of the Big Four banks to reduce its NPL level. These AMCs together initially took on NPLs worth ¥1.4 trillion ($169 billion) and have since slowly sold or auctioned off some of these distressed assets (see p.30).

In 2003, the PRC government established the Central Huijin Investment Co., Ltd. (Huijin)—a wholly owned government investment company that funnels foreign exchange from the State Administration of Foreign Exchange (SAFE) to large state-owned banks. So far Huijin has directly infused capital in the form of foreign exchange (rather than RMB bonds as in previous recapitalizations) to increase bank capital reserves. In exchange, Huijin has taken more than 85 percent of the ownership of CCB and 100 percent of BOC. It has made similar cash injections into ICBC and ABC.

By 2005, government capital spending on both NPL reduction and capital infusion into the Big Four banks reached roughly $250 billion. After the possible recovery of about 30 percent of past bad loans, the NPLs of all Chinese commercial banks at the end of 2005 still amounted to about 8 percent of China's 2005 GDP. Fortunately, China's vibrant economy includes a huge pool of foreign exchange reserves, which reached about $875.1 billion at the end of March 2006 and which has been used to pay for the NPL reductions and capital infusions.

In 2003, revisions to the Commercial Banking Law made a second source of capital infusion possible by per-

mitting foreign investments and requiring Chinese banks to have foreign strategic partners if they wish to offer shares to foreign capital markets. In 2004, CCB sold 9 percent of its shares to its strategic partner Bank of America Corp. (BAC) for $2.5 billion and, in exchange, agreed to put BAC's head of corporate planning and strategy, Gregory Curl, on CCB's new 15-member board. CCB also increased its capital levels by issuing subordinate bonds, which, along with NPL reductions, allowed it to list shares on the Hong Kong Stock Exchange.

Corporate governance reform

The third area of China's interrelated and mutually dependent bank reforms is corporate governance. China has initiated a series of internal governance reforms to bring its banks into compliance with internationally accepted best practice standards and policies.

For example, CCB—the most advanced of the four banks in its level of reforms—has reduced the size of its board of directors from 60 to 15. The bank has also set up a supervisory board, a common practice in Asia. In effect, these reforms mean that a new and smaller board of directors, representing the new Chinese and foreign owners, can now determine CCB's accounting, auditing, supervision, personnel, and compensation policies.

In another change, officials began to investigate and prosecute illegal activities and corrupt officials more thoroughly. Even as CCB was being vetted to launch an initial public offering (IPO) on the Hong Kong Stock Exchange, several top management officials including the former president were charged, tried, and convicted of economic crimes dealing with the bank.

Streamlining operations and adopting new business models

The Big Four are, by international standards, excessively overstaffed. To compete with foreign banks, they will have to cut staff and branches considerably. In 2004, CCB cut the number of its bank branches by one-third and the number of its employees by nearly a quarter. BOC has made similar cuts. CCB has also developed long-term plans for upgrading the training and education of all its employees.

To modernize their business models, the Big Four are adding new good corporate customers and designing prudent loan approval processes. They have also added new lines of banking business, such as home mortgages, car and consumer loans, automated teller machines, and credit cards, which should allow them to reap higher profits. For example, as part of its agreement with BAC, CCB brought in 50 BAC experts to help upgrade CCB operations in risk management, global treasury services, and information technology—areas where BAC has strong expertise. The BAC experts also developed new products and services, such as personal wealth management and credit card services.

The Big Four are, by international standards, excessively overstaffed. To compete with foreign banks, they will have to cut staff and branches considerably.

Positive results...

Despite past dire warnings and continuing concerns, China's bank reforms appear to have moved its banks, particularly the three strongest of the Big Four (CCB, BOC, and ICBC), down the road toward solvency and success. Three main indicators—outside evaluations, outside strategic investments, and retail investments—reveal that China's banks have made significant improvements.

First, beginning in 1998, China's Big Four bank ratings began moving up in all categories, even for the weakest of the Big Four—ABC. By 2004, Moody's Investor Services had characterized China's bank reforms as "positive" and again adjusted its ratings upward. In February 2006, Moody's further upgraded BOC and CCB in overall financial strength and short-term deposits. Though China's ratings are still low by European and American standards, they are now comparable to

Table 1
Moody's Ratings of China's Big Four Banks

	Bank Deposit				Senior Long-Term Debt*		Financial Strength	
	Long-term		Short-term					
Bank	1997	2006	1997	2006	1997	2006	1997	2006
Agricultural Bank of China	Baa2	A2	P3	P1	Baa2	NA	E	E
Bank of China	Baa2	A2	P3	P1	Baa2	A2	E+	D-
China Construction Bank	Baa2	A2	P3	P1	Baa2	NA	E	D-
Industrial and Commercial Bank of China	Baa2	A2	P3	P1	Baa2	NA	E	E+

Notes: 2006 ratings as of April 1, 2006. For Moody's ratings definitions, see www.moodys.com. NA = not available.
*Senior debt = Debt that must be repaid before subordinated debt, in the event of liquidation.
Source: Moody's Investor Services

those of banks in countries such as India and Indonesia and are at their highest levels since 1997 (see Table 1).

Second, beginning in 2003 and accelerating in 2004, major world-class financial institutions became increasingly willing to invest in Chinese banks. These institutions include BAC and Singapore's Temasek Holdings Pte. Ltd. investing in CCB; the Royal Bank of Scotland Group, Temasek, and UBS AG investing in BOC; and Goldman Sachs Group Inc., Allianz AG, and American Express Co. investing in ICBC. BAC has been particularly active and has so far bought 9 percent of CCB for about $2.5 billion, with an option to purchase an additional 10 percent on favorable terms.

Third, in October 2005, CCB successfully listed on the Hong Kong Stock Exchange, raising $9.2 billion, the largest IPO in the history of that exchange. In April 2006, these shares in the secondary market were trading at a premium of 47 percent, an indication of investors' confidence in CCB's future performance.

CCB is clearly leading the way on bank reform, and BOC, ICBC, and ABC will almost certainly follow. Indeed, BOC and ICBC have also received capital infusions from Huijin, accepted foreign strategic partners, reorganized their boards, and plan to list in late 2006.

...But more needs to be done

Despite this progress, observers still spot many weaknesses in China's banking reforms. Foreign financial institutions have expressed various concerns:

Independent problem solving

The reduction of NPL ratios and the recapitalization of the banks occurred because of efforts external to the banks themselves, mainly by Ministry of Finance-funded AMCs and Huijin's capital injections. The banks were unable to solve their problems independently, and they may have difficulty solving their own problems now. The average NPL level of the Big Four, at 10.4 percent of total loan portfolios, is still high by international standards. Though CCB is in the best shape of the Big Four, in 2004 it had an NPL ratio of 3.9 percent compared to BAC's 1 percent and Hong Kong banks' average of about 2 percent (see Table 2). If the Big Four banks do not further improve their credit culture, risk assessment methods, lending practices, and product mixes, they may repeat past mistakes by making loans to old corporate customers that are unable or unwilling to repay, leading to the accumulation of new NPLs. Currently, most potentially bad loans are granted by the three largest policy banks, China Development Bank, China Export-Import Bank, and China Agricultural Development Bank. But the Big Four still approve some loans for inefficient state-owned enterprises, and these loans could become NPLs. A downturn in the Chinese economy could also create NPLs, even in the new category of consumer and mortgage loans, which accounted for 16 percent of the total banking portfolio at the end of 2004, up from zero in 1997.

Corporate culture

The corporate culture of the Big Four still lacks a developed profit motive. Some old lending practices persist, such as focusing on market share rather than profitability and providing loans based on direct orders from the government rather than ability to repay. Shareholder accountability is also lacking. This may be because the PRC government is still the majority owner of the Big Four (Huijin owned 64 percent of CCB at the end of 2005), and recent remarks by PRC officials indicate that the government intends to retain control for the foreseeable future. Also, the Big Four's senior management teams still consist of PRC government officials, whose loyalties are divided between the government and stockholders.

Low profitability

The Big Four still have a relatively low level of return on equity (see Table 3). The Hongkong and Shanghai Banking Corp. Ltd. noted that from 2001 to 2003, every state-owned commercial bank posted an annual return on equity of less than 5 percent, compared with developed-economy banks such as BAC, which had an average return on equity of 18 percent from 2001 to 2003. If the quality of the Big Four's current loan portfolios deteriorates because of, for example, a real estate downturn, the banks will again face more NPLs.

Competition

One concern for the Big Four will be increased competition from both Chinese and foreign banks in the future. Chinese banks, particularly the partly private ones such as Minsheng Bank and China Merchants Bank, may provide

Table 2
Nonperforming Loans of the Big Four (% of total loan portfolio)

	CCB	BOC	ICBC	ABC
2004	3.9	5.1	19.0	26.8
2003	9.1	16.3	21.2	30.8
2002	15.2	22.5	24.4	36.6

Note: CCB = China Construction Bank; BOC = Bank of China Group; ICBC = Industrial and Commercial Bank of China; ABC = Agricultural Bank of China
Sources: ABC, BOC, CCB, and ICBC financial statements

Table 3
The Big Four's Rates of Return, 2004 (%)

	CCB	BOC	ABC	ICBC
Return on assets	0.90	0.51	0.05	0.04
Return on equity	17.50	1.20	2.57	1.40

Sources: ABC, BOC, CCB, and ICBC annual reports

better service—at lower cost—than the Big Four. Foreign banks, ready to enter China's banking sector fully at year's end, will intensify the competition. The Big Four may also increasingly compete with each other. BOC and ICBC will be particularly challenging to competitors if they can follow CCB's lead and lower their level of NPLs, improve their corporate governance, increase their capital, and list in Hong Kong.

Despite past dire warnings and continuing concerns, China's bank reforms appear to have moved its banks, particularly the three strongest of the Big Four, down the road toward solvency and success.

Duration gap

A substantial "duration gap," a mismatch between short-term loans and short-term deposits, exists. For example, CCB's short-term loans make up about 52 percent of its loan portfolio, while short-term deposits stand at 92 percent of total deposits.

New NPLs

In 2004, China's banks experienced rapid loan growth of roughly 13 percent (which lowered NPL ratios simply through dilution), while GDP grew only about 10.1 percent. Lending slowed in 2005, but even this slowdown will not benefit banks unless the new loans are of better quality. Provisions for loan losses and coverage levels (the ratio by which assets cover specific liabilities) therefore need to be higher.

Overcoming obstacles

China's largest banks have made substantial progress over the last three to four years, and the improvements are likely to continue. The banks must, however, overcome some remaining obstacles—including the traditional mentality of mid- and lower-level banking staff who still follow practices from China's former state-planning system and neglect both customers' needs and shareholders' interests. The Big Four must also continue to streamline their operations, increase profitability, and complete important reforms currently under way.

Even with effective banking reforms, China's banks may face serious domestic problems if a real estate bubble bursts or the domestic economy turns downward. China could also encounter major problems if the global economy slows significantly or if US trade policies reduce China's export levels and hurt its economy.

It is more likely, however, that the opening of China's banks to foreign strategic partners, improvements in bank governance structures, and rapid professional development and overhaul of their staffs will make the Big Four banks more competitive in domestic and international markets by the end of the year. China's emerging shareholding bank sector, which includes China Merchants Bank, Communications Bank of China, and Minsheng Bank, will also provide stiff competition for foreign banks.

Although the continued dominance of domestic banks in China's banking market will not make China radically different from most other Asian countries, it may dash foreign investors' hopes of quickly gaining a large market share. Large foreign banking institutions will need to choose whether to join the Big Four—or other shareholding or regional banks—as strategic partners or to begin the longer, more time-consuming process of developing market share by providing better banking services in niche markets. 完

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Challenges and Opportunity for China's Financial Services Industry

Jack J. Ribeiro is a vice chairman of Deloitte and Touche USA LLP and managing partner of Deloitte Touche Tohmatsu's (DTT) Global Financial Services Industry group. With almost 30 years of financial services experience – much of it in the Asia-Pacific region – Jack's initial experiences in Greater China date back to the 1980s, when he was asked to lead the Deloitte's financial services practices of the DTT member firms in Hong Kong and China. He later became a founding member of the organization's China Business Services group – established to help advise foreign clients seeking to do business in China – and remains a frequent visitor to China and a trusted adviser to clients there. As the sector fully opens up to foreign participation at the end of 2006, Jack recently shared his views on how far China has come, and where the main challenges and opportunities lie ahead.

Q: How would you describe China's current financial services environment? And what can the PRC government do to improve the financial services environment?

A: China's financial services environment is at a very interesting stage of development right now; however, there are still some major hurdles that I believe the government needs to address.

First, the government needs to continue to support an environment for good corporate governance – including increased transparency, and improved risk management procedures. PRC banks had poor lending habits in the past, including loans directed for government policy purposes – resulting in very high ratios of nonperforming loans – and so the banks need to be encouraged to improve their governance standards as they relate to lending. To support risk management efforts, the government should also encourage domestic banks to put in place effective technology systems to monitor their risks.

Second, the PRC government needs to ensure that the regulatory environment continues to evolve. Substantial efforts have been made to improve regulation, but the government needs to ensure demonstrable compliance with international standards, if China wants to see a continued growth in foreign investment into the financial services industry.

Third, I would recommend that the PRC government accelerates its plans to adopt a banking deposit insurance system. The Chinese have a great knack for savings – China's savings rate is over 40 percent of its GDP. However, competition to attract some of these savings away from the giant State-Owned Commercial Banks and toward the smaller start-up banks is unlikely to take hold until a deposit insurance system is in place, deigning customers the benefits of a truly competitive environment. Although the PRC government has discussed implementing a deposit insurance system for some time, and drafted measures in 2005, to date these measures remain unapproved by the State Council. Finally, the PRC government needs to establish some form of intermediary body that can oversee reform in the financial services industry. This body would remove the difficulties inherent in the government reforming an industry in which it is still the major shareholder. The government has already taken similar action in regard to general State-Owned Enterprises (SOEs), with the creation in 2003 of the State-Owned Assets Supervision and Administration Commission (SASAC).

I believe the time is ripe for a similar body, specifically focused on the financial services industry.

> China's financial services environment is at a very interesting stage of development right now

Q: What is your advice to foreign companies entering China's financial sector? What difficulties should they be aware of?

