

SECURITIES AND CAPITAL MARKETS LAW IN CHINA

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CHINA'S FINANCIAL MARKETS

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1.1. Introduction

The term 'financial markets' (or capital markets) does not have a legally defined meaning in the People's Republic of China (China). It is sometimes said to be the market where financial products are traded. But what are financial products? Again, there is no clear definition and they are referred to as products that are traded in financial markets. In this way, we can be faced with the problem of circularity in defining financial markets. **1.01**

Given the ever-developing nature of financial markets, it may be neither necessary nor feasible to hammer out a definition. Rather, the term 'financial markets' can be better understood by reference to its economic function of effecting transfers between capital providers or investors, namely people with surplus capital, and capital users, namely people seeking capital for productive purposes. The capital transfer can be effected either directly between capital providers and users, or indirectly through intermediaries such as banks. **1.02**

- 1.03** Depending on the character of the financial intermediation employed or the type of the financial product issued, a financial market includes a range of different submarkets. Money markets and securities markets are, for instance, among the principal submarkets. The term ‘money markets’ is sometimes used to refer to the institutional networks which bring together lenders and borrowers of short-term funds. Classic examples of products traded in the money markets are commercial paper, promissory notes, and certificates of deposits. In contrast, securities markets concentrate on long-term debt and equity instruments, such as shares and debentures, with the stock exchanges as their principle form.
- 1.04** The focus of this book is on the law governing securities markets in China, but the discussion will be placed, where appropriate, in the broader context of Chinese financial markets. This is important, as the tide of financial modernization and innovation has made the traditional boundaries of financial sectors such as banking, insurance, and securities increasingly blurred.
- 1.05** Securities markets can be classified into a primary market and secondary market, according to the different functions. The primary market serves the function of transferring capital from investors to fund users by way of issuance of securities by companies. This is a process of capital formation and securities issuance. The secondary market then provides the trading for securities issued in the primary market. The principal example of this is the stock exchanges where the securities are quoted and traded through a centralized system.
- 1.06** While the secondary market does not contribute directly to capital formation, it provides important support. First, it provides liquidity by enabling investors to convert securities they hold into cash, ideally at minimum cost and with speed and ease. For investors, the availability of liquidity is often a very important consideration. Second, the secondary market has the function of price discovery and thus helps to establish the cost of capital for the issuance of securities in the primary market. When determining the issue price, one usually looks at important indicators in the secondary market—most notably the ratio of share market price to after-tax earnings per share (the P/E figure). This is the financial figure most commonly used to judge the profitability of a listed company. A high P/E figure means that the share price is high and thus the company can raise funds cheaply.

1.2. Evolution of China’s Financial Markets

1.2.1. Before 1978: no financial regulation in the true sense

- 1.07** After the founding of the People’s Republic of China (PRC) in 1949, the Communist Party of China gradually steered the nation toward a centrally planned economy modelled on that operating in the Soviet Union. Under the so-called ‘Socialist Transformation’ policy, private businesses were turned over to collective ownership

and eventually state ownership. Thereafter, as the economy was centrally planned and composed overwhelmingly of state-owned enterprises (SOE), there was little need for the existence of financial markets to fund businesses and allocate resources.

Hence, the financial markets established before the 'Socialist Transformation' policy were dismantled during this time. First, all stock exchanges ceased to operate in 1952, putting an end to the securities market. Second, the People's Insurance Company of China (PICC) was shut down in 1959, quickly followed by the closure of the insurance market altogether.¹ Finally, in the banking sector, the People's Bank of China (PBC) became the only bank operating in China both as the central bank and as a commercial bank. Although the PBC provided the traditional service of saving and lending, it functioned essentially as an instrument of the government rather than a real commercial bank, as understood in western economies. The PBC was used primarily as a conduit through which state money was channelled to fund SOEs under orders from the government. In short, there was no financial regulation in the true sense of the term. **1.08**

1.2.2. 1978–1992: centralized and single regulator

In 1978, the economic reform policy was introduced by the Third Plenary Session of the 11th National People's Congress, marking an important watershed in the development of China's financial markets and indeed the general economy. First, the banking system was reformed to keep up with the transition to a market-oriented economy. As a starting point, the 'Big Four' state-owned banks were established or re-opened to provide specialized services, including the Agricultural Bank of China (ABC) in January 1979 for the agricultural sector, the Bank of China (BOC) in March 1979 for foreign exchange businesses, the Construction Bank of China (CBOC) in May 1983 for big construction projects, and the Industrial and Commercial Bank of China (ICBC) in January 1984 to take over the commercial activities of the PBC. **1.09**

In order to increase market competition in the banking sector, permission was given for more commercial banks—most of which are jointly owned by the state and private investors—to be set up at the national and local levels. Examples include the Communication Bank in 1987. In 1994, three policy banks—the China Development Bank, the Agricultural Development Bank of China, and the Export-import Bank of China—were created to free the 'Big Four' banks from the provision of policy loans, enabling them to function as real commercial banks. **1.10**

The other parts of the financial system also underwent significant reforms and developed rapidly. The securities market was brought back to life in the early 1980s, culminating in the establishment of Shanghai Stock Exchange and Shenzhen **1.11**

¹ Linbo Fan, 'The Insurance Market System' in Joseph J. Norton et al (eds), *Financial Regulation in the Greater China Area: Mainland China, Taiwan and Hong Kong SAR* (London: Kluwer Law International, 2000), 158.

Stock Exchange in 1990 and 1991 respectively. Likewise, the insurance market was revived with the reopening of the PICC in 1980 and the formation of more insurance companies thereafter.

- 1.12** As a consequence of the reform, the PBC took on a dual role in financial regulation. It performed the major functions of the central bank while at the same time supervising and regulating the whole financial system, including banking, securities, and insurance. Thus, this effectively rendered the PBC the single financial regulator at that time.

