

# VIEWPOINT.

The American Chamber of Commerce in Shanghai - Viewpoint March 2019

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## Shanghai 2020: A Financial Vision Unfulfilled



2019





## ABOUT VIEWPOINTS

AmCham Shanghai's Viewpoint series provide insights and recommendations from AmCham Shanghai member companies on important policy issues impacting foreign companies in China. These reports are based on extensive interviews and research by the AmCham Shanghai Government Relations team. The reports are used in AmCham Shanghai's advocacy efforts with the Chinese and U.S. governments.

## ABOUT US

The American Chamber of Commerce in Shanghai (AmCham Shanghai), known as the "Voice of American Business" in China, is one of the largest American Chambers in the Asia Pacific region. Founded in 1915, AmCham Shanghai was the third American Chamber established outside the United States. As a non-profit, non-partisan business organization, AmCham Shanghai is committed to the principles of free trade, open markets, private enterprise, and the unrestricted flow of information.

AmCham Shanghai's mission is to enable the success of our members and strengthen U.S.-China commercial ties through our role as a not-for-profit service provider of high-quality business resources and support, policy advocacy, and relationship-building opportunities.

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## ABOUT THE FINANCIAL SERVICES COMMITTEE

The Financial Services Committee is the primary body within AmCham Shanghai that deals with matters related to financial services. It provides a community for multinational banks, in-house financiers, insurance companies, private equity firms, hedge funds, and start-ups. The Committee's mission is to obtain and exchange information, discuss relevant issues, share resources, access contacts, and source business opportunities within the financial services community. Key initiatives include acting as an interface to the government, regulators and industry, as well as advising and educating AmCham Shanghai members on industry issues. Under the broader committee sits the CFO Forum and Financial Services Technology Working Group.

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**Design:** Snap Printing

*AmCham Shanghai would like to thank the Financial Services Committee as well as all survey participants and interviewees for their contributions to this report.*

## Executive Summary

In March 2009 China's State Council determined that the city of Shanghai would become a global financial center by 2020. In late 2018 to early 2019 AmCham Shanghai surveyed 26 executives in financial services and affiliated sectors to determine how close Shanghai was to achieving this ambition. We later conducted interviews with several respondents. Although the city has made great strides since 2009, respondents argued that Shanghai remains far from its goal. We believe there are several ways to increase the city's attractiveness as a center for international capital, accelerate its progress toward achieving its 2020 ambitions and alleviate the concerns of our members and the international financial services community.

### Key Issues

*Window guidance.* Foreign banks believe the communication of window guidance is provided earlier to local banks than to their Western peers. A similar bias can be seen in China's lack of openness to foreign financial institutions. Whether banks, insurance companies or asset managers, there is an inescapable sense that China still shields domestic financial firms from foreign competition.

*Overregulation.* Regulation of Shanghai's financial markets is inappropriately tight, especially IPOs. By continuing with an approval rather than registration process, China crimps the expansion of entrepreneurial firms, forcing companies to look elsewhere for equity listings. The government has indicated it will change the current process, but it should do so sooner rather than later.

*Transparency.* Financial regulators should provide greater transparency and consistency in the enforcement of regulations as well as ensure that regulators' decisions are not subordinate to political expediency. Greater transparency would also improve the city's reputation as a financial center.

*Capital controls.* China must remove capital controls. In the absence of such a decision, Shanghai will remain China's dominant financial center, but its aspirations to be an international center will remain unfulfilled.

*Lack of high-quality professionals.* Shanghai must increase its supply of high-quality financial professionals. International financial centers require a culture of innovation and the ability to bring in global talent acts as a catalyst for that.