A: My advice today is similar to the advice I gave three years ago, when I was based in the region. First, if a foreign company is looking at China as an investment opportunity, then it needs to view it as a long-term opportunity. There may not be a significant return in the short to medium-term. Second, many financial institutions will select a joint venture [JV] partner as part of their entry strategy for China. If they do so, they need to understand the goals of the JV partner and make sure both parties have similar values and expectations. Failure to do so often leads to disagreements and difficulties as soon as the venture begins to grow. All companies should take time to know their partners – and take a long-term view of their relationship together in China. The third thing to remember is that, although the Chinese are still developing their understanding of financial markets, risk management, corporate governance, and all the other practices we take for granted in the west, they do still have the advantage over foreign

companies in that they have established networks within the Chinese market and know the local customs and behaviors of their existing customers.

All companies should take time to know their partners--and take a long-term view of their relationship together in China.

Q: According to China's World Trade Organization (WTO) entry agreement, China's financial services sector will fully open to foreign companies by December 2006. Do you recommend that foreign companies stay in JV models, or aim to become wholly-owned?

A: While China's WTO commitments mean that foreign companies won't officially need to proceed with a JV partner, in practical terms it will be more costly and difficult to set up an enterprise without the help of a local partner, particularly in a service industry like financial services, where in-depth knowledge of customer behavior is paramount. Still, some companies will probably try to enter the market without a JV, and so my advice to them would be to analyze the field carefully, and be aware of the strategic decisions they will have to make. Should they 'build' or 'buy', for example; 'build' their business locally, employing their know-how from years of western operations, or 'buy' their way into an existing local concern, and attempt to grow it from there? There is no correct answer, as each situation is different. However, foreign companies that decide to proceed without a local JV partner need to go in with their eyes open.

Q: How do you see the future of China's financial services sector?

A: If you look at China's financial service industry today compared to five years ago, you'll see significant developments. Almost everything China is doing moves it further down the path to a more secure financial system; it is taking positive steps forward. The question that remains is whether this change is happening quickly enough – especially considering China's WTO commitments due at the end of the year. There are many other developing markets, many of which already have the desired regulatory structures in place, all competing for foreign investment, and so it is in China's interest to increase the pace of change if it is to enjoy the full benefits of the current foreign interest.

However, when all is said and done, China is likely to become one of the biggest marketplaces in the world for financial services within the next decade. Though Hong Kong has a well established financial services sector, Shanghai will likely become the financial services epicenter for Asia – possibly even surpassing Tokyo. And in 10 to 15 years, Shanghai could be equal to the London and New York markets in terms of the volume of business transacted.

Once Chinese consumers have full confidence in the country's financial services sector, they will invest more of their savings in China's markets through local financial services providers. And once international investors become confident that PRC banks are in sound financial and regulatory shape, more foreign investment will flow in as well. I'm very bullish on the future of the industry in China.

Q: What services does your organization offer in China to help financial services companies meet these challenges?

A: Deloitte Touche Tohmatsu CPA Ltd. in China offers four main business services: audit, tax, consulting, and financial advisory services. Each of these service lines is comprised of many specialist services lines – including areas of particular interest to Chinese businesses right now, such as risk management, corporate governance, technology and security. And each of these services is delivered with a strong industry specialization, ensuring that clients receive advice tailored to take account of the particular circumstances within their sector and their country. ■

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China's NPL Market,

Revealed

Insiders in the growing market for distressed assets in China share their views

Victor Shih and Louie Huang

China's four state-owned asset management companies (AMCs)—formed in 1999 to help solve the country's significant nonperforming loans (NPLs) problem—are approaching the PRC State Council's December 31, 2006 deadline to offload the original ¥1.4 trillion ($169 billion) in NPLs that they acquired in 2000. Since then, the AMCs have also taken on more than ¥600 billion ($74.9 billion) in additional NPLs, and more are expected to flow to the AMCs as the Industrial and Commercial Bank of China (ICBC) and the Agricultural Bank of China (ABC) restructure in preparation for listings. Separately, banks acquiring new NPLs are beginning to sell them directly to investors and are securitizing them for auctions. As a consequence, China's NPL market will likely experience a flurry of activity through this year and beyond.

At the same time, however, many aspects of the market for distressed assets in China remain opaque to foreign investors. To understand the inner workings of this dynamic market, we interviewed 22 investors, regulators, and legal professionals involved in China's NPL market in Hong Kong, Shanghai, and Beijing in July and August 2005. We followed up these interviews with additional phone calls and e-mails. This article details the interviewees' understanding of the NPL market and their views on best practices. Because the interviews were conducted on the basis of confidentiality, the full identities of the interviewees are not disclosed.

The story so far

The PRC government created the AMCs in 1999 as a first step to solve the country's considerable NPL problem. With an initial capitalization of ¥40 billion ($4.83 billion) from the Ministry of Finance (MOF), the four AMCs—China Cinda Asset Management Corp., China

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Great Wall Asset Management Corp., China Oriental Asset Management Corp., and China Huarong Asset Management Corp.—were paired up with China Construction Bank (CCB), ABC, Bank of China (BOC), and ICBC, respectively, and took charge of a combined ¥1.4 trillion in distressed assets by the summer of 2000.

AMCs began selling distressed assets to foreigners in 2001, culminating in the Huarong I auction in which ¥10.8 billion ($1.3 billion) of NPL portfolios were auctioned off to a consortium of foreign investors led by Morgan Stanley. Since then, however, foreign activity in the NPL market has slowed in response to a series of regulatory changes—such as the shift from closed negotiations to open auctions mandated by MOF measures issued in April 2004—and by increased participation by well-funded domestic institutions. The subsequent Huarong II auction in 2003 fell flat, selling only 3 of 22 packages, and the 2005 Xinda auction saw a foreign boycott to protest the AMCs' sale of NPLs to each other at unrealistically high prices. As a result, one Hong Kong investor explained, foreign investors generally view the NPL market as "still frustrating."

Recent pressure on AMCs from the State Council to meet recovery quotas has led to a resurgence in deal flows. Milestones for foreign investors over the past several months include the November 2005 purchase of an ¥11 billion ($1.37 billion) portfolio by US-based DAC Management LLC and the January 2006 purchase of a ¥36.4 billion ($4.55 billion) portfolio by Silver Grant International Industries Ltd., a joint venture between Cinda and Citibank.

With just a few months left before the December 31 deadline, AMCs have yet to digest 40 percent of the NPLs from the original transfer. Some AMC managers are worried that breaking the deadline would tarnish their administrative records, while others are afraid that MOF may push to disband or merge lagging AMCs. As a consequence, activity in the NPL market is expected to increase for the remainder of 2006.

Several interviewees relayed horror stories of "brokers" who disappeared after receiving an up-front finder's fee or who promised an exclusive deal if a "service fee" was paid to an AMC or government official.

Sourcing NPLs

After five years of NPL market growth, foreign investors still face limited options when buying NPLs. AMCs remain the largest seller of distressed assets, although NPLs are increasingly bought directly from banks, companies, and court auctions.

When buying directly from AMCs, some investors interviewed expressed a preference for dealing with AMCs' branch offices, primarily because doing so allows investors to cultivate specialized local knowledge and networks, allowing for a more accurate evaluation of a portfolio's worth. In addition, local branches typically offer a greater degree of flexibility in dealmaking than headquarters. For example, branch offices are much more willing to engage in bilateral negotiations with prospective investors than headquarters.

Some investors also rely on "brokers," or knowledgeable local accounting or legal professionals who know about new portfolios on the market. Most interviewees advise exercising extreme caution when working with a broker, however. Several relayed horror stories of "brokers" who disappeared after receiving an up-front finder's fee or who promised an exclusive deal if a "service fee" was paid to an AMC or government official.

Auctions vs. negotiations

In the early years of the NPL market, NPLs were routinely purchased through closed negotiations between the investor and the AMCs. In April 2004, however, MOF issued measures indicating governmental preference for open auctions in the sale of NPLs.

Court auctions can sometimes be an attractive option because of the higher degree of transparency that comes with court supervision. In addition, assets that go through the court system are often "settled," meaning that the

Recovery Performance of the Four AMCs, Year-End 2005

Asset Management Corporation	Total Assets in 2000 (¥ billion)	Amount Digested (¥ billion)	Cash Recovered (¥ billion)	Cash Recovery Ratio (%)
Huarong	408	243	54	22
Great Wall	346	263	27	10
Cinda	373	201	63	31
China Orient	268	132	32	24
Total	**1,394**	**839**	**177**	**21**

Source: China Banking Regulatory Commission

bank and the borrower have already reached agreement on, for example, a guaranteed transfer of a property title. Finally, open auctions provide better-defined timetables and guaranteed government approval.

They also have drawbacks, however. First, open auctions leave foreign investors with limited flexibility in portfolio pricing and portfolio diversification. Moreover, investors generally face greater uncertainty in attempting to land a deal and have less time to evaluate the portfolio. Finally, as one Shanghai investor explained, "Negotiation is better for everyone. It cuts down on diligence costs because it helps investors get more information, which in turn de-risks investments and leads to higher prices for the AMCs." Thus, investors generally prefer direct negotiations to auctions.

Investors can nevertheless successfully navigate auctions by homing in on the assets in a particular province or region in the auction process, thereby landing a portfolio in which the investor has a comparative advantage. And negotiations are not necessarily finished at the end of an auction. If previously undisclosed information is revealed about a portfolio after the auction, the winning bidder reserves the right to continue negotiations with the AMC. This situation is rare, however.

Foreign investors acquiring portfolios through both negotiations and auctions are facing increasingly active and well-financed AMCs and other domestic financial institutions. To offset competition from these domestic players, larger foreign investors have sought joint ventures with AMCs and other local partners. In addition to spreading risk and providing greater local knowledge, joint ventures—particularly those including an AMC partner—can work closely with the AMCs to ensure a healthy deal flow.

Finding the right information

All interviewees emphasized performing good due diligence as a critical component in the investment process. Simply put, more due diligence means more secure investors, which leads to better investment, though one should also take the costs of these preparations into account.

Who performs due diligence?

Most investors outsource due diligence to local accounting and legal professionals, with larger institutional investors sometimes maintaining their own in-house team. Still other investors, particularly recent entrants in the market, hire foreign accounting firms to source and carry out due diligence.

The foreign pursuit of local research teams is unsurprising given the large number of regulations that govern foreign business transactions in China and the opaqueness of the PRC market. Local partners' ability to navigate this system allows them to play a valuable role in the due diligence process.

While "going local" seems to be the preferred route, some investors are quick to point out its shortcomings. One Beijing-based investor cautioned that hiring local help carries "a reputation risk," as some local firms have been known to fabricate financial records and bribe officials to obtain financial information. Here again, finding reliable local partners is key to cost-effective due diligence. Investors should carefully gauge the reputations and track records of prospective partners, though during their research investigations they may find that many foreign investors are reluctant to reveal information about their own local partners.

Although performing due diligence can make a profound impact on eventual investment returns, costly due diligence can adversely affect the bottom line.

How should due diligence be conducted?

Although the primary focus of diligence remains on the financial and legal aspects of the assets, investors are quickly expanding the number of areas in which they conduct due diligence. A Hong Kong-based investor, for instance, noted that the reputation of the local court can provide important information about the likelihood of winning judgment against the debtor.

More broadly, as one Shanghai investor explained, due diligence is "not just about companies and assets anymore, but also [about] the balance between the interests of the bank and the local government." Prospective investors should try to understand the local governments' interests in areas where they are seeking to acquire assets. A local government might object to the acquisition of a particular tract of land, even though an investor might obtain the relevant title previously owned by the debtor. Local authorities might also oppose the closure of a state-owned enterprise (SOE). In these cases, confrontation with the local government is unlikely to result in victory for the foreign investor. Thus, investors should try to understand the positions and goals of all players involved before attempting to acquire an NPL package.

Although performing due diligence can make a profound impact on eventual investment returns, costly due diligence

can adversely affect the bottom line. Several investors expressed worries that due diligence can go over budget in China. The investors interviewed revealed that to avoid this potential pitfall, due diligence budgets are usually determined not by the potential of the portfolios, but rather by their size. One Shanghai-based investor, for example, said that he would spend no more than $1 million on due diligence for a portfolio of $50 million. For a portfolio of $1 billion or more, he would spend about $5 million.

Time is the final issue facing investors in their due diligence strategies. The move toward open auctions means that investors have comparatively less time to submit bids. Given the time and cost constraints, investors must try to obtain as much information as possible as quickly as they can. One Shanghai-based investor explained his firm's strategy to simplify due diligence: "You can't do diligence on all the loans in the portfolio, so you have to be selective on which ones you research. First you look at the balances and decide on some cutoff number. For those below that number, you don't perform diligence. For those above, you do diligence and find out whether or not they have collateral. Some of them have guarantees; a few of those are worth some money. For the rest, you go to the loans with collateral and find out which ones have titles." In essence, these and other simplification strategies involve locating the assets with the greatest profit potential in a portfolio and using them as a basis for placing a bid.

Acquisition and government approval

Both regulators and investors say that the approval of smaller deals is increasingly automatic, although the approval process is still opaque. Investors are now less concerned about gaining approval than about the amount of time approval takes and the consequent value that is lost as a result of administrative delays. Even so, veteran investors observe that MOF approval can be obtained in about half the time it took a few years ago.

Currently, a typical deal with an AMC requires three levels of approval. First, the local AMC branch where the assets originate must approve the deal. Investors who work regularly with a local branch will find that the branch can become an important ally in the quest for approval from the AMC headquarters, the second step in the approval process. For national-level auctions, the AMC headquarters usually gives automatic approval to the winning bidder. In the early years of the NPL market, the National Development and Reform Commission and State Council also had to approve deals, but these steps are, in general, no longer necessary. Today, only MOF approval is required at the central-government level, primarily to ensure that the deal does not involve a military industry.

Investors that want to repatriate profit upon servicing the acquired NPLs must obtain permission from the State Administration of Foreign Exchange; this process is now highly institutionalized (see the *CBR*, September–October 2004, p.32).

Recovery and profit

Debt servicing is perhaps the most complex step in the NPL process. Given the uncertainty surrounding China's legal institutions and the country's complex political terrain, investors deploy a wide range of options to maximize recovery of NPLs.

Collateralized loans with attached title are the gems of an NPL portfolio because investors are usually assured of ownership of a property, which they can sell or renovate.

Not all secured loans come with title, however, and investors often must go to court to obtain title to the collateral. Investors at times also look for loan guarantees, although obtaining returns from these often involves lengthy negotiations or legal action. Here, an investor's ability to navigate a locality's political environment can significantly sweeten or sour a deal. For example, because some local governments are under great pressure to attract foreign direct investment (FDI), a prospective investor would do well to promise local officials that it will invest in the local economy. As one Shanghai-based investor explained, such promises "can help local governments meet FDI quotas and [strengthen] their willingness to help you in return."