1.2.3. 1992–present: multiple sector-based regulators

- 1.13** With the rapid development of the financial markets since the early 1990s, China has been moving steadily toward a sector-based regulatory model with separate regulators for banking, securities and insurance.² First, in October 1992, responsibility for securities regulation was spun off from the PBC to the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC). These two securities regulators were merged and the surviving CSRC was vested with the exclusive authority to regulate the securities market in April 1998. Second, in keeping with the booming insurance market, the China Insurance Regulatory Commission (CIRC) was established in November 1998. Finally, in April 2003, the China Banking Regulatory Commission (CBRC) was set up to take over the function of direct banking regulation from the PBC.
- 1.14** Together with the PBC as the central bank, the above three highly specialized and mutually independent regulatory commissions make up China's financial regulatory framework, collectively referred to as *Yihang Sanhui* (one bank, three commissions). Different regulatory commissions are responsible for the administration and supervision of different financial sectors, namely banking, securities, and insurance. This sector-based regulatory model corresponds to the segmentation of financial services and markets in China, a policy commonly known as *Fenye Jingying*, *Fenye Jianguan* (separate operation, separate regulation). As shall be discussed later, the adoption of this regulatory regime has been heavily influenced by overseas experience, particularly that of the US.

1.3. Overview of Financial Markets in China

- 1.15** As China's current financial markets and regulation are essentially structured along the traditional lines of banking, securities, and insurance, the three sectors will be discussed in turn.

² For fuller discussion of the development of China's financial reform after its WTO accession, see eg James Barth et al (eds), *Financial Restructuring and Reform in Post-WTO China* (London: Kluwer, 2006).

1.3.1. Banking

1.3.1.1. Chinese banks

Apart from the central bank,³ there are several different types of institutions in China's banking system, including *guoyou shangye yinhang*, other commercial banks, policy banks, and non-bank financial institutions. All commercial banks take the legal form of a company, being either a limited liability company or a joint-stock limited company.⁴ As shall be explained, this complex banking system is attributable to a host of historical, political, and cultural factors. **1.16**

The first category comprises the state-owned commercial banks (*guoyou shangye yinhang*), chiefly the so-called 'Big Four', including the Bank of China, the ICBC, the CBOC, and the ABC. As noted before, these banks were previously specialized banks, but are all now developing into comprehensive commercial banks. Due to their historical background and strong foundation, they are very large, with huge client bases, and together command the lion's share of the market in terms of public savings, deposits, and loans.⁵ **1.17**

In order to meet the challenge brought about by China's accession to the World Trading Organization (WTO), reforms have been carried out to improve the quality of the 'Big Four' banks and eventually secure their listing on the stock market. On 27 October 2005, the CBOC made the breakthrough, becoming the first of the 'Big Four' banks to be listed in HK. This was followed by the Bank of China, which was listed in HK on 1 June 2006 and dual-listed in Shanghai soon after on 5 July 2006. A couple of months later, the ICBC was dual-listed in HK and Shanghai simultaneously on 16 October 2006. In July 2010, the ABC was finally dual-listed in Shanghai and HK, in what was then the world's largest initial public offering by value. **1.18**

Second, there are three state-owned policy banks, including the China Development Bank, the Agricultural Development Bank of China, and the Export-import Bank of China. As discussed earlier, these three banks were established in 1994 to take over the provision of policy loans from the 'Big Four' banks. They specialize in different areas and operate independently of each other: the China Development Bank is charged with financing key construction projects of the state; the Agricultural Development Bank of China handles policy loans in the agricultural sector; and the Export-import Bank of China provides policy financial support for the import and export of capital goods such as mechanical and electrical products **1.19**

³ For more discussion of the central bank in China, see Chapter 2.

⁴ *Zhonghua Renmin Gongheguo Shangye Yinhang Fa* [Law of the PRC on Commercial Banks] (adopted at the 13th session of the Standing Committee of the 8th National People's Congress of the PRC on 10 May 1995, amended on 27 December 2003), art 2.

⁵ Yang Li et al (eds), *2006 Annual Report on China's Financial Development* [*Zhongguo Jinrong Fazhan Baogao 2006*] (Beijing: Social Sciences Academic Press, 2006), 76–9.

and complete sets of equipment. In recent years policy banks, particularly the China Development Bank, have tried to engage in commercial banking business.

- 1.20** Third, about a dozen so-called joint-stock commercial banks (*gufenzhi shangye yinhang*) have been established since the 1980s, such as the Merchant Bank, the Minsheng Bank, the Pudong Development Bank, and the Shenzhen Development Bank (now renamed PingAn Bank). A common feature of these banks is that they are small or medium-sized and relatively efficient. Originally they conducted business on a regional basis; they have since been gradually branching out nationwide to rival the large state-owned banks.
- 1.21** Further, there is a residual group of banking or non-banking financial institutions engaged in deposit-taking and lending business. This includes, among others, urban commercial banks, rural commercial banks, urban credit unions, and rural credit unions. Urban/rural commercial banks transformed from urban/rural credit unions, respectively. As part of the overall financial reform programme, urban credit unions sprang up like mushrooms from the beginning of the 1980s, and totalled more than 5,000 by the 1990s. Credit unions were, however, found to have many problems in relation to risk management, and thus since the mid-1990s, the central government has implemented the policy of transforming credit unions into commercial banks. There are now more than 100 urban commercial banks nationwide. In general, urban commercial banks are small in size and are positioned to serve the local economy, particularly small and medium-sized businesses. Hence, commercial banks in more economically developed regions, such as Shanghai Bank, have grown more rapidly.
- 1.22** Finally, it is worth noting the recent establishment of the Postal Savings Bank of China. As early as 1986, the postal office was allowed to engage in deposit-taking business, and in 2004 its scope of business expanded to full-scale banking services. In March 2007, the postal banking business was spun off to establish the Postal Savings Bank of China. This bank takes advantage of the nationwide network of the post office and claims to serve the agricultural sector, small and medium-sized enterprises, and individual clients. It has recently experienced rapid growth and, as of the end of 2011, was ranked the sixth largest commercial bank in China, after the 'Big Four' and the Bank of Communications.