### Recommendations

For Shanghai to become a global financial center on par with London or New York, we recommend:

- 1) Removal of capital controls
- 2) The renminbi become fully convertible
- 3) Ending arbitrary, government-backed interventions in the stock market
- 4) Internet restrictions be lifted in the city's financial zone
- 5) The city establish a financial skills training academy
- 6) Banks and other financial institutions create and institutionalize world-class ethics training

## Introduction

A decade has passed since the March 2009 declaration by China's State Council set the ambitious target of Shanghai becoming one of the world's preeminent financial centers by 2020. With 2020 fast approaching, and the State Council having just reiterated its ambitions for Shanghai in March of 2019, AmCham Shanghai surveyed 26 executives in banking and financial services to get both an empirical and qualitative sense of how close Shanghai is to achieving the State Council's aim.

To help benchmark Shanghai's progress toward this goal, we returned to a June, 2012 report that AmCham Shanghai released in conjunction with the Brookings Institution: *Achieving 2020: An Assessment of Shanghai's Plan to Become an International Financial Center by 2020*. Among other things, the report listed the attributes considered critical to the success of a global financial center. These include: availability of high quality finance professionals, rule of law, appropriate regulation (financial stability, toughness, predictability, speed), avoidance of excessive taxation, high quality support services, and openness to foreign entry.

*Achieving 2020* also listed several disadvantages that in 2012 continued to work against Shanghai's ambitions. These included: limited ability to use sophisticated financial products, limited global use of the renminbi, opaque political decision processes, concern with political favoritism, distance from Beijing's financial institutions and hesitation about the use of Chinese law for global transactions.

Since then, China has taken important steps to open its financial sector. The 2018 National Negative List removed limits on foreign ownership in the banking sector and allowed foreign firms to take up to 51% ownership in firms in financial securities,

fund management, futures, and life insurance. In July the Shanghai municipal government issued the 100 Measures, a cocktail of policies that included new commitments to open the financial sector in a bid to upgrade Shanghai's status as an international financial center.

However, our report shows that Shanghai is still far from achieving its 2020 goal. The reasons for this are complex, not least the fact that Shanghai has little autonomy to determine key policies. The city's financial regulators can work to burnish its reputation at the margins, but the power to remove the largest structural hurdles to Shanghai's success lies solely in Beijing.

## Attributes of a World-Class Global Financial Center

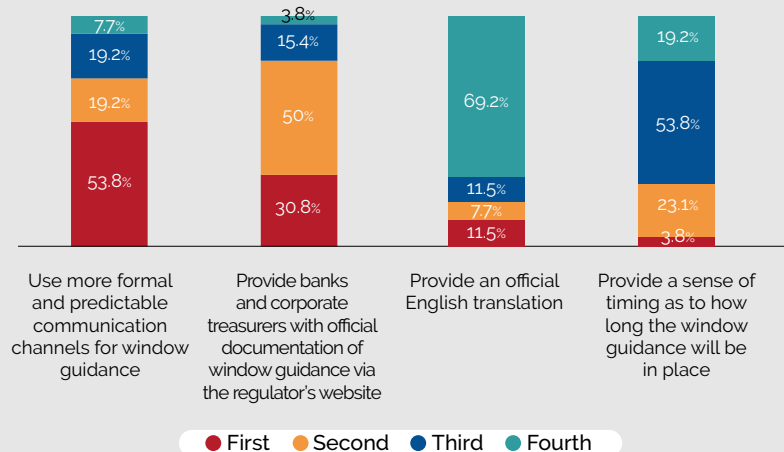
Asked to select two financial centers that Shanghai should emulate to best serve their needs, most respondents (85%) chose Hong Kong, with Singapore second at 46%. Interviewees who supported this view praised connections between Shanghai and Hong Kong, including an investor base that deeply understands

the Chinese market, Chinese-listed companies on the Hong Kong Stock Exchange and cultural similarities between the two cities. Shanghai could also benefit from emulating Hong Kong's openness to foreign capital, risk compliance and legal and accounting frameworks.

However, others felt Shanghai should follow the example of London or New York. One interviewee cited the size of China's equity and bond markets, the country's GDP and its capital and risk financing needs as reasons for doing so. A banker commented that although Hong Kong – which shares “aspects of similar culture, institutions, and political ownership” with the mainland – may be the financial center easiest to copy, Shanghai should instead pursue the New York or London model, both of which value legal transparency.