At times, foreign investors place unsecured loans on sale immediately after acquisition. Smaller local investors are sometimes willing to buy these loans because they have more localized knowledge or connections. Interviewees also mentioned cases in which local governments bought NPLs from foreign investors to reduce the debt level of the local SOEs that they were seeking to protect. In these cases, the local governments bought NPLs from the foreign investors instead of directly from the local AMCs because they did not want to be accused of unduly pressuring local AMCs into selling NPLs cheaply to them.

Even after obtaining title to properties, investors often face enormous hurdles in recovering value from the properties. Interviewees most commonly voiced concerns about partial title to a property. Because a real estate developer often borrows from multiple banks to finance a development, a loan default often leads to multiple partial titles falling into the hands of multiple AMCs. To secure complete title to a property, an investor must approach, and deal with, multiple AMCs. Even the most connected JV investor interviewed expressed deep frustration with its repeated failed attempts to gain complete title to certain properties. Even with title to more than 80 percent of the floor space, an investor may not necessarily renovate a building as it pleases because of PRC laws protecting the rights of a property's minority owners. In one case, an investor secured title to all of the floor space in a building, except for the elevator shafts, but was still unable to renovate the building.

Foreign investors often rely on local partners in the recovery process. Although investors may, with approval from the Ministry of Commerce (MOFCOM), set up entities to service and restructure NPLs, most investors choose to get around the MOFCOM licensing process by subcontracting work to local partners or forming JVs. (Thus far, we are aware of only one wholly foreign-owned fund with a MOFCOM license to service debt in China.)

One reason foreign investors rely on local partners is to bypass the possible regulatory obstacles in obtaining MOFCOM approval. In addition, foreign investors work with local partners because foreign law firms may not directly handle matters dealing with PRC law. Finally, interviewees say that local JV partners are useful in recovery because, as one Shanghai investor explained, they "can bend the rules a little bit more and get into some gray areas."

Even after obtaining title to properties, investors often face enormous hurdles in recovering value from the properties.

Although most interviewees were unwilling to specify their expected profit margin from investing in Chinese NPLs, many expressed their profit margins in relative terms. One veteran investor said that the profit margin today is much lower than in the early days of the NPL market. A Beijing-based investor stated that because the risk is much higher in Mainland China than in more established markets like Taiwan or Hong Kong, investors expect a higher profit margin for NPLs, in the 20–30 percent range, rather than in the 10–20 percent range. It is unclear whether most profit margins actually fall into that range.

A glass half full?

The interviewees expressed a wide range of views about the future of the NPL market, from cautious optimism to deep pessimism. Some of the earliest participants in the market have now withdrawn, citing increasing competition from well-financed local investors with government ties.

At the same time, however, some investors are more optimistic and believe that money can still be made in the NPL market by focusing on highly profitable assets hidden in NPL portfolios. They are more optimistic in part because of the enormous size of the NPL market, the greater transparency in and the institutionalization of the regulatory process, and the improvements in PRC legal institutions. Investors in established relationships with local partners expressed the greatest confidence in their ability to profit from the NPL market.

On the whole, investors may have more reasons to be optimistic. Although the era of wild profiteering is largely over, cautious investors that are willing to invest in a network of knowledgeable local contacts can still expect a reasonable return from their investments in China's NPL market. 完

Stephen S. Roach, Chief Economist
Morgan Stanley

The Coming Rebalancing of the Chinese Economy

China is sending the world a very important message: A critical midcourse correction in its development model is in the offing—a shift away from export- and investment-led growth to more of a consumer-driven dynamic. This change will not be abrupt, but it will likely be an increasingly dominant characteristic of the Chinese growth outcome for years to come. It is aimed, first and foremost, at providing greater stability to the Chinese economy. It will also have profound implications for the global economy and world financial markets.

This conclusion is consistent with the basic thrust of China's just-enacted 11th Five-Year Plan. It also fits with my own macro analysis of the Chinese economy. And it's a deduction that stood up well to a full-blown debate that I just witnessed in Beijing (see my 21 March dispatch, "Inside the China Debate"). The essence of the coming adjustment is actually very simple: A long-standing strategy of resource mobilization—powered by the recycling of a huge reservoir of domestic saving into export- and investment-led growth—has now outlived its usefulness. Senior Chinese officials believe the time is right to shift to more of a self-sustaining internal demand model, driven by private consumption. This rebalancing will not only enable China to deal more effectively with both internal and external imbalances, but it will also allow the reformers to turn their attention to the critically important quality dimensions of the growth experience.

China's rebalancing imperatives are obvious. The economy has become far too reliant on exports and fixed investment. Depending on the metric chosen, these two sectors now account for between 70% and 80% of the overall Chinese GDP. And they are still expanding collectively at around a 25% annual rate. If those trends were to continue, the sustainability of the Chinese growth model would be at risk. Years of rapid export growth have already led to serious trade frictions and heightened risks of protectionism. Moreover, a continuation of soaring investment growth could result in excess capacity and deflation. At the same time, there is an increasingly urgent need to boost private consumption, which fell to a record low of just 50.7% of Chinese GDP in 2005, far below the 65% norm for most economies. Similarly, the mix between capital-intensive manufacturing (47.3% of GDP in 2005) and labor-intensive services (40.3%) reflects yet another layer of distortions in China's economy that biases its growth dynamic away from job creation—precisely the opposite of what a reform-oriented system requires. Only by a shift in the mix of the economy can China rectify these imbalances and avoid their potentially destabilizing implications.

The Chinese leadership is stressing three important aspects of rebalancing—the first being a moderation of the overall growth objective. The new five-year plan calls for a 7.5% average of real GDP growth through 2010, a marked downshift from the 9.5% average pace of the preceding 25 years. This should not be viewed as a worrisome shortfall but instead as more of an effort to raise the quality of Chinese growth. My sense is that China's policymakers are now quite concerned about the externalities of hyper-growth. Bottlenecks in strategic materials have emerged as a serious problem in recent years, as have the impacts of soaring energy prices. There are also worries that the blistering 10% GDP growth of the past three years has led to widening income disparities and environmental damage. These developments all heighten the risks of instability, long the biggest threat to reforms. This is where senior macro officials draw the line. As Premier Wen stressed recently at the China Development Forum, "China will never backtrack on reforms." A refocusing of growth objectives from quantity to quality should be viewed as an important means to preserve China's commitment to reforms.

The second leg of the stool is the government's intent to rebalance the mix of GDP growth over the next five years. Ma Kai, Chairman of the all-important National Development and Reform Commission, has taken the lead in stressing the need to boost both the consumption and services shares of Chinese GDP. He has also underscored the imperatives of an enhanced safety net—not just social security but also rural healthcare and education. This was viewed as necessary to improve income security, thereby reducing the excesses of precautionary saving that continue to inhibit the expansion of private consumption. The math and time lags of the likely shift in the mix of Chinese economic activity are consistent with the more moderate GDP growth target over the next five years. That reflects the likelihood that the impetus from rapidly growing exports and investment could fade well before the added support from consumption kicks in.

Financial reforms are a third key aspect of China's rebalancing strategy. The focus, so far, has largely been on banking reforms. But there are equally strong needs for capital markets reforms, especially the development of a corporate bond market. Currency reforms have also been given considerable attention recently, reflecting in part the mounting bilateral trade tensions with the U.S. Related to that, senior Chinese financial authorities have expressed concerns over the excessive accumulation of foreign exchange reserves. The rebalancing of the real economy toward increased domestic consumption should lead to more rapid gains in Chinese imports, a related narrowing of its trade surplus and a reduction in the pace of reserve accumulation. Rebalancing on the real side of the economy thus provides China with more leeway to broaden and deepen its financial sector reforms.

The implications of this multifaceted rebalancing are likely to be profound, both for China and the rest of the world. The tilt away from exports and investment toward consumption, along with the moderation of aggregate GDP growth such a rebalancing implies, could challenge many of the perceptions about the "China factor" now held in financial markets. Three potential impacts strike me as most important:

1. **Commodity markets.** A reduction of investment growth is likely to temper China's impact on the demand side of many industrial commodity markets. In 2005, China accounted for around 25% of worldwide demand for aluminum and about 30–35% of global consumption in copper, iron, steel and coal. As the pace of Chinese industrial activity slows in the years ahead, pressures on the demand side of industrial materials markets should ease—underscoring the downside risks to commodity inflation at just the time when most investors have concluded that there will be no stopping the upside of a "super commodity cycle." China's efforts at energy conservation—a targeted 20% reduction in energy content per unit of GDP over the next five years—could push prices of oil and refined products lower, as well. "Resource-conserving growth" has now become an important mantra in Chinese macro circles.

2. **Currency and trade tensions.** Courtesy of rebalancing, China may be more inclined toward RMB appreciation as a means to promote a shift away from the excesses of export-led growth and provide a stimulus for internal demand. The extent and pace of this appreciation will remain very much dependent on the stability of its financial system. Pro-consumption initiatives should also boost Chinese import demand, reducing China's net-export surplus and thereby providing support for its major Asian trading partners such as Japan, Taiwan and Korea. The combination of RMB appreciation and reduced external surpluses should play an important role in relieving the anti-China trade tensions now building in the international community.

3. **The Chinese consumer.** The Chinese consumer will not spring to life overnight. But this is likely to be a major story over the next 3–5 years. Chairman Ma of the NDRC stressed that the emphasis will initially be placed on building the infrastructure of consumer markets. This implies emphasis on China's labor-intensive tertiary industries involved in distribution and delivery—underscoring not only the opportunities for wholesale, retail, and transnational shipping but also for e-based trade retail systems. Conditional on the improvement of income and safety-net support, growth in the Chinese consumer products industry should move rapidly up the value chain from soft- to hard-goods over the next several years. Significantly, under the terms of WTO accession, foreign multinationals will be allowed increased access to China's domestic retail trade opportunities within three years.

None of this is without peril, and the Chinese leadership is fairly transparent in identifying major risks. It all boils down to concerns over stability. This continues to be the key constraint on reforms and development in China—and it probably always will be. After all, the dismantling of state-owned enterprises ("SOE"s) has resulted in the shedding of over 60 million jobs by the state sector since 1997. Rapid economic growth has long been viewed as the major tool at China's disposal to offset these cuts in employment. In that respect, China's willingness to tolerate the slower 7.5% GDP growth trajectory over the next five years could be drawn into question. However, with SOE reforms now well advanced and the layoff pace having moderated recently to around 2 million workers per year, there is good reason to believe that China is now better able to withstand the impacts of this midcourse correction without compromising its focus on reforms.

China remains the world's greatest growth story. But there must be far more to its transition than the raw power of an industrial-production-led development model. An important rebalancing is now at hand that will temper the excesses of the current strain of growth and insure the sustainability of a more balanced and increasingly consumer-led economy. This will also enable China to shift its focus from the quantity to the quality of growth. Over the years, I have learned not to underestimate the will and determination of China's macro managers. Time and again, they have made the right moves at the right time. I am equally confident in their ability to execute the coming rebalancing.

Morgan Stanley

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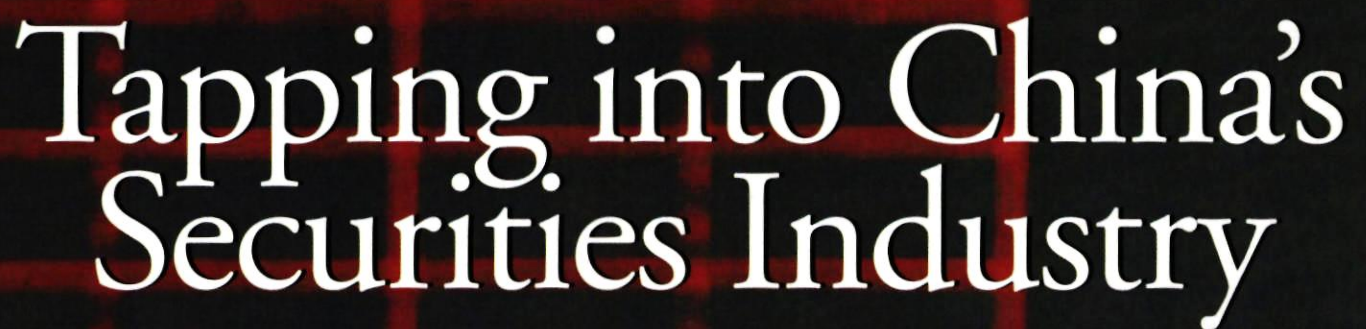
Tapping into China's Securities Industry



Allowing the US securities industry greater market access in China would benefit both countries

David Strongin

Many of the Securities Industry Association's (SIA) leading member firms have identified China as the largest single emerging market in the world. Within the next 40 years, some analysts estimate, China could be the world's largest economy in terms of GDP.

As a result, China will need an enormous supply of capital and a market that can efficiently allocate savings. Analysts predict that over the next five years China will need to invest more than $1.5 trillion in improvements to physical infrastructure. At the same time, China will accelerate its ambitious reform program even while its nascent pension system begins to address the needs of a huge and rapidly aging population. In 2005, 7.6 percent of China's population was over 65; by 2025 that number is projected to reach roughly 14 percent. The country's infrastructure, privatization, and social welfare demands will require an increasingly more efficient and sophisticated deployment of capital.

To meet these demands, China will need to accelerate the modernization of its capital markets. China's first stock market opened in 1990. Between 1998 and 2000, market capitalization more than doubled from $231 billion to $581 billion; market capitalization peaked at $681 billion in 2003. Despite losses in recent years—market capitalization fell to $640 billion at the end of 2005—China has the second-largest emerging stock market in the world after South Korea.

The PRC government has acknowledged the need to reform the securities industry and has stated that it

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wants foreign investors and foreign firms to participate. Many analysts believe that China's capital markets will benefit from the presence of US securities firms—from their technology, expertise, capital, products and services, and best practices. Indeed, as local firms adapt to increased competition, they will inevitably adopt new technologies and practices, and the quality of their products and services will rise to meet world standards. Also, experience demonstrates that more competitive capital markets improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist in the exchange of goods and services. And, because financial markets are inextricably linked to increased investment and economic growth, strengthening China's capital markets will help to alleviate the significant financing constraints that Chinese firms currently face.

With foreign industry involvement, consumers of public- and private-sector financial products and services can expect a broader and better array of products and services at lower cost.