1.3.1.2. Foreign banks

- 1.23** An increasing number of foreign banks have entered the Chinese market, particularly after China's WTO accession in 2001. The presence of foreign banks in China takes several different forms. The first form is the so-called foreign-invested legal person bank (*waizi faren yinhang*), which is incorporated as an independent legal person under the Chinese law. Second, foreign banks can set up China branches (*waiguo yinhang fenhang*), which are not independent legal persons in China. The final form is the representative office of foreign banks. The representative office

cannot engage in substantive business in China, and is set up by foreign banks usually as the first step of their China adventure to gather relevant information on whether, and how, they should proceed further. As of the end of 2011 there were 39 foreign-invested legal person banks, 93 foreign bank branches, and 207 foreign bank representative offices, with the foreign banks coming from a total of 47 countries and regions.⁶

As per its WTO commitment, China has gradually removed previous restrictions on various issues, such as geographical location, client type, and business scope, for foreign banks to operate in China. Now, foreign banks are given national treatment: foreign-invested legal person banks are treated in the same way as Chinese banks with respect to business scope and regulatory standard; as foreign bank branches are not independent legal persons, they are still subject to some business restrictions, but the restrictions have been much reduced. In order to better perform its regulatory duty and protect the interests of depositors, the CBRC has encouraged foreign banks to transform their China branches into foreign-invested legal person banks. Compared to foreign bank branches, foreign-invested legal person banks are much larger in terms of value of assets and deposits. As of the end of 2011, foreign-invested legal person banks accounted for 87.66 per cent of all foreign bank assets in China and 95.56 per cent of deposits taken by foreign banks. **1.24**

1.3.2. Securities market

1.3.2.1. Stock exchanges

As a major initiative of China's economic reform since the late 1970s, the securities market has been given much development priority by the Chinese leadership and thus has experienced rapid growth.⁷ There are currently two national stock exchanges in Shanghai and Shenzhen, which were established in 1990 and 1991 respectively. By the end of 2012, the two exchanges were handling an aggregate of 2,494 listed companies, with a total market capitalization of 23.04 trillion yuan (CNY) (roughly USD 3.78 trillion), which accounted for about 44.36 per cent of China's gross domestic product (GDP) in 2012 and overall the Chinese stock market was ranked the second largest stock market in the world.⁸ **1.25**

The current relationship between the two stock exchanges in Shanghai and Shenzhen is more complementary than competitive, as a result of the governmental planning and control. Essentially, the CSRC decides in which markets the stock exchanges may operate, and what financial products can be traded **1.26**

⁶ From the official website of the CBRC, <http://www.cbrc.gov.cn>.

⁷ For a fuller account of the development of China's securities market, see Hui Huang, *International Securities Markets: Insider Trading Law in China* (London: Kluwer Law International, 2006), Ch 2.

⁸ CSRC, *2012 Annual Report*, 16, available at the official website of the CSRC, <http://www.csrc.gov.cn>.

there. The Shanghai Stock Exchange operates a Main Board market (*zhu ban*), while the Shenzhen Stock Exchange, in addition to its Main Board, established a Small-and-Medium Enterprise Board (*zhong xiao ban*, SME Board) in 2004 and a Growth Enterprise Market (*chuang ye ban*, GEM) in 2009.⁹ In general, companies listed on the Main Board are larger, in terms of market capitalization, than their counterparts on the SME Board and the GEM.¹⁰ In September 2000, the Shenzhen Stock Exchange stopped listing companies on its Main Board and concentrated on the development of the SME Board and the GEM.¹¹

- 1.27** It is important to note that the equity structure of the Chinese stock market differs greatly from those in western nations. There are, depending on the criteria used, several different types of shares in China. Apart from the dichotomy of common and preferred shares, which is familiar to westerners, there are other special classifications, and these seem to be peculiar to China. This has resulted in the distinctive feature of market segmentation, which is essentially a historical product of China's progressive economic reform, with both economic and political reasons behind it.¹²
- 1.28** First, depending on the nationality of eligible traders and the currencies in which the shares are traded, there are traditionally two broad types of shares in the market: A-shares and B-shares. A-shares are basically limited to domestic investors, with both the principal and dividends denominated in the local currency, namely the CNY. In contrast, B-shares are generally designed for foreigners, including investors from Taiwan, Hong Kong, and Macau. While B-shares carry a face value denominated in CNY, they are traded in foreign currency on the basis of exchange rates at the time of transactions. No companies can issue B-shares unless they meet certain requirements prescribed by the government. So far, only about 100 companies have been approved to issue B-shares. In terms of market capitalization, B-shares account for a fairly small proportion, both in individual companies and as a whole, and thus their impact on the market is quite limited. A point to note is that, due to market segmentation, although B-shares carry the same voting and other relevant rights as A-shares, the prices of A-shares and B-shares for the same listed company are always different, sometimes by a significant degree.
- 1.29** Second, and more importantly, A-shares have been further sub-divided into three subsets in light of the strictly defined groups of shareholders in China: state shares (*guojia gu*); legal person shares (*faren gu*); and public individual shares (*shehui geren gu*). Only public individual shares may be freely traded on the stock exchange (they are therefore called tradable shares); state shares and legal person shares are subject

⁹ The GEM is also called the ChiNext or the Second Board.

¹⁰ For more discussion of the listing criteria of those submarkets, see Chapter 4.

¹¹ For this reason, the Main Board and SME Board of the Shenzhen Stock Exchange are sometimes collectively referred to as the Main Board of the Shenzhen Stock Exchange.

¹² For a detailed discussion of this, see Hui Huang, *International Securities Markets: Insider Trading Law in China* (London: Kluwer Law International, 2006), Ch 2.

to severe trading restrictions (and are therefore collectively called non-tradable shares). In general, non-tradable shares account for about two thirds of the shares in most listed companies.