Another banker praised London's broad financial ecosystem – where brokers, insurers, lawyers, and other service providers are all situated in one spot – and suggested that Shanghai develop a similar ecosystem, but while also reforming its governance system.

### To improve window guidance, the regulator(s) should (in order of importance):





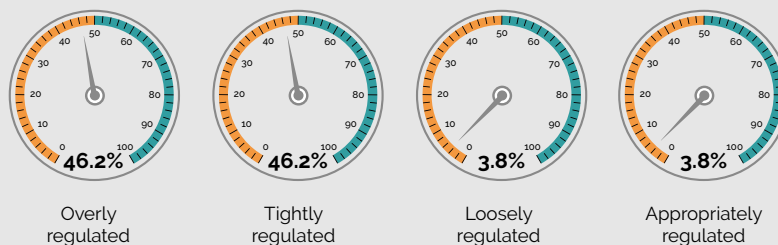
## Window Guidance

One prerequisite for international financial center status is that all banks, domestic or foreign, be treated equally. In Shanghai, however, window guidance frequently favors domestic banks over foreign banks. For example, foreign banks often receive informal, last-minute notification of policy changes by Chinese regulators, such as new foreign exchange controls. The informality and suddenness of these notifications disadvantages U.S. and other foreign banks relative to their domestic peers, which may receive earlier notification of policy changes through informal channels.

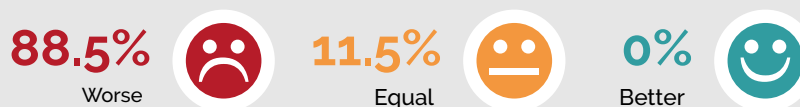
For example, forums such as the Shanghai Bankers Association, a membership organization staffed by former regulators, have internal committees dominated by Chinese banks, and it's through these committees that regulators can feed information formally and informally to domestic banks. Chinese banks also enjoy close relations with regulators, in large part due to a revolving door policy where many senior roles are filled by former regulators. And this relationship is strengthened by consistent interaction. As one banker said: "[Chinese banks have] so many more branches all over China that regulators have an ability to interact with the Chinese banks across so many more venues and so these Chinese banks can have a broader composite view of a regulator's intent. Whereas with foreign banks our local presence is so limited that our interactions with the regulators are much fewer."

While Chinese banks represent a far greater systemic risk than their foreign peers and therefore may require more regulatory interaction, their ties with regulators mean that Chinese banks enjoy the unfair competitive benefits of receiving policy change alerts ahead of others.

### Compared to other international financial centers, how would you describe Shanghai's financial market?



### In terms of the specificity, transparency and consistency of the enforcement of regulations, how does Shanghai compare to other international financial centers?



## Regulation

A vast majority of respondents felt that Shanghai was either overregulated or tightly regulated. For a specific example, most interviewees pointed to the IPO process, which in Shanghai is based on regulatory approval rather than the registration approach used in the U.S.

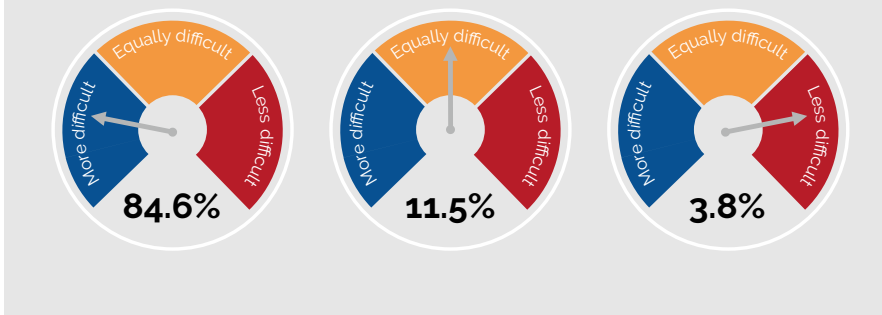
Despite considerable discussion about shifting Shanghai's market to a registration process, with its focus on corporate disclosure, nothing has yet come to fruition. But the pitfalls of the current system are manifold, including opacity around the regulator's decisions, lack of clarity on timelines, and the possibility of rent-seeking behavior, which has plagued the approval committee in the past. Moreover, a backlog of companies wanting to list in Shanghai has built up, many of which would appeal to domestic investors but are forced by the delays to list overseas. Last, the discovery process can be subverted by the government deciding to regulate it during key political times. "In effect," remarked one banker,

"your ability to tap liquidity in the market is restrained by whatever regulatory priority exists."