Limited foreign access

China's 2001 World Trade Organization (WTO) entry commitments in the securities and asset management sectors marked the country's first step toward liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures (JVs) in which foreign ownership is capped at 33 percent. China's WTO commitments also limit foreign participation in China's asset management sector to ownership of no more than 49 percent of domestic fund management firms. These WTO commitments make no provision for further increases in foreign ownership in either securities or asset management firms. Instead, the commitments suggest that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future.

Benefits for the United States

By providing research, operational support, and advisory services for their overseas operations, US securities firms help create a significant number of jobs in the United States. According to the Bureau of Labor Statistics, US employment in the securities industry reached almost 791,000 in December 2005, up from 755,000 in 2003. The financial services sector also provides the essential infrastructure for global trade in other goods and services and is a key driver of global economic growth. Growth in the US financial services sector in overseas markets stimulates demand for a wide range of other US services, such as telecom, professional, and information technology services.

—David Strongin

China's WTO commitments in the securities sector also limit these minority owned JVs to underwriting the A shares of Chinese corporations, and to underwriting and trading government and corporate debt, B shares and H shares. The fundamental right to *trade* in A shares was not conferred on these minority JVs. (A shares are renminbi [RMB]-denominated shares limited to domestic investors, foreign financial firms with qualified foreign institutional investor [QFII] status, and foreign strategic investors; B shares are foreign-currency denominated shares listed on PRC exchanges and are open to both domestic and foreign investors; and H shares are shares of PRC companies listed in Hong Kong.)

Though the QFII program, which the PRC government developed in 2003 and further opened to foreign investors in January 2006, provides an alternate mechanism for investment in Chinese equities by foreigners, the program is still subject to strict limitations. In addition, the QFII program is not part of China's WTO commitments and is therefore "unbound" and subject to change at any time.

Foreign securities firms participate in a variety of primary and secondary capital markets' activities in the Chinese debt and equity markets. These transactions—principally the underwriting of private and public securities and secondary market activities—are, however, with the exception of B shares, conducted offshore.

China's need to modernize its capital markets

The efficient allocation of capital is a precondition for robust economic growth and job creation. The allocation of capital relies on deep, liquid, and transparent financial markets, which price risks correctly through two complementary intermediation functions: a healthy bank loan market and transparent capital markets. The creation of such mar-

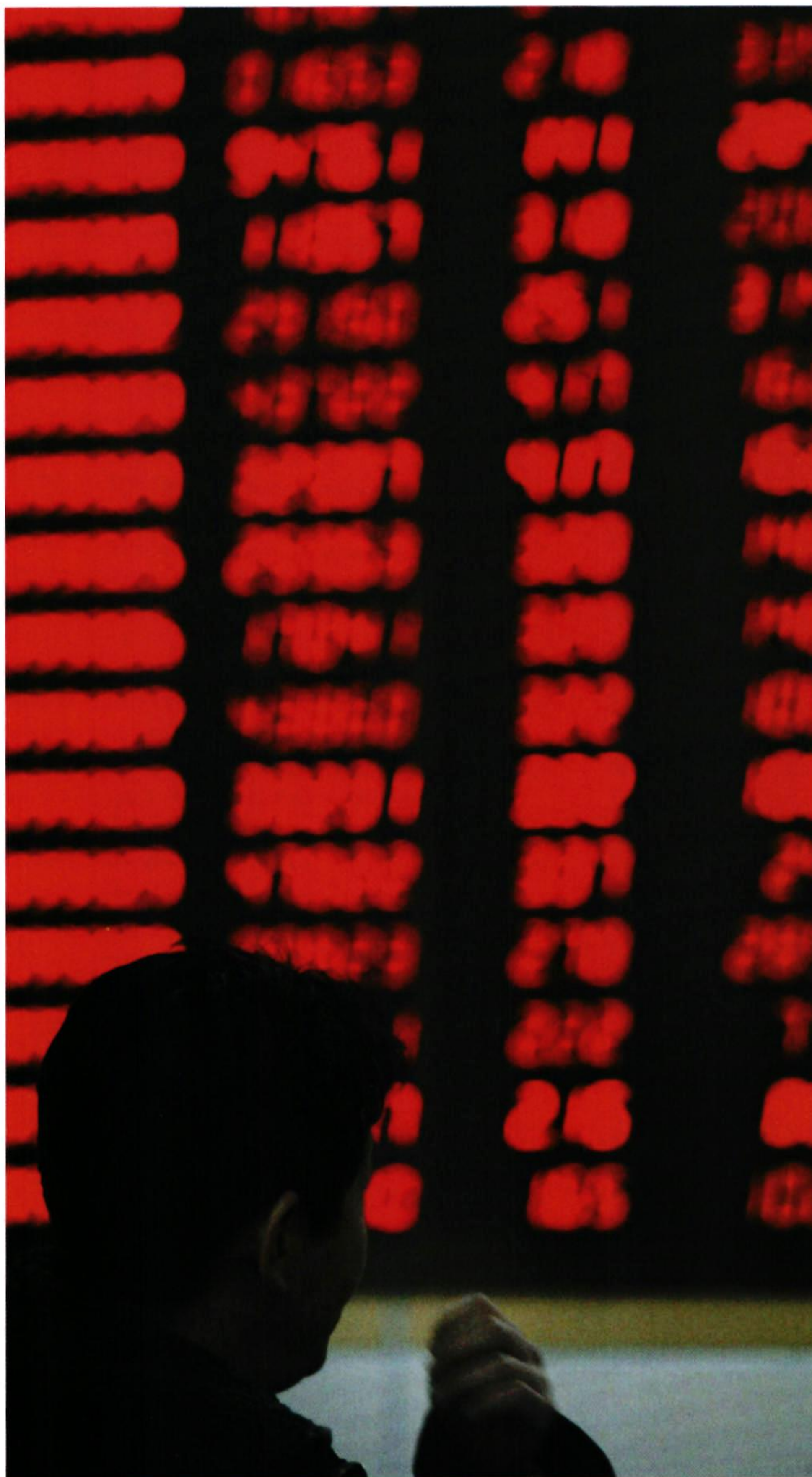
kets will benefit Chinese corporations and investors and help facilitate much-needed banking reforms.

Foreign firms can act as catalysts to the development of China's capital markets, particularly when, as now, China's domestic securities firms are being squeezed by a fall in secondary market volumes, an over-dependence on primary offerings, and the absence of significant alternative revenue streams such as derivatives markets. In addition, as the China Securities Regulatory Commission (CSRC) focuses on improving corporate governance, strengthening accounting standards, and developing investor confidence, firms face increasingly costly compliance obligations. Firms also must meet the challenge of implementing state-of-the-art risk management systems while providing a growing customer base with innovative products and services. All of these developments will, at least in the short term, result in higher costs.

By bringing expertise, best practices, and technological skills to Chinese capital markets, foreign securities firms can help China improve its securities industry in several ways:

■ Foreign expertise and market liberalization will help attract the human capital necessary to build quality capital markets and produce the market changes that are necessary to serve China's own capital and investor needs over the next few decades.

■ JVs in the securities and other industries generally report that US and other foreign firms export best



practices and high levels of technology and know-how. PRC regulatory officials have expressed the desire to encourage cooperation between domestic and foreign firms in stock ownership, business management, and technology and have said that such cooperation is good for clients of PRC banks.

- With foreign industry involvement, consumers of public- and private-sector financial products and services can expect a broader and better array of products and services at lower cost.

- US firms will likely continue their dialogue with regulatory authorities to enhance China's substantive and procedural financial market rules and help foster regulatory transparency.

Though foreign industry involvement can improve many aspects of the securities industry, China must take steps in two distinct, but reinforcing, areas to modernize and strengthen its capital markets. First, improvements in market access would improve the ability of foreign securities firms to compete in a fair manner with local firms. Second, steps in market reform would better regulate the industry and increase transparency.

Market access

Permit full ownership and the right to choose corporate form

The PRC government should allow foreign firms to establish securities companies in China, including wholly owned entities, with the ability to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and all classes of equity, hybrid

mortgage products, derivatives trading, and asset management. The right to enter a market and establish a wholly owned presence in a form of the firm's own choosing is relatively common in today's global markets.

Currently, foreign investors can enter China's security market in two ways: by establishing a new JV with a Chinese partner or by taking a stake in an existing brokerage—the path that a number of foreign securities firms have chosen. Because in most cases the negotiations that result in a JV or a foreign stake are opaque, however, potential entrants have little available in the way of guidance on how to arrange such JVs.

broaden trading in those markets, and make more capital available to Chinese issuers.

Implement a QDII program

China is in the process of launching its long-awaited qualified domestic institutional investor (QDII) program to promote Chinese investment in foreign stocks and bonds. The People's Bank of China (PBOC) announced the launch of the program in April 2006, and PBOC, the China Banking Regulatory Commission, and the State Administration of Foreign Exchange released interim measures that permit qualified commercial banks to pool RMB from domestic institutions and individuals and convert them into foreign exchange for investment overseas in fixed-income securities. As the *CBR* went to press, PRC regulatory bodies were expected to issue the QDII program's other implementation rules, which will allow qualified mainland insurance companies, fund management firms, and securities brokerages to convert RMB into foreign currency, raise funds in RMB or foreign currency, and invest in overseas securities.

Such a program will further liberalize China's capital accounts. It may also help familiarize Chinese domestic investors with international best corporate and brokerage practices and give them access to top-quality research under conditions that would respect officials' concerns about currency flows.

The most reliable and expedient way for China to meet its massive capital demand is to access the larger pools of capital available in the global markets.

Improve the QFII program

China's decision to permit foreign investment in A shares through QFIIs beginning in 2003 was a landmark step in the development and liberalization of China's capital markets. More recently, PRC authorities have taken steps to increase the number of QFIIs and the amount invested by QFIIs. Nevertheless, a few QFII requirements are onerous and have substantially limited the utility of the program, as well as the number of investors that can take advantage of it.

The Management Regulations for Strategic Investments by Foreign Investors in Listed Companies, which took effect in January 2006, open most of the country's A-share companies to large, strategic foreign investors, in addition to foreign financial investors with QFII status. Along with the QFII program, China has recently taken steps to allow certain large foreign investors to purchase shares in domestic companies. These new rules will allow foreign investors to buy stock in Chinese companies that have completed the share-reform program (exchange of non-tradable shares to common A shares). Foreign investors that meet certain government standards can buy existing shares or purchase new shares that might be issued. But requirements that an investor purchase at least 10 percent of the company, and hold the stake for at least three years, could limit the desirability of the program.

China would do well to make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would almost certainly result in greater foreign investment in China's securities markets, deepen and

Permit foreign securities firms to trade RMB with Chinese entities

Foreign firms need the ability to trade RMB to take advantage of any future openings in China's securities sectors. China permits foreign banks, but not foreign securities firms, to conduct RMB business with foreign and domestic enterprises and approves banks to issue RMB-denominated bonds to finance their RMB activities.

In January, the People's Bank of China made moves to allow market forces a greater role in setting the RMB's value. China began using a new system for setting the value of the RMB, began allowing over-the-counter transactions in the interbank spot foreign exchange market, and introduced market makers. The People's Bank of China also granted 13 banks—five of which are foreign—market-maker status, allowing the banks to quote bids, offer rates, and trade the RMB against foreign currencies. Securities firms may not trade RMB, however.

Reduce capitalization requirements

Rather than establishing a capital requirement based on a technical assessment of the risk of the business to be entered, China has promulgated a fixed minimum capital requirement of ¥500 million ($62 million) for foreign securities and asset management firms wishing to form JVs. This fixed minimum capital requirement is so high that it dissuades smaller foreign entrants, reduces the overall attractiveness of the JV vehicle, and discourages foreign direct investment. This requirement serves as a *de facto* market entry barrier.

Market reform

Promote regulatory transparency

A transparent industry is generally one in which public and industry players have the opportunity to participate in the rulemaking process, access information about proposed rules, question and understand the rationale behind draft rules, and have sufficient opportunity to review and comment on them. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that attract participants, increase efficiency, and spur economic growth and job creation. The absence of transparency in the implementation of laws and regulations can seriously impede the ability of firms to compete fairly and often distorts the market.

Though CSRC has improved its policies on prior consultation and has presented many proposed regulations for public comment, much progress is still needed. Short comment periods are insufficient to review complex new regulations, particularly those intended to affect foreign firms whose ability to comment is hampered by distance and language.

Increase scope of derivatives regulation

Interim derivative rules, which took effect in March 2004, have prohibited securities firms from creating and distributing derivative products. The inability of securities firms to engage in these activities hampers the development of these markets. Foreign firms hope that China's newly revised Securities Law will lead the State Council to formulate measures on the issuance and trading of derivatives.

Mutual benefits

The most reliable and expedient way for China to meet its massive capital demand is to access the larger pools of capital available in the global markets. Foreign securities firms can contribute to the development of China's financial markets by sharing their expertise on the infrastructure needed to effectively serve a sophisticated and globally oriented client base. Foreign players can also provide new financial products and services that meet the changing needs of Chinese investors, demonstrate the benefits of high corporate governance standards, and consult on legal issues that must be addressed to help domestic equity and capital markets flourish. Ultimately, the modernization of China's financial system, especially its capital markets, will benefit both China and the world. 完

Critical Eye on Xi'an

Continued from page 57

Compared with eastern locations, however, Xi'an's workforce is relatively weak in management skills, and most people, whether in business or government, have had much less exposure to foreign companies than their eastern counterparts. For example, one company interviewed for this article noted that communication is not as open and clear as it is on the east coast and that companies have to follow up more to make sure things get done.

As in other interior cities, costs are significantly lower than on the east coast. City investment literature from 2005 estimated labor costs ranging from ¥400–¥600 ($50–$75) per month for an unskilled worker up to ¥2,500–¥7,000 ($312–$874) for experienced technical staff. Real estate is also cheaper, with monthly office and residential rents ranging from ¥30–¥70 ($3.75–$8.74) and ¥9–¥25 ($1.12–$3.12) per square meter, respectively.

Environment

Although Shaanxi is often thought of as a dry and dusty place, local officials say that Xi'an has access to plenty of water. The city gets its drinking water from the Qinling Mountains, which lie to the south of the city. Eight rivers also flow through the municipal area. Water may not be in short supply, but its quality is dubious. The Shaanxi Provincial Environmental Protection Bureau reports that in 2004, 77 percent of samples taken from the Wei River, the largest river flowing through southern Shaanxi, were Grade IV or below—not fit for direct human use.