As the economic reform proceeds, the government has been making great efforts to gradually solve the problem of market segmentation, with a view to bringing the market more in line with international norms. **1.30**

The A-share/B-share distinction has become blurred over time. The severance of the A and B-share markets is largely due to the incomplete convertibility of renminbi (RMB) and China's restrictive foreign currency policy. For example, precluding domestic investors from taking up B-shares is regarded as a measure to preserve the nation's foreign currency reserve. As the RMB is moving toward convertibility and internationalization, the separation between A-shares and B-shares has started to disappear. On the one hand, since February 2001, B-shares have been made available for domestic investors to purchase with foreign currency; on the other, the A-share market is gradually being opened up to foreigners. For instance, since November 2002, large financial institutions that count as Qualified Foreign Institutional Investors (QFII) have been able to purchase a quota of tradable shares in the A-share market.¹³ It is speculated that A-shares and B-shares markets will be merged in future, and thus the distinction between A-shares and B-shares will become history. **1.31**

Compared with the smooth way in which the A-share/B-share distinction has been reduced, the tradable/non-tradable shares segregation has proven a much harder problem to address. Non-tradable shares were created by the government in the early 1990s to prevent uncontrolled sales of SOEs to the private sector, but the system artificially distorted the functioning of the market, becoming a serious impediment to its further development. For instance, in the face of a high percentage of non-tradable state shares in listed companies, hostile takeovers are practically impossible.¹⁴ Since 2000, several unsuccessful experiments have been attempted to reform the non-tradable shares to make them freely tradable on the stock exchanges. **1.32**

In April 2005, the CSRC issued a new plan for shareholding structure reform entitled *Guquan Fenzhi Gaige*. Unlike its predecessors, this plan adopts a market-based process rather than a government-imposed approach, and thus has proven to be a great success. Two points need to be noted about this reform. First, the reform takes a gradualist approach, and there is a legal limit on the percentage of non-tradable shares which can be made freely tradable on a yearly basis. The legal limit is just a minimum requirement, and the individual company can prescribe a more stringent **1.33**

¹³ There are other ways in which foreign investors may acquire A-shares in China. For more discussion, see Chapter 12.

¹⁴ For more analysis of takeovers in China, see Chapter 10.

limit. This means that it will take some time, maybe a considerable period of time in some cases, for the reform to be complete. The purpose of this is to spread the impact of the reform on the market over time. Second, under the reform, the holder of previously non-tradable shares—notably the state—is given the right, and not obligation, to sell the shares freely on the stock exchange. The state policy is to sell most state shares into private hands, retaining only a tiny core that the state deems crucial for national defence, energy security, and so on. Hence in foreseeable future, with all non-tradable shares becoming freely tradable, the Chinese stock market will assume a radically different landscape, which will have far-reaching implications for corporate governance as well as securities regulation.

- 1.34** Finally, some Chinese companies are cross-listed on overseas exchanges, and their shares listed there are named after the location of the exchanges. For instance, H-shares are shares listed on the Hong Kong Stock Exchange while N-shares are listed on the New York Stock Exchange. The trading of these shares is mainly subject to the laws of listing locations rather than Chinese laws. Additionally, the overseas market capitalization of such shares usually represents a very small fraction of the total market capitalization of individual companies. Therefore, these shares have very little impact on the Chinese stock market. Notwithstanding their diminished relevance to this discussion, they are noted here for the sake of completing the picture of China's stock market.
- 1.35** Apart from shares, there are other financial products traded on the stock exchanges, including bonds, securities investment funds, and warrants. In comparison with the equity markets operated by the two stock exchanges, their bond markets are much less developed. There are a variety of publicly traded bonds, including treasury bonds, local government bonds, enterprise bonds, corporate bonds, convertible bonds, and equity warrant bonds.

1.3.2.2. Futures exchanges

- 1.36** In addition to the two stock exchanges in Shanghai and Shenzhen, there are several futures exchanges in China. Futures products can be divided into commodity futures and financial futures. The three exchanges for trading commodity futures include the Shanghai Futures Exchange, whose trading products are mainly industrial materials such as metals, rubber, and fuel; the Zhenzhou Commodity Exchange, which specializes in the trading of agricultural products such as wheat, cotton, sugar, and rice; and the Dalian Commodity Exchange, where trading items are from the agricultural and industrial sectors, such as yellow bean, corn, palm oil, and coke. In 2011, the volume of commodities traded in the above three exchanges accounted for 38.03 per cent of the global volume of commodities trading.
- 1.37** Compared with its commodity futures counterpart, China's financial futures market is less developed. The China Financial Futures Exchange is currently the only place where financial futures are traded. It was established in 2006 in Shanghai,

with five shareholders: the two stock exchanges and the three commodity futures exchanges. It was 2010 before it offered its first product, namely Shanghai-Shenzhen 300 Index Futures, but it has since released several other products.

1.3.2.3. Off-exchange markets

After the two national stock exchanges in Shanghai and Shenzhen were established in the early 1990s, all securities trading was required to be conducted on the exchanges. This in effect precluded the development of off-exchange markets. The 2005 Securities Law has changed the situation, providing that legally issued securities shall be traded on the stock exchanges or other places approved by the State Council. **1.38**

As an effort by the Chinese government to build a multilayered capital market, the off-exchange markets cater for companies that are not listed in the two stock exchanges in Shanghai and Shenzhen. This is important, simply because the two stock exchanges in Shanghai and Shenzhen cannot meet the needs of the rapidly growing economy in China: as of the end of 2012, there were more than 100,000 joint-stock companies, but less than 2,500 of them had been listed in the two stock exchanges. In practice, the off-exchange markets can be broadly grouped into the following several categories. **1.39**

The first category is the so-called 'Third Board Markets' (TBM, *san ban shi chang*), which can be further divided into two sub-groups, the Old TBM and the New TBM. The Old TBM provides a trading place primarily for companies that are delisted from the two stock exchanges. In contrast, the New TBM is designed for companies that are high-tech growth enterprises and whose shares are being traded publicly for the first time. It is thus similar to the GEM of Shenzhen Stock Exchange, with the major difference being that its listing criteria are lower than those of the GEM. In 2006, companies in the Beijing Zhongguancun Science and Technology Park were the first to be listed on the New TBM. In August 2012, the State Council allowed the New TBM to expand to other three high-tech parks, including Shanghai Zhangjiang, Wuhan Donhu, and Tianjin Binhai. As of the end of 2012, there were 56 companies listed on the Old TBM and 200 companies on the New TBM. On 16 January 2013 a new trading platform, operated by the National Small and Medium-sized Enterprise Equity Transfer System Limited, was formally unveiled, marking a new era of the development of the TBM. **1.40**