As to areas of under-regulation, several interviewees highlighted the regularity with which corporate announcements or earnings reports are preceded by abnormal trading in companies' stock. This "manipulation of the market" – or insider trading – not only undermines foreign asset managers' confidence but also harms domestic shareholders, most of whom are individuals. This and other ethics violations can be solved in part by creating a regulatory regime that punishes ethics violators but must also be institutionalized and reinforced within financial institutions. Companies must work to educate and train their employees on best practices and enshrine these values in their corporate governance practices.

Respondents overwhelmingly agreed that Shanghai does worse than other financial centers in the specificity, transparency and consistency of the

## Compared to other international financial centers, how would you describe the process of receiving licenses in Shanghai:



enforcement of regulations. "From a U.S. perspective it's a lot worse," said one respondent, who while acknowledging the substantial improvements in company law since the mid-1990s, contrasts it with the U.S., where a large body of regulatory interpretation or published guidance allows lawyers to give clients guidance that will likely mirror the regulators' interpretation of the law.

While in China the Supreme People's Court has published interpretations and guidance on laws and financial regulators also issue clarifying notices, lawyers still say that much depends on how the government exercises its discretion. This can lead to multiple consultations and uncertainty about the legality of any proposed action. And unlike in the U.S., companies cannot sue the regulator over inappropriate decisions. As one survey taker says, "Uncertainty becomes part of any transaction."

The absence of a clear legal and regulatory framework combined with companies' fear of regulators' decisions being subordinated to political expediency undermines Shanghai's qualification for world financial center status. Another factor that may hinder Western financial institutions is what respondents described as their zealous

adherence to regulatory standards, to the point of being "self-regulating."

## Licenses

Most respondents said it was more difficult to receive a license in Shanghai than in other financial centers. One interviewee said that issuing of licenses was not a matter of difficulty but again one of political expediency. "If the government wants them [the regulator] to do something, they can do it very quickly," he observed. Several respondents saw the absence of recognizable "standards" in the license processing procedure as a fundamental weakness.

However, others observed that viewed from a historical perspective the ability to obtain a license had improved in some areas of financial services. One banker further pointed out that licensing in Canada and Germany could be as equally demanding or even slower than in China. There is cautious optimism that the recent consolidation of the financial bureaucracies could lead to improvements in the licensing process for foreign financial institutions, although the recent experience of Visa and Mastercard highlights the perennial issue of regulatory obfuscation and foot-dragging in the issuance of licenses.

## Tax Regime

Many respondents acknowledged improvements in the tax system, including a move to online tax filing that has not only improved efficiency and transparency but also lowered the opportunity for rent-seeking behavior by tax inspectors. But concern remains that the tax collection process is subject to the vagaries of local and central government tax revenue targets. When tax collectors face pressure to make up a tax shortfall or achieve higher tax revenue targets, they reportedly pursue every detail in order to levy higher taxes. Several interviewees pointed to this inconsistency in the application of tax regulations compared to other financial centers, saying it makes Shanghai less attractive.

There was also criticism of the speed with which recent VAT reforms had been introduced and skepticism about the intent of government or tax bureau outreach prior to similarly significant policy changes. "Consultation is a formality; it does not feel like a two-way process," said one respondent.