Like all major Chinese cities, Xi'an is struggling to reduce air pollution, and air quality has improved since coal burning was banned in the city center in 2002. Plans to replace coal with natural gas as the city's main source of fuel may raise air quality further. Many of the city's taxis already run on natural gas. Whether such gains can outpace the inevitable rise in the number of cars on the road is open to question. 完

In post-WTO China, danger and opportunity still come in equal measures.

Five years ago, the WTO welcomed China into the global market - a proud moment for both the government and its people. The resulting increase in trade and investment has transformed the Country and brought wealth and prosperity to millions.

However, the complexities and hidden dangers of doing business in China remain and for many companies, they threaten their ability to operate and invest in the world's most dynamic market.

Unsure of how to effectively manage the risks or capitalize on opportunities, they often find themselves victims of fraud and corruption, see their brands being the subject of rampant counterfeiting or are otherwise unable to operate transparently and compete ethically.

Successfully managing these risks requires a combination of local knowledge, professional expertise and an ability to bridge the gap between foreign companies and local concerns. It requires a strategic approach, with enterprise-wide implementation - something only Hill & Associates can claim to deliver.

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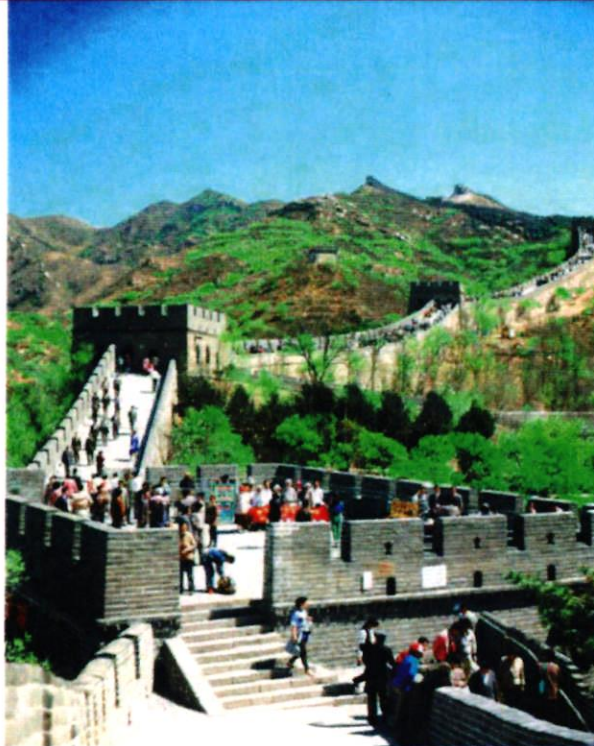
Investment & Operational Risks in the People's Republic of China



Introduction

On the surface, China is one vast market with a strong central government and no opposition. But in reality, China is a conglomerate of disparate markets at greatly varying levels of economic and social development. Although the Central Government is taking steps to improve conditions by instituting a stronger rule of law, building a more modern financial system, and creating a more transparent business environment, especially since joining the WTO, such issues will not be resolved overnight. Many investors, lured by a perceived "first mover advantage" experience a rude awakening – the result of insufficient due diligence, local knowledge and risk management. Theirs is an experience of confusion, missed opportunities, lost profits, or worse. Some admit the failure to accurately assess the risks cost them a decade's worth of investment.

Hill & Associates regularly provides our clients in China with the means to minimize their exposure to the following, most prevalent risks of doing business in the Middle Kingdom:

Legal

▲ *Rule of Law.*

Chinese judges usually have little appreciation of or experience with commercial concepts, and are often susceptible to pressure from local interest groups. Even companies that receive a favorable ruling may find that enforcement is difficult, especially with regard to bankruptcy proceedings. WTO membership has increased the recognition of overseas arbitration awards and rulings, but avoiding legal problems in the first place is still the best solution.

▲ *Economic Regulations.*

China's market-oriented economy is still complicated by numerous legacy restrictions on usual corporate activities such as distribution and the importation of goods. Many regulations overlap the responsibilities of different authoritative bodies or departments, making it necessary to consult all of them and pay additional levies for doing so—increasing the hidden cost of doing business in China. Regulatory risk is high in China, and businesses planning to operate there need to understand how the regulations may apply to them before entering into any agreements.

▲ *Transparency.*

Chinese businesses are accustomed to operating behind closed doors. Perhaps because of China's rapid changes, the various levels of transparency co-existing in governmental and corporate organizations make it even more difficult to identify the truth. At many Chinese companies, the ability to assess the financial and market health is intrinsically connected to the knowledge held by one specific individual—often the founder or CEO. Verifying that the individual's and company's history (and reputation) really matches what has been presented is crucial.

Social and Environmental

▲ *Business Ethics.*

The concept of ethics in business is fairly new to China, primarily introduced by multinational corporations (MNCs). Simply speaking, the legal system is ill-equipped to keep pace with misdirected entrepreneurship. Companies of all sizes need to contain the risk before a problem appears by instituting ethics training programs, conducting pre-employment screenings, and performing due diligence on partners, vendors, and investment targets.

▲ *Corporate Governance.*

Corporate Governance is another fairly new concept for China. At many privately owned companies, one person, usually the chairman of the company, is still the only person responsible for all corporate governance issues. Rank and file employees generally defer to the management without question. Such environments are breeding

grounds for fraud. Investors can identify corporate culture risks of a potential partner early and make the development of a comprehensive internal control program, with division of responsibilities, part of the partnership or investment discussion.

▲ *Partners.*
Prospective business partners in China will freely admit that they are looking to the foreign partner to supply capital or technology. Stories abound of joint ventures set up with subsequent competition coming from a duplicate factory established by a relative or friend of the local joint venture partner's general manager. Foreign investors can reduce such risks by simple due diligence and by segregating access to sensitive information that could be used to create competition.

▲ *"Guanxi."*
Over the past five to eight years, the market has become more regulated, making guanxi (relationships, connections) less important than sound business sense in many areas. However, "guanxi vendors" often approach foreign investors claiming to be able to help the foreign investors accomplish their business goals by brokering their connections. Sometimes, these connections may not exist, may be used by the vendors themselves to accomplish very different aims, or may actually be a reputational liability for the foreign investor. Again, thorough due diligence is essential.

▲ *Social Accountability.*
Working conditions can vary enormously across China, especially in regard to rural vs. urban conditions. Manufacturers focused only on squeezing out the maximum profits without recognizing the risk to their foreign investor's reputation are unlikely to consider such issues as safety, the environment, workers rights, etc. Foreign companies must be prepared to guard or insure against these social accountability risks.

Fraud and Corruption

▲ *Fraud and Corruption.*
Fraud and corruption are endemic in China. Furthermore, "conflict of interest" is not a widely understood concept in China. Awareness, training and internal controls are good methods for reducing the likelihood of such problems, but foreign investors need to understand that investigations of employee, supplier, or partner behavior will be a cost of doing business in the country.

▲ *Intellectual Property Rights.*
Both Chinese and foreign companies suffer in China from weak intellectual property (IP) protection. Counterfeits account for as much as 40% of all the goods manufactured in China. The concept of the sovereignty of IP has taken a long time to filter down to the provincial level despite the vocal support of the central government in Beijing. Although admission to the WTO and TRIPs has made fighting counterfeiting a priority, the problem is likely to continue for some time. Foreign investors are well advised to seriously evaluate the types of manufacturing operations they wish to bring to China and keep products requiring high levels of proprietary research and development in places with better protection until China catches up.

▲ *Capital Flight.*
Illegal capital flight is also a pressing problem. China's Crime Prevention Research Unit at the Ministry of Justice estimates that USD 58.8 billion left the country illegally between 1997 and 1999. Much of the capital fraudulently obtained by individuals in positions of power finds its way out of China via investment vehicles and private bank accounts. With money laundering regulations becoming stricter in every country, foreign investors must exercise extensive due diligence before investing.

Businesses planning to operate or invest in China can expect to take great advantage of one of the fastest growing economies on the planet. But great opportunities are rarely without risks. Through the provision of local knowledge, insight and experience, Hill & Associates can help your company minimize risks, prevent crises and improve transparency, allowing you to reap greater rewards from your China investments.

About Hill & Associates Ltd.

Hill & Associates is the largest risk management and business intelligence consultancy in Asia. We employ over 350 people across 17 offices around the world including 3 in China. By combining our local knowledge and professional expertise with an unrivalled geographic coverage, we enable companies to operate safely, efficiently and without disruption in some of the world's most challenging markets. Our integrated solutions address a wide range of business and security risks including regulatory and compliance issues, while improving transparency and executive decision making in the process. To learn more about Hill & Associates services and solutions, visit us at www.hill-assoc.com or send us an email at info@hill-assoc.com.

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Life Insurance Industry Heats Up

China is scheduled to fully open its already competitive life insurance industry to foreign companies by the end of the year. What will it mean for the industry—and the companies?

Richard Daniel Ewing

China's insurance sector generated roughly ¥493 billion ($61.3 billion) in premiums during 2005, making it the eleventh-largest insurance market in the world. Life insurance accounted for about 75 percent of these premiums. Property and casualty insurance, which is quickly becoming more popular as affluent consumers purchase more homes and cars, made up the remaining quarter.

Among emerging markets, China has the second-largest and fastest-growing life insurance industry, behind South Korea. Driven by 1.3 billion potential consumers and a strong economy, the country's life insurance market could double in size by 2010. Though it is still relatively small by global standards, China's life insurance market generated roughly ¥365 billion ($45.4 billion) in annual life insurance premiums in 2005, and starting from a small base, the market grew about 30 percent annually from 1996 to 2004 (see Figure 1). In 2005, as insurers struggled for more profitable growth, the growth rate slowed—but remained comparatively high at about 13 percent.

Opportunities in the life insurance industry have bred competition (see Figure 2). Though established domestic insurers still dominate China's industry, a host of foreign carriers and new domestic firms are battling for market share. Because China's life insurance industry should fully open to foreign companies by December 11, 2006, in accordance with China's World Trade Organization (WTO) entry agreement, global insurance companies have been preparing to expand aggressively in China. For multinational insurance companies, China has become a target market because, unlike those of major developed countries, its insurance market offers the prospect of long-term growth. Thus, the industry is poised for a period of intense competition that will bring more choices to China's consumers and help reshape the financial services industry.

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Fuel for growth

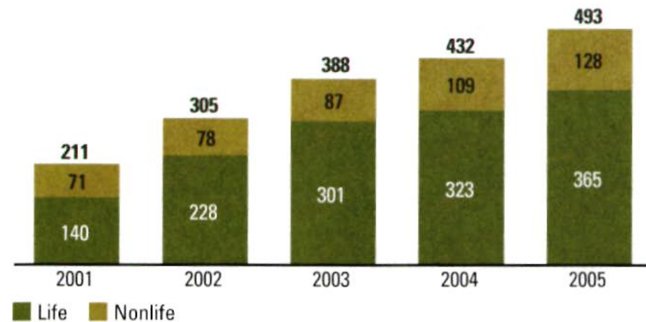
Many factors are fueling the rapid growth of China's life insurance industry. The country's high savings rate, weak social security system, growing elderly population, and lack of alternative savings vehicles are major drivers. The fact that only a small percentage of PRC citizens have bought life insurance also means that there is plenty of room for growth.

Table 1
Per Capita Spending on Life Insurance, 2004

Country	Amount ($)	% GDP
Japan	3,027	8.4
United States	1,686	4.2
South Korea	1,011	7.2
Brazil	46	1.4
China	**30**	**2.4**
India	16	2.4
Indonesia	15	1.3

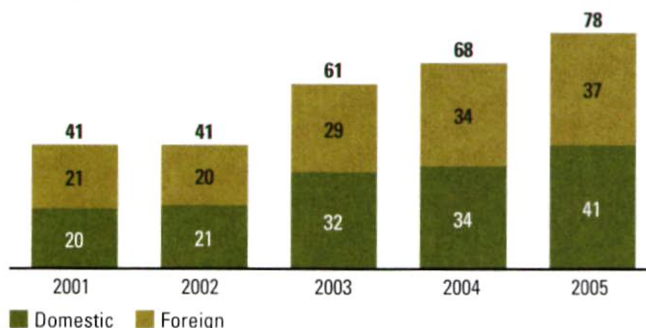
Sources: Insurance Information Institute, World Bank, China Insurance Regulatory Commission, and Xinhua's China Economic Information Service

Figure 1
Insurance Industry Premium Income in China, ¥ Billion



Note: Figure includes domestic and foreign firms
Source: China Insurance Regulatory Commission; Xinhua News Agency's China Economic Information Service

Figure 2
Number of Insurance Companies in China



Sources: Bear, Stearns and Co. Inc. Equity Research Department; Wachovia Corp. Equity Research; Xinhua's China Economic Information Service

China's savings rate is roughly 40 percent—one of the highest in the world. According to recent surveys, savings are driven primarily by a desire to provide financial security for family members, largely because economic reforms have reduced the government's role in providing a social safety net, particularly retirement benefits. China's demographic profile heightens this need to save. The one-child policy has reduced family size, and the average age in China will rise from 29 to 39 over the next 10 years. As a result, the importance of saving and financial planning will increase as China's population ages, prompting more Chinese to rely on insurance for a secure retirement.

Because Chinese savers have limited investment choices, life insurance provides an attractive savings vehicle for many consumers. The majority of Chinese savings are in low-interest bank deposits in part because the other main investment option—the stock market—is volatile and has performed poorly in recent years.

In addition, China's life insurance market is under-penetrated. In 2005, about 38 percent of Chinese households had life insurance, and Chinese consumers spent an average of $35 on life insurance that year, accounting for 2.5 percent of GDP. This level is similar to those of other developing countries (see Table 1). It is, however, far below the average in developed countries. For example, about 90 percent of households in Japan and South Korea had life insurance in 2005.

Going head to head

China's modern insurance industry took off in 1984 when the People's Bank of China spun off its insurance division, the People's Insurance Co. of China (PICC). In 1996, PICC was split into property insurance, reinsurance, and life insurance companies. The state-owned life insurance operation was renamed China Life Insurance Co., and it controlled virtually all life insurance operations in the country. Meanwhile, in an effort to transform the industry, the government gradually introduced competition. In the late 1980s and early 1990s, new domestic shareholding insurance companies such as Ping An Insurance (Group) Co. and China Pacific Insurance (Group) Co., Ltd. were founded, and foreign insurers began establishing representative offices. By the late 1990s, foreign companies could take a stake of up to 25 percent in Chinese insurance companies or form joint ventures with a foreign stake of up to 50 percent.