The second category is the so-called 'Regional Equity Trading Markets' (RETM, *qiyu guquan jiaoyi shichang*). Unlike the TBM, which is approved by the State Council and accommodates companies nationwide, the RETM is set up by the local governments mainly to serve local companies which are not listed on the two stock exchanges in Shanghai and Shenzhen. The RETM consists of three different types of institutions: (1) the Local Property Trading Institution (*difang chanquan jiaoyi jigou*), which trades many types of property, including equity interests; (2) the **1.41**

Local Equity Trading Institution (*difang guquan jiaoyi jigou*), which specializes in the trading of equity interests; and (3) the Local Equity Custodian Institution (*difang guquan tuoguan jigou*), which is empowered to do equity transfer registration and thus can perform the function of effecting equity transfer.

- 1.42** The third category is the over-the-counter market (OTC). In late 2012, seven securities firms were allowed to operate OTC markets as a pilot project. The OTC markets are currently designed for the issuance and trading of private equity products.

1.3.3. Insurance market

- 1.43** As noted earlier, commercial insurance activity resumed in China in 1980 when the PICC was re-opened for business. In recent years, with the rapid progress of social security reform, the insurance market in China has been growing by leaps and bounds. As at the end of 2009 there were more than 130 insurance companies, in comparison with 52 in 2002; their overall business volume hit a record high of 1.1 trillion CNY, almost quadruple the figure of 2002, and their overall assets were worth 4.1 trillion CNY, representing a nearly five-fold increase from 2002. In terms of market capitalization, the China Life Insurance has become the largest listed insurance company in the world. Consistent with its WTO commitments, China has expedited the opening up of its insurance market, with up to 47 foreign insurance companies having entered the Chinese insurance market by the end of 2009.¹⁵
- 1.44** Several general observations can be made about the Chinese insurance market. First, as shown above, the market has grown very rapidly, with an average 24 per cent annual increase in insurance policy income for the first decade of the new millennium. Second, the market is highly concentrated, so as to form an effective oligopoly. At the end of 2009, up to 96 per cent of market share was collectively in the hands of the five largest insurance companies, including the PICC, China Life Insurance, China PingAn Insurance, New China Life Insurance Company, and China Pacific Insurance. Third, as China's social-economic reform deepens, the growth potential for the insurance market is huge. The depth of China's insurance market—as measured by the ratio of insurance policy income to GDP—was just 3 per cent in 2011, compared to the average figure of 5 per cent worldwide, and even 12 per cent in developed economies. The figure of insurance density in China was about CNY1062/person (roughly USD171) in 2011, while even in 2007 the figure was USD4,087 in the US and USD7,114 in the UK.¹⁶ The CIRC aims to increase insurance depth and density to 5 per cent and CNY2100 during the period of the 12th Five-Year Plan.

¹⁵ From the website of the CIRC, <http://www.circ.gov.cn>.

¹⁶ Caifang Jiang, *Minzhu Diqu Baoxian Qiye Jinzheng Zhanlue Yanjiu [Research on Competition Strategies of Insurance Companies in Ethnic Minority Regions]* (2009, Central South University), 6.

1.4. Characteristics of China's Financial Markets

1.4.1. Unbalanced market structure

China's transition toward a market-based economy has proven, 30 years on, to be a huge success, and the financial markets have developed significantly to support that transition. The chief tasks of any financial system are to attract savings and channel them as efficiently as possible to productive investments. China's financial system already does an outstanding job of effecting transfers between those with surplus resources for investment and those seeking funds for productive enterprise. However, since the financial system itself is in transition, there are still obstacles to its overall efficiency in allocating resources. Of particular relevance here is the unbalanced structure of the Chinese financial system in terms of the component markets. **1.45**

The development has not been even among financial submarkets, with the banking sector having a highly dominant position. As a matter of tradition and culture, Chinese people save a lot by international standards, and most of their financial assets are held in bank deposits or in cash. In China, banks intermediate almost 75 per cent of the economy's capital; this figure is typically less than 20 per cent in developed countries.¹⁷ This means that China depends too heavily upon the banking system for capital allocation, leading to the underdevelopment of other financing methods through securities markets such as bond and equity markets. **1.46**

China's pattern of financial development can be explained by reference to political economy theories. To start with, political preferences before the era of economy reform clearly created path dependencies in shaping the current situation. As discussed earlier, during the era of the centrally planned economy, capital and products markets were virtually non-existent; at the early stage of economic reform, state-owned banks were the first batch of financial institutions to be set up to provide subsidized lending to capital-intensive infrastructure projects and manufacturing industries. Further, according to financial economists, debt finance is well suited to manufacturing where there are hard assets to pledge as collateral, whereas equity finance is more appropriate for high-growth sectors where assets are less tangible.¹⁸ It is thus unsurprising to see the dominance of the banking market in China, a country which has developed a role for itself as the world's factory. **1.47**

1.4.2. State ownership of financial institutions

The state owns or controls major Chinese financial institutions, resulting in a high level of concentration in the provision of financial services. For instance, the Big **1.48**

¹⁷ Diana Farrell et al, 'How Financial System Reform could Benefit China' (2006) (special edition) *The McKinsey Quarterly*, 46–47.

¹⁸ Franklin Allen et al, 'Does Economic Structure Determine Financial Structure?' working paper, Wharton School, University of Pennsylvania, December 2006.

Four state-owned commercial banks form the mainstay of China's banking system, accounting for 52.2 per cent of the total banking assets at the end of June 2008.¹⁹ The remaining banks are relatively small, with joint-stock commercial banks and foreign banks representing only 14 per cent and 2.3 per cent respectively. The situation is even worse for the insurance industry, where just the two largest state-owned insurance companies, namely the PICC and China Life Insurance, together command a market share of 70 per cent.²⁰ The state-owned financial institutions effectively enjoy a collective monopoly in the financial services and markets.