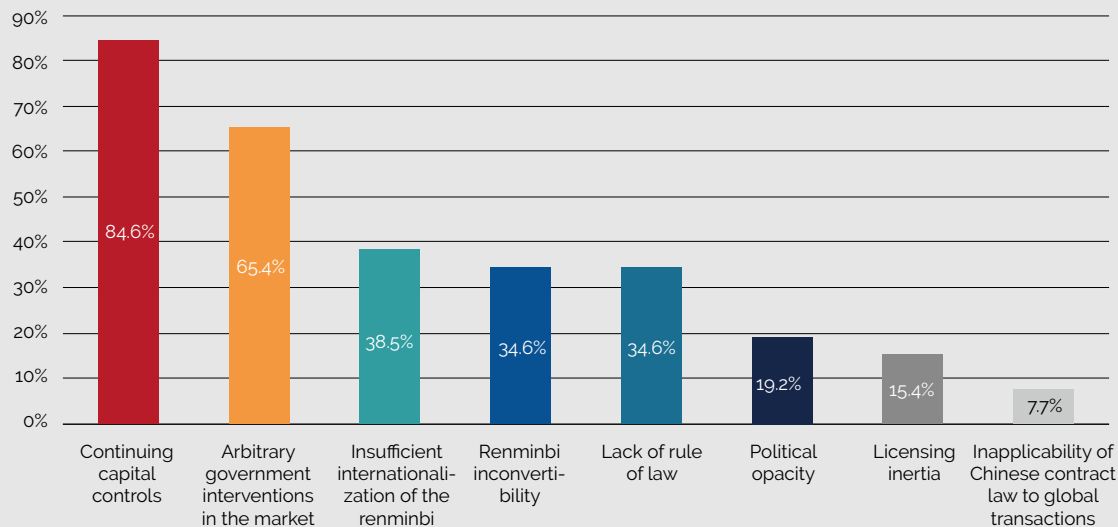
## Barriers to Shanghai's Ambitions

Few respondents indicated confidence that Shanghai will become a significant global financial center anytime soon. When asked which three factors they felt would most likely hold Shanghai back from achieving this ambition, survey respondents listed capital controls (85%), arbitrary government interventions in the market (65%), insufficient internationalization of the renminbi (39%), and renminbi inconvertibility and lack of rule of law (both 35%).

## Capital Controls

In China, capital controls show little

### If 5-10 years from now Shanghai is still not an international financial center, which factors are most likely to have held China back?



sign of being lifted. But unless they are, Shanghai's international financial center status ambitions will come to naught. Writ simply, capital controls are akin to market access restrictions for financial institutions, but an absence of capital controls is essential for international financial market status. And the deleterious effects of capital controls not only negatively impact all financial sectors in which Western companies operate but also undermine China's ambitions for its domestic corporate champions to succeed overseas.

For example, capital controls work against the success of Chinese companies going outbound, as insurance premiums necessary to cover their offshore operations often get stuck or delayed in China. Within China, the current capital control regime also limits or slows the growth prospects of start-ups that rely on offshore venture capital.

#### Renminbi Inconvertibility

Further thwarting Shanghai's ambition is renminbi inconvertibility. Until the currency becomes fully convertible, it's difficult

to envisage Shanghai ever achieving its ambition to become a global financial center.

One banker raised three roadblocks to full convertibility: equity caps, currency access, and suspension of trading. All these issues keep capital locked in China. Although Stock Connect allows equities to be traded between the mainland and Hong Kong, these equities are subject to a daily cap. Another issue is that the China currency (RMB) comes in two variations. The onshore version called CNY is regulated by the Peoples Bank of China. The offshore version called the CNH has market-driven pricing. The CNY and CNH should have the same FX rate to the USD since they are supposed to be the same currency, but capital controls in the China onshore market cause a slight variation in FX pricing between the two. Related to this is that any CNH to be remitted into China's onshore market is treated as a foreign currency and thus exposed to capital controls that add friction to the payment process. Finally, suspension of trading is a major concern for investors.