When China joined the WTO in 2001, it agreed to open financial services gradually to foreign competition over five years. Up until December 2004, foreign competition in the life insurance sector was restricted to a handful of cities including Beijing, Chongqing, Guangzhou, Shanghai, Shenzhen, and Tianjin, and product categories were limited to individual policies. Foreign life insurers can now do business anywhere in the country and sell group policies.

Over the years, China Life, Ping An, and China Pacific have grown into genuine rivals and continue to dominate the industry (see Figure 3). State-controlled China Life commands 44 percent of the life insurance market, but has seen its share erode gradually. Ping An and China Pacific are the second- and third-largest firms with 16 percent and 10 percent of the market, respectively. New China Life Insurance Co., Ltd. and Taikang Life Insurance Corp. Ltd., which are shareholding companies, and other newer entrants are smaller players that collectively account for one-fifth of the market.

For multinational insurance companies, China has become a target market because, unlike those of major developed countries, its insurance market offers the prospect of long-term growth.

As competition escalates, China's domestic life insurance carriers are becoming more international. Major domestic carriers have turned to overseas capital markets and sought foreign partnerships to garner technical expertise. The PRC government supports the trend. China Insurance Regulatory Commission (CIRC) Chair Wu Dingfu stated to the press in December 2005, "We want to see Chinese insurers go global, and we will encourage them to have overseas IPOs [initial public offerings]." State-owned China Life started this trend in earnest with a massive $3.5 billion overseas IPO in late 2003 and is now reportedly seeking strategic partners to strengthen its operational capabilities. Apart from China Life, all other major domestic insurers have brokered strategic investments with major global financial players, including HSBC Holdings plc, the Carlyle Group, Prudential Financial, and Credit Suisse Group (see Table 2). Ping An also raised $2 billion by floating in Hong Kong, and New China Life and Taikang are each considering overseas IPOs this year.

Today 22 foreign life insurers (21 joint ventures and 1 wholly owned subsidiary—American International Group, Inc.'s American International Assurance Co., Ltd. [AIA]) operate in China, and more are on the way. These foreign insurers captured a larger slice of the market in 2005, when their share rose from 2.5 percent in 2004 to nearly 9 percent. This jump was due to increased market access and notably to Italy's Generali China Life Insurance Co. Ltd. landing a massive $2.4 billion group pension plan contract from its partner, China National Petroleum Corp. Though this single deal may distort the picture, international carriers are com-

Figure 3
Life Insurance Market Share in China, 2005

Source: China Insurance Regulatory Commission; Xinhua's China Economic Information Service

Table 2
Major Foreign Strategic Investors in China's Life Insurance Industry, 2005

Domestic Firm	Premiums (¥ billion)	Foreign Strategic Investors	Ownership Stake (%)
China Life	160.7	Reportedly seeking partners	NA
Ping An Life	58.8	HSBC	19.9
China Pacific Life	36.2	The Carlyle Group*	24.9
New China Life	21.0	Zurich Financial Services	18.9
		Meiji Life Insurance Co.	4.4
		International Finance Corp.	1.5
Taikang Life	17.8	Winterthur Group**	15.0
		Softbank Corp.	1.0
		Government of Singapore Investment Corp.	8.3

Notes: NA = not applicable
*Prudential Financial invested through the Carlyle Group's purchase
**Winterthur is a subsidiary of Credit Suisse Group
Sources: Corporate press releases; *Financial Times*; *South China Morning Post*; *Wall Street Journal*; Xinhua's China Economic Information Service

peting fiercely with domestic rivals. Foreign carriers have captured sizable market share in the cities in which they compete. AIA, for example, is the third-largest insurer in Shanghai with about 9 percent of the market, and foreign insurers are collecting nearly half of all new premiums in Guangzhou. Foreign carriers are moving quickly to expand their distribution networks into key markets across the country by opening new branches and partnering with local companies.

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Industry dynamics and distribution

The booming life insurance market has created ripple effects throughout China's economy. Employment in the industry is rising rapidly as demand for actuaries, underwriters, and managers skyrockets. Since 2001, 500,000 new life insurance agents have joined the sector, bringing the total number of agents to more than 1.5 million. Most life insurance in China is sold through agent networks.

Establishing a strong distribution platform will be critical to success for all players in the market. Bancassurance (the sale of insurance products on a commission basis through a bank's branches and salesforce) has become a major distribution channel for China's life insurers. Between one-tenth and one-quarter of all individual life premiums come from these low-cost bank channels. In Shanghai, for example, New China Life is using hundreds of bank branches to sell its policies through alliances with China Construction Bank (CCB) and others. (Though banks offer a professional, pre-existing platform, the lapse rate for these policies is often high because bank staff are less well trained in selling insurance products, leading customers to second-guess their purchases.)

Independent brokers and direct distribution are small but growing channels. Direct online distribution channels do not yet have a significant presence in China but may offer growth opportunities as the country's Internet economy expands.

Beyond their cooperation in distribution, China's insurance and banking sectors are becoming increasingly intertwined. Banks are hoping to expand their product offerings, while some insurers are interested in acquiring ownership in domestic banks. Ping An, for example, is bidding against foreign rival Citibank for a controlling stake in Guangdong Development Bank. Meanwhile, the Bank of China and CCB are applying for permission to establish their own insurance companies. This convergence of banking and insurance in financial services is natural for an emerging market and promises to create integrated financial services companies over time. In the near term, however, the competition with banks may complicate distribution strategies for some insurers.

Growing pains

China's life insurance sector is experiencing growing pains. First, many agents lack proper training and turnover is high. Second, domestic and foreign insurers are struggling to build operational expertise in core areas such as risk analysis and underwriting. Late last year, PRC

Regulating China's Insurance Industry

China has been building a legal and regulatory foundation for the insurance industry for more than a decade. In 1995 it passed the PRC Insurance Law, which provides a broad legal framework and dictates the requirements for establishing insurance companies. As the industry grew larger and more complex in the late 1990s, and its importance to broader economic and social reforms increased, the government created a specialized regulatory agency to manage the industry. Established in 1998, the China Insurance Regulatory Commission (CIRC) took on duties previously carried out by the People's Bank of China (PBOC) and began to regulate and monitor the development of the insurance industry. CIRC controls access by foreign firms and formulates rules and regulations that govern standards and conduct. Its mandate is to oversee business operations, protect the interests of policy holders, direct market development, and evaluate financial risk. Chair of CIRC since 2002, Wu Dingfu had previously served as vice chair of CIRC and as the secretary general of the Chinese Communist Party's (CCP) Central Commission for Discipline Inspection, the CCP's anticorruption organization.

China's National People's Congress (NPC) amended the PRC Insurance Law in 2002. The revisions, which took effect January 1, 2003, codify World Trade Organization commitments and allow insurers to offer short-term health insurance policies and to invest in other insurance-related enterprises. CIRC solicited comments to further revise the law in 2004; observers are uncertain when the NPC will review and pass these revisions.

—Richard Daniel Ewing

Vice Premier Huang Ju stressed the need to invest in risk management and managerial talent in the insurance sector. These capabilities are essential to ensure that rapid expansion does not lead to financial turmoil.

Third, many domestic life insurers are burdened by unprofitable policies. Many of these "negative interest spread" policies were sold in the high-interest rate period of the mid-1990s and guarantee roughly 10 percent returns to policy holders. Subsequent interest rate reductions left carriers facing persistent and significant investment losses. Regulations that required Chinese insurers to invest the bulk of their assets in low-yield investments, namely bank deposits and bonds, also reduced investment income and hurt profitability until recently.

Fourth, other investment products are starting to vie for China's vast savings, creating more competition for domestic and foreign life insurers. Mutual fund investments, for example, have grown dramatically in recent years while life insurance premium growth has slowed.

CIRC pushes reforms

CIRC has been promoting numerous reforms to strengthen the life insurance industry. At the top of the list is corporate governance reform. CIRC Chair Wu Dingfu has spoken publicly on the subject and has issued a series of new regulations to improve transparency, especially where ownership and control are concerned. Among other changes, the new rules require more independent directors on corporate boards, the creation of audit and compensation committees, and tighter requirements for holding special shareholder sessions. His efforts are already bearing fruit. In January 2006, China Life split its chair and chief executive positions in a move to improve its corporate governance structure.

CIRC has also loosened investment restrictions for life insurers' massive ¥1.5 trillion ($186.6 billion) capital reserves. This move has sparked a major shift in investment allocations from bank deposits into higher yield government bonds, corporate debt, and equities. Investment returns rose sharply to 3.6 percent last year, up 0.7 percentage points from 2004. China's insurance companies are huge investors in the bond market; they held roughly two-thirds of all corporate bonds and took up about three-quarters of all new corporate bond issuances in 2005 (excluding bond issuances from the financial services sector). CIRC also recently opened infrastructure funds to insurers and, as the *CBR* was going to press, was expected to issue measures that allow insurance companies to invest foreign currency holdings abroad.

The third major reform priority for the government is to raise solvency standards. China Pacific Life, New China Life, and Taikang were cited in 2004 for failing to meet these standards and have needed to raise capital to cover their obligations. Though tougher capital requirements may slow growth, they should reduce risks to the sector.

Foreign firms may want to consider a focused, tactical approach—for example, building a strong presence in a few key markets rather than pursuing a broad national expansion strategy.

Finally, CIRC has launched another series of changes that include easing pricing restrictions, revising statutory mortality tables, and allowing some carriers to establish asset management companies.

A stronger foundation for growth

Taken together, these reforms should go a long way toward improving regulatory supervision and expanding options for insurers. They will also set the stage for a period of unprecedented competition that could help sustain the market's rapid growth over the next several years. (If competition causes prices to fall, however, foreign and domestic insurers may face shrinking profit margins.) As in more mature markets, efficient operations and superior underwriting will be key ingredients for profitable business. Under pressure from foreign firms, China's domestic insurers should become increasingly professional and sophisticated. In particular, risk management, product diversity, and corporate governance structures will likely improve.

Foreign life insurers will almost certainly capture a significant portion of the market over the next few years. Foreign firms may want to consider a focused, tactical approach—for example, building a strong presence in a few key markets rather than pursuing a broad national expansion strategy. Though major urban centers, such as Beijing, Guangzhou, and Shanghai, are fiercely contested and penetration rates there are relatively high, many large inland markets offer attractive opportunities. Some foreign firms are already building a presence in places such as Wuhan, Hubei; and Chengdu, Sichuan.

The development of the life insurance sector in China will help drive reforms more broadly through the financial services industry. As the country continues its transformation into a market economy, it will also provide a greater range of investment choices to ordinary Chinese. 完

Western Hub

Virginia A. Hulme

Capital of Shaanxi, Xi'an lies in the geographic center of China. More than 3,000 years old, Xi'an was China's capital for more than 1,000 years and 13 dynasties. But there is more to this ancient city than the famed terracotta warriors, imperial hot springs, and city walls. Sixty percent of the Shenzhou 6, the spaceship that carried China's second manned space flight, was made in Xi'an, a fact that hints at the city's technical prowess.

The city's five official pillar industries largely reflect this history and technical strength: tourism; high technology, including national defense industries, particularly aeronautics such as satellites, missiles, and planes; equipment manufacturing; culture and education; and modern services, such as logistics, finance, and consulting. Chief among Xi'an's strengths for foreign investors are its transportation links and its technically skilled workforce.

The heart of China

Xi'an's central location gives ready access to 600 million consumers and 10 provincial capitals within 12 hours' travel time. Seven highways connect Xi'an to Baotou, Inner Mongolia; Chengdu, Sichuan; Chongqing; Hefei, Anhui; Lanzhou, Gansu; Shijiazhuang, Hebei; Taiyuan, Shanxi; Wuhan, Hubei; Yinchuan, Ningxia; and Zhengzhou, Henan (see map). The ports of Lianyungang, Jiangsu; Qingdao, Shandong; Shanghai; and Tianjin are only one day away by truck, or four days by rail.

Xi'an is also on the Eurasia rail link, which runs from Lianyungang in Jiangsu to Rotterdam in the Netherlands, giving firms in the city the option of shipping to Central Asia and Europe by rail. (Technical, tax, and customs barriers of the countries along the route currently lessen the appeal of this option, however.) In 2004, Xi'an's rail stations processed 23.8 million passengers and 41.3 million tons of freight, up 26.1 percent and 12.7 percent from 2003, respectively.

Travelers can fly to six international destinations from Xi'an—Seoul and Pusan in South Korea and Tokyo, Nagoya, Niigata, and Fukuoka in Japan—as well as nearly 50 other Chinese cities, including Hong Kong and Macao. In 2004, 6.3 million passengers and 111,000 tons of cargo flowed through the Xi'an Xianyang International Airport, up 45 percent and 28 percent over 2003, respectively.

Foreign investment

By the end of 2005, Xi'an had attracted 2,258 companies from 58 countries, with a total utilized foreign investment of $3.12 billion. More than 30 Fortune 500 enterprises have set up in Xi'an.

Preferential policies

Xi'an offers several tax incentives for foreign investors, in addition to various national-level policies. Most of these incentives focus on export-oriented enterprises and those in high-tech and other encouraged sectors.

For instance, manufacturing foreign-invested enterprises (FIEs) are normally taxed at a rate of 24 percent. Between 2001 and 2010, enterprises in sectors in which the state encourages investment are taxed at 15 percent. High-tech enterprises registered in the Xi'an High-Tech Industries Development Zone and manufacturing enterprises registered in the Xi'an Economic and Technology Development Zone (ETDZ) are also taxed at 15 percent. Advanced technology enterprises may qualify for additional tax breaks.

FIEs that reinvest profits may receive a refund of 40 percent of the tax paid by the enterprises in which the money was reinvested; that amount rises to 100 percent for

Critical Eye on Xi'an

The ancient capital is repositioning itself as northwest China's technology and transportation hub

export-oriented or advanced technical enterprises. Most FIEs that export 70 percent of their total annual output value can recover half of their income tax paid that year.

Income gained from the transfer of technology, technical development, and related technical consultation and services may be exempt from business tax. In some cases, FIEs may deduct half of research and development (R&D) expenses from the income tax payable that year. Export-oriented or advanced technology FIEs, or those in other favored industries, can be exempted from local income tax, city real estate tax, and vehicle- and ship-use license tax.

11th Five-Year Plan Highlights

Xi'an's 11th Five-Year Plan (2006–10) focuses on building and improving infrastructure, both inside of the city and between Xi'an and other cities.