- 1.4.9** State-owned financial institutions traditionally favour SOEs and provide limited financing to private enterprises in China. In response to the global financial crisis, in late 2008 China launched a massive 4 trillion CNY (US \$586 billion) stimulus package, but much of this has been directed toward the sort of infrastructure projects that are dominated by large SOE.²¹ Of more than 7 trillion CNY loaned out in the first half of 2009 by Chinese banks, only an estimated 10 per cent has gone to smaller firms. This represents inefficiency in the financial system, as private enterprises—domestic, foreign-owned, and joint ventures—are the engine of growth in China's economy, together contributing about 60 per cent of all GDP output, 68 per cent of China's exports, and half of national tax revenues.²² In other words, China's small and medium-sized private firms do more for the national economy than large state-owned firms, but get less help from the financial system dominated by state-owned institutions. In practice, due to very limited access to banking loans, smaller firms have to resort to informal financing from friends and family, or to black-market lending schemes for which interest rates can be far higher than official bank rates. Empirical data show that smaller firms rely on informal or even illegal channels for more than one third of their financing needs.²³

1.4.3. Share ownership patterns in listed companies

1.4.3.1. Individual participation in stock markets

- 1.50** The Chinese securities market has a very high proportion of individual investors. As of the end of 2011, there were about 0.203 billion trading accounts for shares and close-ended funds in China, of which 99.51 per cent were individual investors.²⁴

¹⁹ From the website of the CBRC, <http://www.cbrc.gov.cn>.

²⁰ From the website of the CIRC, <http://www.circ.gov.cn>.

²¹ Yang Li (ed), *Zhongguo Jinrong Fazhan Baogao 2008–2009 [Report on China's Financial Development in the Year of 2008–2009]* (Beijing: Social Sciences Literature Press, 2009), 299–300.

²² Li (ed), *Report 2008–2009*, 299–300.

²³ Jianjun Li et al, *Zhongguo Dixia Jinrong Guimo yu Hongguan Jingji Yingxiang Yanjiu [Research on the Macro-economic Impact of Underground Financing Scale in China]* (Beijing: China Finance Press, 2005), 76–81.

²⁴ CSRC, *2011 Annual Report of the CSRC* (2011), 19, available at the official website of the CSRC, <http://www.csrc.gov.cn>. Note, however, that the real number of individual shareholders in China should be smaller than that suggested by the number of trading accounts, because of the phenomenon of multiple accounts being used by investors.

Table 1 Holdings of the largest shareholders in Chinese listed companies

Largest shareholding	2002	2008
Above 50 per cent	40 per cent	20.8 per cent
Between 20 per cent and 50 per cent	52.6 per cent	64.9 per cent
Below 20 per cent	7.4 per cent	14.3 per cent

Sources: Lin Lefeng, *Zhongguo Shangshi Gongsu Guquan Jizhongdu Yanjiu [Research on the Level of Shareholding Concentration in Chinese Listed Companies]* (Beijing: Economic Management Press, 2005), 151; Deng Hui, 'Woguo Shanghai Gongsu Guquan Jizhong Moshi xia de Guquan Zhiheng Wenti' [Checks and Balances on the Controlling Shareholders under the Concentrated Ownership Structure of Chinese Listed Companies] (2008) 6 *Zhongguo Faxue [China Law Science]*, 145, 146.

According to a recent survey conducted by the Securities Association of China (SAC) and the China Securities Investor Protection Fund Company (CSIPFC),²⁵ most of these individual investors are middle-aged individuals or senior citizens, with an average age of 40 years. The majority of them (70 per cent) are on a low or middle income, and 35.2 per cent have an annual income below RMB 24,000 (US \$3,582). Moreover, many Chinese individual investors may lack basic financial or investment knowledge, as about 45 per cent of them have no higher education.

1.4.3.2. Distribution of share ownership in listed companies

State ownership is very high in China's listed companies as a whole, generally representing two thirds of all shares of listed companies, as most listed companies have been transformed from SOE. 1.51

Since the late 1990s, the CSRC has been encouraging the growth of institutional investors as a strategic measure for the healthy development of China's capital markets. There are several different types of institutional investors, including securities investment funds, social security funds, annuities, insurance funds, securities firm funds, and qualified foreign institutional investors. There is evidence of a significant increase in institutional share ownership in China in recent years. As of the end of 2011, institutional investors altogether held about 73.45 per cent of tradable A-shares. However, since tradable A-shares account for only about one third of all Chinese shares, the figure for institutional holdings in total Chinese equities reduces to 24.48 per cent.²⁶ This is significantly lower than the proportion of equities held by their counterparts in the US and the UK, estimated at 52 per cent and 60 per cent respectively, as early as 1994. 1.52

²⁵ The Securities Association of China and the China Securities Investor Protection Fund Company, *Zhongguo Zhengquan Shichang Touzizhe Wenjuan Diaocha Fenxi Baogao [An Analytical Report on the Survey of Investors in China's Securities Markets]* (July 2007), 4.

²⁶ From the official website of the CSRC, <http://www.csrc.gov.cn>.

- 1.53** At the level of the individual company, the share ownership structure has been found as follows:

As shown in the table 1, the percentage of companies whose largest shareholders have absolute control (more than 50 per cent shareholding) reduced from 40 per cent in 2002 to 20.8 per cent in 2008; the percentage with respect to relative controlling shareholders increased from 52.6 per cent to 64.9 per cent during the same period. The changes were the interim result of the shareholding structure reform launched by the CSRC in 2005. This suggests a transition from an absolute controlling shareholder model to a relative controlling shareholder model, but the overall level of ownership concentration in most Chinese listed companies remains high.