Main Goals

- Attain average annual GDP growth of 12 percent
- Construct new city center north of Wei River
- Use natural gas for 97 percent of energy by 2010
- Upgrade water, power, and heating systems
- Improve water quality in eight rivers
- Develop six key industries: high technology, equipment manufacturing, tourism, cultural industry (exchanges, film, performances), modern services, and software
- Move city government north to south bank of Wei River and build new city center there

Transportation Projects

- Build two subway lines
- Develop rail hub ranked fifth nationwide
- Build new Xi'an-Zhengzhou railway
- Build Beihuan cargo line from Xi'an to nearby cities
- Build Xinzhu container transportation center
- Build Xinfeng cargo marshalling yard, to be the largest in northwest China
- Build Xi'an North Railway Station
- Expand Xi'an Xianyang International Airport
- Finish third ring road
- Build freeways to Hangzhou, Zhejiang; Hefei, Anhui; and Nanjing, Jiangsu

Source: Xi'an Municipal Development and Reform Commission

A new attitude

One of the more interesting aspects of the foreign investment climate in Xi'an is the determination of city and zone officials, particularly in the high-tech zone and the Bureau of Foreign Trade and Economic Cooperation, to serve investors better. This determination stems, at least in part, from the loss of a large investment to a rival city.

Xi'an's main competitor in the race to attract foreign investment is Chengdu, capital of Sichuan. Xi'an officials were rudely awakened in 2003, when Intel Corp., which had looked at both cities, chose Chengdu for a $375 million investment. Xi'an officials interviewed for this article were refreshingly frank about their need to do better, noting that the Intel incident led the city to overhaul its investment promotion policies. Now, say Xi'an officials, high-level administrators make investment promotion a top priority—an attitude that is relatively rare among officials in western China. At the working level, every agency related to investment has experts on hand to perform feasibility studies quickly, and 23 teams provide assistance to potential investment projects. The effort seems to be bearing fruit. In recent years, Xi'an has attracted large investments from ABB Inc., Applied Materials, Inc., and Micron Technology, Inc.

Despite these successes, city officials note that foreign investors may still face challenges, such as finding all the necessary information to make business decisions. To help foreign investors navigate the regulatory maze, Xi'an, like many other Chinese cities, has created a "Green Channel,"

Virginia A. Hulme *is editor of the* CBR.

The author would like to thank Lin Jun of the US-China Business Council's Beijing office for his research assistance on this article.

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or a one-stop service area that brings 40 different government departments together in one location. Several officials admitted that the city's soft environment is not as good as that of most east coast cities, but is improving.

In the zone

Xi'an has two main investment zones, the Xi'an ETDZ and the Xi'an High-Tech Industries Development Zone. The Yanliang National Aviation High-Tech Industrial Base, approved by the National Development and Reform Commission in 2004, is a relatively new national-level zone. Local-level zones include the Qujiang Tourism and Holiday Resort Development Zone, located near the Dayan Pagoda and featuring a reconstructed Tang Dynasty garden, and the Chang-Ba Ecological Zone, where a conference center for the Boao Forum for Asia is to be built.

Xi'an ETDZ

The Xi'an ETDZ, located on the north side of the city, was established in 1993 and became a national-level zone in 2000. In 2002, the ETDZ opened the first export-processing zone (EPZ) in northwest China. Goods can clear customs in the EPZ, which provides a 24-hour clearance service. In the first three quarters of 2005, the ETDZ exported goods worth $135.4 million.

Xi'an ETDZ boasts 1,800 companies, 600 of which are FIEs. Of these, 15 are Fortune 500 companies, including ABB Inc., BP, the Coca-Cola Co., Hitachi Ltd., Mitsubishi Corp., and Siemens AG. Companies in the zone focus on petrochemical, electronics, food and beverages, and biopharmaceuticals.

Xi'an ETDZ has spent ¥3 billion ($374.6 million) on infrastructure and plans to spend another ¥3 billion in the

Xi'an at a Glance

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Top 10 Foreign Investors, 2005

No.	Country/ Region	Company
1.	Japan	Xi'an Daikin Qing'an Compressor Co., Ltd.
2.	Japan	Brother Sewing Machine (Xi'an) Co., Ltd.
3.	Taiwan	Xi'an Tinghsin Food Co., Ltd.
4.	Japan	Xi'an Typical Brothers Industries Co., Ltd.
5.	US	Xi'an BC Coca-Cola Beverages Ltd.
6.	Germany	Siemens Signalling Co. Ltd.
7.	Japan	Xidian Mitsubishi Switch Co., Ltd.
8.	US	Xi'an Fedders Dongfang Air Conditioner Compressor Co., Ltd.
9.	US	Xi'an Sensor Electric Co., Ltd.
10.	Germany	Xi'an Schaltbau Electric Co., Ltd.

Note: Ranked by actual amount invested.
Source: Xi'an Municipal Bureau of Foreign Trade and Economic Cooperation

next two years. As part of these plans, the zone will develop four sub-zones. The central zone will focus on modern services, such as real estate, finance, and insurance; trade and commerce; catering; and entertainment. The EPZ will focus on machinery and electronics production. The Jing-Wei Industrial Zone will concentrate on making heavy-duty trucks, new materials, and machinery and equipment. Finally, the Caotan Ecological Industrial Zone hopes to take advantage of plans to relocate the city government to grow into the new city center, with a focus on food processing, biopharmaceuticals, culture, education, and entertainment. The city's new railway station will be located in the ETDZ.

Xi'an High-Tech Industries Development Zone

Located in the southwest corner of the city, the Xi'an High-Tech Industries Development Zone, established in 1988, won national-level approval in 1991. The zone features a business incubator and specialized parks for software, pharmaceuticals, and other industries. Its main industries are electronic information, equipment manufacturing, biomedicine, and autos. Of the zone's 6,000-plus enterprises, roughly 10 percent are FIEs. The zone also aims to attract innovative companies; according to zone officials, it already has 6,000 innovative projects, some of which have won patents. In addition, some of the processing operations use their own inventions. Foreign companies in the zone include Honeywell, Royal Philips Electronics NV, Robert Bosch GMBH, Brother Industries, Ltd., NEC Corp., Fedders Corp., Fujitsu Ltd., and PepsiCo, Inc.

Like Xi'an's city foreign investment officials, the high-tech zone officials emphasize that they have changed their mindset "from management to service." The zone's investment promotion bureau introduces potential investors to the zone, the investment service bureau signs the investment agreement for land and construction, and the economic development bureau helps investors find their way through the maze of regulatory approvals needed to set up a firm in China. The zone also offers incentives for technology start-ups by Chinese who have studied abroad, R&D centers, and other companies with a technology component.

Strong hard skills, weaker soft skills

One of Xi'an's advantages is its technically skilled workforce. The city has 37 public and 36 private universities, more than 660 research institutes, 400,000 specialized technicians, 800,000 university students, and 150,000 information technology engineers. These institutions provide a deep pool of technical talent for companies based in the city.

Continued on page 44

By the Numbers

	2005	Increase from 2004 (%)
GDP	¥127.0 billion	13.1
Fixed-Asset Investment	¥83.5 billion	29.1
Value-Added Industrial Output	¥42.0 billion	12.1
Total Retail Sales of Consumer Goods	¥66.7 billion	15.2
Consumer Price Index	0.3%	—
Government Revenue	¥8.4 billion	15.8
Population	7.4 million	—
Urban Disposable Per Capita Income	¥9,628	12.7
Rural Net Per Capita Income	¥3,460	10.1
Trade		
Total Trade	$3.9 billion	26.2
Exports	$2.6 billion	29.5
Of which FIE Exports	$195 million	18.9
Imports	$1.3 billion	19.8
Foreign Direct Investment		
Number FIEs Approved	159	-1.0
Amount Contracted	$1.4 billion	33.0
Amount Utilized	$571 million	107.0

Note: FIE = foreign-invested enterprise
Sources: Xi'an Municipal Government, Xi'an Municipal Bureau of Foreign Trade and Economic Cooperation

Sales and Investment

January 16–March 15, 2006

The following listings contain information from recent press reports of business contracts and negotiations exclusive of those listed in previous issues. For the most part, the accuracy of these reports is not independently confirmed by the *CBR*. Firms whose sales and other business arrangements with China do not normally appear in press reports may have them published in the *CBR* by sending the information to the attention of the editor.

Compiled by Maria Repnikova

Advertising, Marketing & Public Relations

INVESTMENTS IN CHINA

WPP Group plc (UK)
Bought 65% stake in Shanghai-based Sapphire Bright Ltd. 03/06.

Architecture, Construction & Engineering

CHINA'S IMPORTS

Otis Elevator Co., a unit of United Technologies Corp. (US)
Won a contract to supply and install 120 elevators for Shunfa Jiajing Tiancheng residential complex in Hangzhou, Zhejiang. 03/06.

INVESTMENTS IN CHINA

Triumphal Associates Bhd (Malaysia)/Shandong Shantui Machinery Ltd.
Signed agreement to jointly manufacture parts for construction equipment. 03/06.

Automotive

INVESTMENTS IN CHINA

Cummins, Inc. (US)/Beiqi Foton Motors Ltd. (Beijing)
Will form diesel engine joint venture in Beijing. $242 million. 03/06.

FCC Co., Ltd. (Japan)
Established WFOE, China FCC Foshan Co., Ltd., in Guangdong to produce and sell clutches and related components for four-wheeled vehicles. 02/06.

Mitsubishi Motors Corp. (Japan)
Will buy 20% stake in South East Motor (Fujian) Co., Ltd. from Taiwan-based China Motor Corp. 02/06.

Getrag Getriebe-Und Zahnradfabrik Hermann Hagenmeyer Gmbh & Cie. KG (Germany)/Jiangling Motor Co. Group (Jiangxi)
Formed joint venture, GETRAG (Jiangxi) Transmission Co. Ltd., to produce manual and automated manual transmissions and sets of transmission components in Jiangxi. (Germany:67%-PRC:33%). 01/06.

Aviation & Aerospace

CHINA'S IMPORTS

AAR Landing Gear Services, a unit of AAR Corp. (US)
Will provide landing gear maintenance, repair, and overhaul services for China Eastern Airlines Corp. Ltd.'s fleet of 767-300 aircraft. 03/06.

INVESTMENTS IN CHINA

European Aeronautic Defense & Space Co. NV (the Netherlands)/AVIC II (Beijing)
Will form joint venture to develop and build helicopters. $481 million. 03/06.

SR Technics Group (Switzerland)/Shanghai Foreign Aviation Service Corp.
Will form a joint venture, Shanghai SR Aircraft Technics, to provide technical services at Shanghai International Airport. 01/06.

Banking & Finance

CHINA'S IMPORTS

Wincor Nixdorf International GmbH (Germany)
Will provide 877 ATM machines to ABC. 03/06.

Euronet Worldwide, Inc. (US)
Will provide ATM machines and outsourcing services to the PRC Postal Savings and Remittance Bureau. 01/06.

INVESTMENTS IN CHINA

Xinhua Finance Ltd. (Hong Kong)
Bought Beijing Alpha Financial Engineering Co. Ltd. $2 million. 03/06.

The Goldman Sachs Group, Inc., American Express Co. (US), Allianz AG (Germany)
Bought 10% stake in ICBC. $3.8 billion. 01/06.

Shamil Bank (Bahrain)
Launched Shamil China Realty Modaraba to invest in Xuan Huang China Realty Investment Fund Ltd., a joint venture between Shamil Bank and CITIC. $100 million. 01/06.

OTHER

Lazard LLC (Bermuda)
Opened representative office in Beijing. 03/06.

The National Commodity and Derivatives Exchange Ltd. (India)/Dalian Commodity Exchange (Liaoning)
Signed MOU on information sharing. 01/06.

Chemicals, Petrochemicals & Related Equipment

INVESTMENTS IN CHINA

Degussa AG (Germany)/Fujian Nanping Xinyuan Investment Co., Ltd.
Will form a joint venture, Degussa Wellink Silica (Nanping) Co., Ltd., to manufacture and market performance silica. (Germany:60%-PRC:40%). 02/06.

Electronics, Hardware & Software

CHINA'S IMPORTS

SCAM Co., Ltd. (South Korea)
Won a contract from Sichuan Changhong Electric Co. Ltd. to provide 50,000 NF-1 GPS units. $10.9 million. 02/06.

INVESTMENTS IN CHINA

Darwin Partners Inc. (US)
Bought Suzhou-based Suzsoft Co., Ltd. 03/06.

FlipChip International, LLC (US)/Millenium Microtech (Shanghai) Co., Ltd.
Formed joint venture in Shanghai to provide wafer level packaging and flip chip bumping services. 02/06.

Schneider Electric China Investment Ltd., a subsidiary of Schneider Electric SA (France)/Shaanxi Baoguang Group
Formed joint venture, Schneider (Shaanxi) Baoguang Electrical Apparatus Co. Ltd., to manufacture and distribute medium-voltage vacuum circuit breakers in Baoji, Shaanxi. (France:70%-PRC:30%). 02/06.

Environmental Equipment & Technology

CHINA'S IMPORTS

Bio-Treat Technology Ltd. (Singapore)
Won two turnkey municipal projects in Funing and Xiangshui, Jiangsu. $24.7 million. 03/06.

Electrowatt Infra AG, a unit of Jaakko Pöyry Group Oy (Finland)
Won an extension of services contract in the Kunming water supply tunnel project from Zhangjiu River Water Diversion and Water Supply Project Administration

Bureau of Kunming, Yunnan. $1.2 million. 01/06.

INVESTMENTS IN CHINA

Asian Environment Holdings Ltd. (Singapore)/Harbin Binxi Economic Development Zone (Heilongjiang)
Signed a deal to build and operate a water supply and wastewater treatment plant. $23 million. 03/06.

Veolia Environnement SA (France)/SINOPEC (Beijing)
Will form a joint venture to treat the wastewater of Beijing Yanshan PetroChemicals Co., Ltd., a SINOPEC unit located near Beijing. 01/06.

Food & Food Processing

INVESTMENTS IN CHINA

Uni-President Enterprises Corp. (Taiwan), Nissin Food Products Co. (Japan)/ NissinHualong Food Co. (Hebei)
Will form bottled-drinks joint venture, Jinmailang Drink (Beijing) Co., in Beijing. (Taiwan:50%-Japan:16.7%-PRC:33.3%). 02/06.