1.4.4. Policy market

- 1.54** The Chinese stock market was established by the government under its economic reform policy with the primary function of raising funds for financially distressed SOE. Ever since then, the government has painstakingly looked after the market in a paternalistic fashion. Hence, the Chinese stock market is the direct result of government policies, rather than a natural product of economic development as is the case in western countries. In practice, the government often directly intervenes in the market with administrative measures and policies. This role played by the government makes the market vulnerable to policies, which has led to its being called a 'policy market' (*Zhengce Shi*).
- 1.55** Indeed, market fluctuations in China are mostly caused by government policies. It is not uncommon that share prices have nothing to do with relevant corporate performance but are fairly sensitive to government policies. One study examining the major ups and downs of the market between 1991 and 1997 found that these movements were due not to economic factors but to material government policies.²⁷
- 1.56** There is an interesting and peculiar method through which the government controls the development of the market in China. In the official government newspaper, the *People's Daily* (Renmin Ribao), the government often uses its editorials to exert an influence on the stock market. For instance, in response to the overheated market in 1996, the *People's Daily* published an editorial which bitterly criticized the mania of trading shares and pointed out that the market was full of irregularities and was too speculative.²⁸ As a result, the stock market slumped dramatically on three consecutive days. Likewise, after two years of a bear market, the *People's Daily* published another editorial to stimulate the market in 1999.²⁹

²⁷ Liang Yang, *Neimu Jiaoyi Lun [Insider Trading]* (Beijing: Law Press, 2001).

²⁸ Editorial, 'Properly Viewing the Current Stock Market', *Renmin Ribao [People's Daily]* 15 December 1996, at 1.

²⁹ Editorial, 'Improving Confidence and Quickening Development', *Renmin Ribao [People's Daily]* 15 June 1999, at 1.

Not surprisingly, compared to the rule of law, government policies change more frequently and are much less predictable. In order to meet the needs of the rapidly growing market, the government has to change its policies correspondingly. One commentator has found at least 13 noticeable cases of the government directly interfering with the market before 2000, seven of which rescued and stimulated the market and the rest of which chilled and slowed it.³⁰ To a large degree, this situation remains today. **1.57**

1.4.5. The gaming nature of the markets

The Chinese securities market, as an emerging market in a transitional economy, has one distinctive feature: that of being highly speculative. In 2001 Mr Wu Jinglian, a well-respected economist, compared the Chinese securities market to a casino, prompting hot debate on the way in which the Chinese securities market is run and regulated.³¹ The gaming nature of the securities markets can be attributed to a host of cultural, social, economic, and political factors. **1.58**

Compared to its more mature overseas counterparts, China's securities market has historically had a much higher P/E figure. The P/E figure in most developed stock markets is around 15–20, whereas in China it is about 45–55.³² Such a high P/E means that share prices are generally far too high, departing considerably from the fundamentals of listed companies. Put differently, the intrinsic values of shares and share market prices have been disconnected and the pricing function of the market is ineffective. As the high P/E figure suggests, the market becomes flooded with speculative activities, which need to be expelled. **1.59**

The high P/E figure's chilling effect on long-term investments is exacerbated by the fact that most listed companies in China do not distribute cash dividends, or if they do, they distribute them in a very low proportion to their already poor profits. Indeed, at present, most Chinese listed companies choose to give bonus shares (*Songgu*) instead of cash dividends to their shareholders. Thus, it is hard for investors to receive a return on their investments in the form of dividends, which leads them to trade shares in order to realize their gains. **1.60**

As a consequence, the rate at which shares change hands on the Chinese stock market is significantly higher than that in its overseas counterparts. The high rate **1.61**

³⁰ Zhiling Li, *Jiedu Zhongguo Gushi [Understand China's Stock Market]* (Shanghai: Sanlian Publishing House, 2002), 3.

³¹ Tai Feng, 'It is Not Harsh to Describe the Market as a Casino', *Zhongguo Jingji Shibao [China Economic Times]* 15 February 2001, at 3; Jianjin Zhang, 'A Meaningful Debate on the Stock Market', *Jianghuai Chenbao [Jianghuai Morning]* 18 February 2001, at 3.

³² In comparison, the P/E figure between China and overseas markets should not be taken at face value for a number of reasons, including the difference of sampling for calculation and the high proportion of non-tradable shares on China's market.

reflects the fact that Chinese investors enter the market in speculative mood and trade shares with a high frequency.

1.5. China and Global Financial Markets

1.5.1. The global financial crisis of 2008: implications for China

- 1.62** In China, the effects of the global financial crisis (GFC) have been severe, though certainly not quite as severe as in major overseas markets such as the US. The Chinese securities market was hard-hit during the GFC. The Shanghai Stock Exchange Composite Index slid from its peak of 6124 on 16 October 2007 all the way down to 1664 on 28 October 2008, representing a drop of 73 per cent in just one year.³³ This had the usual effect of forcing the CSRC to suspend the application of initial public offerings altogether for about ten months from September 2008, in a bid to prevent further market decline and panic.
- 1.63** Chinese financial firms were also reported to have suffered from the financial crisis. For instance, at the time that US investment bank Lehman Brothers filed for bankruptcy, the ICBC held a total of USD15.5 million in bonds of or related to Lehman; the Bank of China was reported to have extended USD50 million in credit to Lehman; and China Merchant's Bank held USD70 million worth of bonds issued by Lehman. Moreover, significant losses have arisen from overseas equity investments by many Chinese companies. A prominent example is that Ping An, China's second largest life insurance company, cross-listed in Shanghai and Hong Kong, suffered a major loss of CNY 22.79 billion (roughly USD3.3 billion) from its ill-fated investment in the Belgian–Dutch financial group Fortis.
- 1.64** It should be noted that although China's financial markets and institutions have been affected by the GFC, the impact appears less direct and less severe than is the case with overseas markets. To date, the Chinese financial system as a whole has survived the crisis in relatively good shape: no major financial institutions have fallen and no major scandals over transactions of complex financial products have occurred. The losses suffered by Chinese financial institutions, as noted above, are essentially the consequence of their ill-fated investment in overseas markets rather than in domestic markets. Further, the overall risk exposure of China's financial institutions and listed companies in overseas markets is quite limited and manageable. For example, the above-mentioned Lehman bond investment by the ICBC accounted for just 0.03 per cent of its total bond portfolio and 0.01 per cent of its total assets. In short, the GFC has had only a limited impact on China's financial markets.³⁴

³³ From the website of Shanghai Stock Exchange, <http://www.sse.com.cn>.