InBev NV/SA (Belgium)
Will increase its stake in Fujian Sedrin Brewery Co. Ltd. from 60.52% to 100%. $754 million. 01/06.

Forestry, Timber & Paper

INVESTMENTS IN CHINA

Metso Paper, Inc., a subsidiary of Metso Corp. (Finland)
Will buy Shanghai-Chenming Paper Machinery Co. Ltd. 02/06.

Insurance

INVESTMENTS IN CHINA

Insurance Australia Group Ltd. (Australia)
Signed investment MOU with Shanghai-based China Pacific Property Insurance Co. Ltd. 02/06.

Media, Publishing & Entertainment

CHINA'S IMPORTS

M-Mode Bhd (Malaysia)
Launched two online games for China Unicom subscribers. 01/06.

INVESTMENTS IN CHINA

Nurun Inc., a subsidiary of Quebecor Media Inc. (Canada)
Bought Shanghai-based China Interactive Co. 02/06.

OTHER

Shanda Interactive Entertainment Ltd. (Shanghai)
Signed an exclusive license agreement with South Korea-based NHN Games Corp. to operate ArchLord, a 3D multiplayer online role playing game, in China. 02/06.

Metals, Minerals & Mining

INVESTMENTS IN CHINA

Arcelor SA (Luxembourg)
Will buy 38% stake in Shandong-based Laiwu Steel Corp. Ltd. $225 million. 02/06.

PAMP SA (Switzerland)/ The Great Wall Gold and Silver Refinery (Sichuan)
Formed a joint manufacturing and marketing venture. 02/06.

SGL Carbon AG (Germany)/Sinyuan Industrial Material Co. Ltd. (Zhejiang)
Formed joint venture, SSG Ningbo Co. Ltd., to manufacture expanded graphite products in Ningbo, Zhejiang. (Germany: 60%-PRC:40%). 02/06.

OTHER

Dynasty Gold Corp. (Canada)/Avocet Mining plc (UK)
Signed MOU, with Avocet contributing up to $1.8 million to advance Dynasty's Hatu exploration project in Xinjiang. 03/06.

Packaging & Labeling

INVESTMENTS IN CHINA

Rexam plc (UK)
Bought Shanghai-based FangXin Ltd. $74 million. 02/06.

Petroleum, Natural Gas & Related Equipment

CHINA'S INVESTMENTS ABROAD

Andes Petroleum Co., a joint venture of CNPC and SINOPEC (Beijing)
Acquired oil and pipeline assets in Ecuador of Canada-based EnCana Corp. $1.4 billion. 03/06.

INVESTMENTS IN CHINA

Ivan Ventures Inc. (Canada)/China United Coalbed Methane Corp. (Shandong)
Will jointly explore coalbed methane in eastern China. 03/06.

Stolt-Nielsen Transportation Group (SNTG), a subsidiary of Stolt-Nielsen SA (UK)/Lingang Harbor Affairs Co. (Tianjin)
Signed MOU for the long-term lease of waterfront property, on which SNTG will build a chemical and oil products terminal. 03/06.

Reflection Oil & Gas Partners Ltd. (UK)/China United Coalbed Methane Corp. (Shandong)
Will jointly explore, develop, produce, and sell coalbed methane from Luliang, Shanxi. 02/06.

OTHER

Jiffy Lube International, Inc. (US)
Opened first store in Shanghai. 03/06.

Petromin Resources Ltd. (Canada)/DPDC, a subsidiary of SINOPEC (Beijing)
Signed MOU to form a strategic business alliance to identify and develop oil and gas resources in Canada and abroad. 03/06.

Total SA (France)/ PetroChina (Beijing)
Signed production-sharing contract for evaluation, development, and production of the natural gas resources of the South Sulige block of Ordos Basin, Inner Mongolia. 03/06.

Abbreviations used throughout text: ABC: Agricultural Bank of China; ADB: Asian Development Bank; ASEAN: Association of Southeast Asian Nations; ATM: automated teller machine; AVIC I and II: China Aviation Industry Corp. I and II; BOC: Bank of China; CAAC: General Administration of Civil Aviation of China; CATV: cable television; CBRC: China Banking Regulatory Commision; CCB: China Construction Bank; CCTV: China Central Television; CDB: China Development Bank; CDMA: code division multiple access; CEIEC: China National Electronics Import and Export Corp.; China Mobile: China Mobile Communications Corp.; China Netcom: China Netcom Corp. Ltd.; China Railcom: China Railway Communications Co., Ltd.; China Telecom: China Telecommunications Group Corp.; China Unicom: China United Telecommunications Corp.; CIRC: China Insurance Regulatory Commission; CITIC: China International Trust and Investment Corp.; CITS: China International Travel Service; CNOOC: China National Offshore Oil Corp.; CNPC: China National Petroleum & Gas Corp.; COFCO: China National Cereals, Oils, and Foodstuffs Import and Export Corp.; COSCO: China Ocean Shipping Co.; CSRC: China Securities Regulatory Commission; DSL: digital subscriber line; ETDZ: economic and technological development zone; GSM: global system for mobile communication; GPS: global positioning system: ICBC: Industrial and Commercial Bank of China; IT: information technology; LNG: liquified natural gas; MII: Ministry of Information Industry; MOFCOM: Ministry of Commerce; MOU: memorandum of understanding; NA: not available; NDRC: National Development and Reform Commission; NORINCO: China North Industries Corp.; PAS: personal access system; PBOC: People's Bank of China; PetroChina: PetroChina Co., Ltd.; RMB: renminbi; SARFT: State Administration of Radio, Film, and Television; SEZ: special economic zone; SINOPEC: China National Petrochemical Corp.; SINOTRANS: China National Foreign Trade Transportation Corp.; UNDP: United Nations Development Program; SME: small and medium-sized enterprise; WFOE: wholly foreign-owned enterprise

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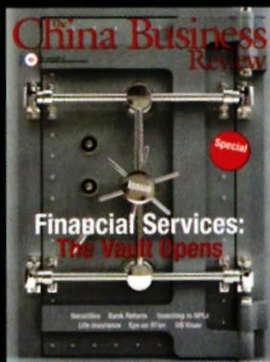

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China Business

Devon Energy Corp. (US)/CNOOC (Beijing)
Signed 11th production-sharing contract for block 11/34 in the Yellow Sea. 02/06.

Pharmaceuticals

OTHER

PharmaFrontiers Corp. (US)
Acquired exclusive license for the intellectual property rights and research results of autologous T-cell vaccine for rheumatoid arthritis from the Shanghai Institutes for Biological Sciences. 01/06.

Ports & Shipping

INVESTMENTS IN CHINA

FedEx Corp. (US)
Will increase its stake in Tianjin Datian W. Group from 50% to 100%. $400 million. 01/06.

Rail

CHINA'S IMPORTS

Pfleiderer AG (Germany)
Signed a contract with the PRC Ministry of Railways for transfer of railway technology. 01/06.

Real Estate & Land

INVESTMENTS IN CHINA

GuocoLand (China) Ltd., a subsidiary of Guocoland Ltd. (Singapore)
Bought 94.93% stake in Jiangsu-based Nanjing Ma Hui Property Development Co., Ltd. from San Bao Group Co., Ltd. $39.9 million. 01/06.

Research & Development

INVESTMENTS IN CHINA

Toyota Motor Corp. (Japan)/China FAW Group Corp. (Jilin)
Will form R&D joint venture to design vehicle exteriors and interiors. (Japan:50%-PRC:50%). 02/06.

OTHER

Siemens Ltd. (China), a subsidiary of Siemens AG (Germany)/East China University of Science and Technology (Shanghai)
Formed strategic alliance to conduct research on automation. 02/06.

Telecommunications

CHINA'S EXPORTS

Huawei Technologies Co. Ltd. (Guangdong)
Won a five-year contract from UK-based Vodafone Group plc to supply third-generation mobile handsets. 02/06.

ZTE Corp. (Guangdong)
Will provide Digital Subscriber Line Access Multiplexer products to Greece-based Hellenic Telecommunications Organization. 02/06.

ZTE Corp. (Guangdong)
Will provide broadband Internet services to Venezuela-based Cadafe Co. 01/06.

CHINA'S IMPORTS

Navitone Technologies, Inc. (US)
Will provide Mobile Resource Manager and Mobile Customer Relationship Management software and wireless service to Shanghai Unicom, a unit of China Unicom. 02/06.

UTStarcom, Inc. (US)
Won contracts from Beijing-based China Telecom to deploy RollingStream end-to-end Internet protocol television solution in two cities in Fujian. 02/06.

CHINA'S INVESTMENTS ABROAD

Nortel Networks Corp. (Canada)/Huawei Technologies Co. Ltd. (Guangdong)
Will form a Canada-based joint venture to develop equipment for broadband connections to homes. 02/06.

INVESTMENTS IN CHINA

Monstermob Group plc (UK)
Bought M Dream China Co. Ltd. $35 million. 01/06.

OTHER

Green Packet Shanghai Ltd., a subsidiary of Green Packet Bhd (Malaysia)/Zhejiang Telecom Co. Ltd.
Entered into agreement to promote wireless communication in Zhejiang. 01/06.

Qualcomm Inc. (US)/Yulong Computer Technology Co. Ltd., a subsidiary of China Wireless Technologies Group (Beijing)
Signed license agreement allowing Yulong to develop, manufacture, and sell subscriber units implementing third-generation CDMA standards. 01/06.

Textiles & Apparel

INVESTMENTS IN CHINA

Lotto Sport Italia SpA (Italy)/Scienward International Holdings Ltd. (Shanghai)
Formed joint venture Lotto China Ltd. to produce and sell sports and leisure products. 01/06.

Omikenshi Co., Ltd. (Japan)
Will set up a subsidiary, Omikenshi Shanghai Co., in Shanghai. 01/06.

Tourism & Hotels

OTHER

InterContinental Hotel Groups plc (UK)/Shanghai Greenland Group
Signed four new management contracts. 02/06.

Visas: What Your Company Can Do

Michael Overmeyer

The introduction of mandatory interview requirements for all individuals applying for a visa to enter the United States and the increased scrutiny given to PRC nationals with technical backgrounds has disrupted plans for many US companies operating in China. When these new policies were first introduced, companies regularly found themselves facing months-long delays in bringing Chinese employees, customers, and business partners to the United States. Applications for PRC nationals that were sent to Washington for security reviews were routinely lost, with some companies waiting for more than six months only to learn the applicant would have to reapply. In addition, mandatory collection of fingerprints from all visa applicants offends some high-level Chinese executives.

Companies have seen some progress in these areas. In early 2005, the US and PRC governments launched reciprocal multi-entry visas valid for one year. The US government also extended the validity of security checks it performs on PRC nationals with technical background to one year. In early 2006, the US departments of State and Homeland Security announced a package of new visa initiatives. Although none will bring immediate help to US companies in China, some elements—such as the proposed use of video conferencing for interviews—could eventually ease delays.

Despite these improvements, companies continue to face costly delays and unpredictability. Although there are no guarantees with the visa process, some companies have reported a better level of success after adopting the following best practices:

Apply early

This is the most important thing companies can do to increase the likelihood that their Chinese employees, customers, and business partners obtain a visa in time to visit the United States for important meetings or training programs. Unless the US Congress decides to appropriate funds for large increases in the number of consular officers responsible for conducting visa interviews, applicants will often face lengthy waits when scheduling an interview appointment. Check the State Department's Visa Wait Times website for the latest information on how long applicants have to wait for their interview (http://travel.state.gov/visa/temp/wait/tempvisitors_wait.php). Some applications, especially those of individuals with technical backgrounds, will be referred to Washington for a security review. The State Department says a large majority of these cases are completed within 30 days.

Reach out to US consular officials

Many companies have strong relationships with the US commercial officers in China, but fewer are in contact with the consular section of the US embassy in Beijing and the consulates in Chengdu, Sichuan; Guangzhou, Shanghai, and Shenyang, Liaoning, which are responsible for granting visas. Increasing the consular office's familiarity with your company can help reduce denials. Send the consular officer in charge of nonimmigrant visas information about your company's activities in China and its plans to bring employees, customers, and business partners to the United States. Be sure to put this on official company letterhead and to use the same letterhead when supplying supporting material for visa applicants.

Alert key US commercial and economic officers of travel plans

Commercial and economic officers at US posts in China can provide an unofficial supporting voice to visa applicants. Although neither has any authority to intervene in visa decisions, commercial and economic officials often work with their colleagues in the consular section on an informal basis to help US businesses obtain visas for their employees, customers, and business partners.

Notify the Business Visa Initiative of large events

The State Department's Washington-based Business Visa Initiative can assist companies with coordinating complicated visa matters. Companies should make sure that organizers of trade shows in which they are involved inform the Business Visa Initiative of their program and of whom they expect to attend. Companies often face complications when bringing delegations to the United States that include members from different parts of China. Coordination can be difficult as these applicants must apply for visas at different US posts in China. Companies can contact the Business Visa Initiative at businessvisa@state.gov or 202-663-3198 to ask that they inform the relevant posts of the company's needs.

Stress the importance of being prepared for the interview

Careless errors can have a significant effect on business plans. For example, employees, customers, and business partners who forget to bring necessary materials to the interview may be put at the end of the line for scheduling a new appointment. If applicable, applicants should bring their bank records, vehicle registration, residential lease or deed, marriage certificate, and birth certificates of children. All of these will help show that the applicant has strong ties to China and will not remain in the United States. Ensuring that applicants are prepared for their interviews will help avoid unnecessary and easily avoidable delays.

Provide appropriate supporting materials

Companies must provide visa applicants with detailed invitation letters from their US offices. These letters should include the applicant's name, passport number, date of birth, and a clear description of the trip's purpose. Be sure to provide extra copies of the invitation letter for the applicant to take along on his or her trip to the United States, since immigration officers sometimes ask to see the letters. For this reason, invitation letters should also include contact information for someone in the United States who can vouch for the visitor upon his or her arrival in the United States. This is especially important if the applicant is not fluent in English.

Take advantage of local AmCham services

Working with the US embassy and consulate, the local American Chambers of Commerce in Beijing and Shanghai provide helpful services to a qualified group of their members. These services can often allow Chinese employees of US companies—and, on a more limited basis, Chinese customers—to arrange interview appointment dates sooner than had they contacted the embassy or consulate directly.

For more helpful information from the US Embassy in Beijing, see https://www.usavisainformation.com.cn/eng/index.aspx

Michael Overmeyer *is manager, Government Affairs, at the US-China Business Council in Washington, DC.*

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