³⁴ Hui Huang, 'China's Legal Responses to the Global Financial Crisis: From Domestic Reform to International Engagement' (2010) 12(2) *Australian Journal of Asian Law* 157.

Although the impact of the GFC on China's financial system has been relatively mild, one would be wrong to believe, in considering the relatively good health of the Chinese financial markets throughout the financial storm, that China's financial regulatory system is advanced and problem-free. Rather, a closer examination reveals the irony that the positive functioning of China's financial system in this financial crisis is largely attributable to its lack of sophistication and its isolation from the global economy. **1.65**

To begin with, the Chinese financial markets are still underdeveloped. At present, the financial products traded on the Chinese financial markets are quite limited and the technology of securitization is yet to become widely used. There are some traditional financial derivatives in China, such as options and warrants, but they are far lower in number than those found in overseas markets and far less sophisticated than their overseas counterparts, such as collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and synthetic CDOs. As securitization and complex financial instruments have been identified as one of the core causes of the current financial crisis, it is not hard to understand why China's financial system has not suffered any home-grown problems. **1.66**

In addition, the Chinese financial system's isolation from the outside world has helped to stop the effects of the financial crisis flowing on to China. Although China has worked to open up its financial markets since its accession to the WTO, this process is gradual, cautious, and ongoing. For the time being, foreigners have only limited access to the Chinese financial markets. For example, foreign investors cannot trade in China's stock market except through several designated means, such as the QFII method. Further, the Chinese government still exerts tight control over its currency policy. For instance, there are restrictions on capital accounts; the Chinese currency, the RMB or CNY, is not fully convertible yet; the exchange rate is set within a managed floating range. All these measures have collectively operated as a firewall to insulate China's financial system from the spills of the financial crisis overseas. **1.67**

China can take some comfort from the fact that its financial system has sustained relatively modest losses in the current financial crisis; however, it should not be overjoyed about its lucky escape and overlook the real problems it faces. Indeed, the financial crisis has clearly exposed that China has lagged behind the rest of the world in terms of financial innovation and modernization. **1.68**

China's financial system cannot afford to remain primitive and closed to the outside world forever. The techniques of securitization and financial derivatives, if used and regulated properly, can make the market more efficient and effective. In fact, China has successfully used securitization, on a trial basis, to deal with its massive amount of non-performing loans in the banking sector. Although securitization has the potential to be abused, it remains an ingenious financial innovation capable of performing important economic functions. This is particularly so for **1.69**

China, where the banks still have a relatively high level of bad loans and the home mortgage market is huge and rapidly growing. It would seem to follow that China will not—nor should it—abandon efforts at financial innovation in the face of the GFC. China is thus best advised to further develop its financial markets by introducing those financial tools while at the same time strengthening its regulatory system to avoid abuse.

1.5.2. Shanghai: toward a new global financial centre

- 1.70** China is now the world's second largest economy, but its financial system is nowhere close to this ranking. According to the recent Global Financial Centers Index, which ranks the competitiveness of financial centres, Mainland China does not have a centre in the top 20: Shanghai ranks 21st and Shenzhen 30th, compared to the third place Hong Kong occupies.³⁵ Clearly, China needs to develop a more efficient financial system, with at least one or two world-class financial centres, to support its continued economic growth.
- 1.71** On 25 March 2009, the Chinese central government approved a programme proposed by the Shanghai municipal government to build Shanghai into a major global financial centre by 2010.³⁶ Under the 12th Five-Year Plan of Financial Industry Development and Reform, one of the key tasks is to accelerate the development of Shanghai as a global financial centre.³⁷ With strong governmental support at both the national and local levels, the financial services industry in Shanghai has made rapid progress in recent years. In fact, as early as 2001, Shanghai surpassed Hong Kong in terms of stock market capitalization, though this was subsequently reversed. And in 2007, Shanghai replaced Hong Kong as the world's largest centre for initial public offerings.
- 1.72** There has been ongoing debate as to how Shanghai will rise as China's global financial centre and how Hong Kong should respond to this. For a long time, Hong Kong has served as a powerful financing source for Mainland companies, which has in turn helped Hong Kong maintain its status as one of the leading financial centres in the world. The emergence of Shanghai as a financial centre is seen by many as a direct threat to Hong Kong. In this regard, Shanghai and Hong Kong both have competitive advantages. For Shanghai, the key advantages include the powerful underlying national economy and strong Chinese government support. Hong Kong, on the other hand, also has its own advantages, the most important

³⁵ The ranking is an aggregate of indices from five key areas: people, business environment, market access, infrastructure, and general competitiveness. It is compiled and published twice a year by Z/Yen Group, which is a commercial think-tank, consultancy, and venture firm headquartered in the City of London. For more details, see <http://www.zyen.com/activities/gfci.html>.

³⁶ Zhang Ran, 'Shanghai Aims at International Financial and Shipping Center', *China Daily* (26 March 2009).

³⁷ People's Bank of China et al, *12th Five-Year Plan of Financial Industry Development and Reform* (17 September 2012), 32.

of which are rule of law, a free market economy, and integration into the Chinese economy under the 'One Country, Two Systems' arrangement.

However, the relationship between Shanghai and Hong Kong should have more options than simply competition. A big country such as China could and should have more than one global financial centre—considering that the US has several financial centres, including New York, Chicago, Boston, San Francisco, and Washington DC, all of which are ranked in the top 20 in the recent Global Financial Centers Index. This is particularly so in China's current context of political economy. Hong Kong is uniquely positioned to act as a gateway to China, whose financial market is still quite restricted in many aspects with regard to the rest of the world due to issues such as foreign exchange control. The Chinese government's recent support for Hong Kong's development into an offshore RMB centre is a good example of the complementary relationship Hong Kong can have with financial centres in the Mainland.

1.73

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