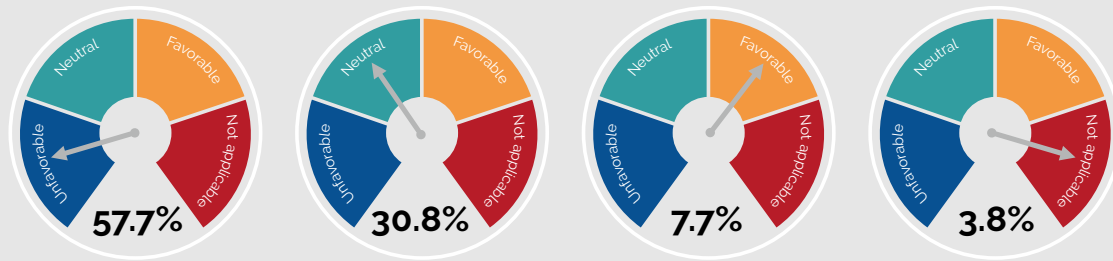
It's unclear how much progress China wants to make in this regard. The majority

of our interviewees attest that their own companies and their clients struggle to conduct cross-border transactions in an efficient manner because of these controls. But even if the government does not lift the controls, it could do more to make repatriation of profits or dividends easier. Or as one respondent observes: "Cross-border transactions are a lot harder than they need to be."

#### Arbitrary Stock Market Interventions

The specter of arbitrary stock market interventions continues to haunt bankers and other financial services executives. The most egregious example is the ham-fisted intervention of 2015 - 2016, when China's government acted in multiple ways to prevent a market meltdown, including instructing state-backed financial institutions to buy shares and implementing six-month share lock-ups for major investors. While the government was concerned that the stock market tremors might impact the broader economy or even trigger social unrest, its actions led many to doubt both China's financial savvy and whether it would ever let the stock market function like

**Using three measures – market access, trust in the market, stock settlement times – how would you describe investors' and/or your clients' views of the Shanghai stock market?**

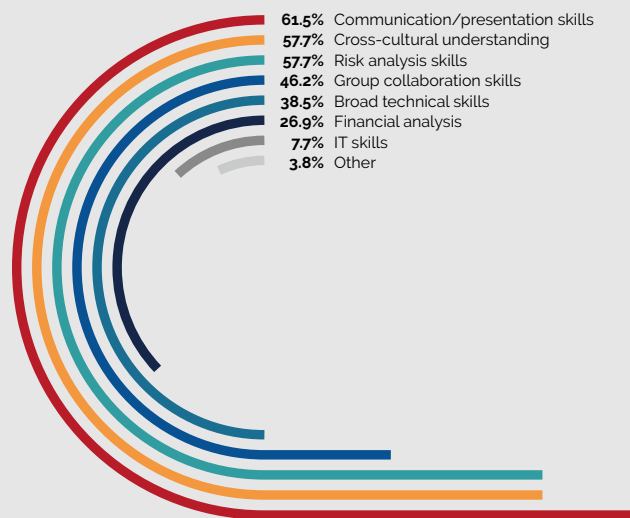


its counterparts elsewhere in the world. "In most countries the role of the stock market is basically a price discovery mechanism, the Chinese government also eyes it as a mechanism for social policy and implementation," says one banker.

More generous voices suggest that China's government and financial regulators learned lessons from the 2015 - 2016 market volatility, particularly that political intervention is an ineffective tool for calming a stock market. Indeed, one interviewee argues that because China's market is so much bigger than other emerging markets, "there is a bias of wanting to hold them accountable to global norms rather than emerging market norms."

However, there is considerable evidence that the government continues to intervene in the market, just that now the tools are different. When it deems it necessary, "team China" uses state funds to purchase ETFs and stocks to steady the market. This new approach in some ways mirrors tactics used by the Bank of Japan, which also occasionally intervenes in the market. More recently, the government has directed state banks not to demand the sale of shares that had been pledged as collateral by firms facing financing or cash flow problems. Such directives indicate that the government has not yet cured itself of the temptation to intervene in the market

**Which THREE employee attributes or skill sets are most valuable to help Shanghai become a world-class international financial center?**



if political imperatives so demand. It should do otherwise. "The government needs to let the market act like a market. In every other market that China wants to emulate, that is a consistency," advises one banker.

**Availability of High-Quality Local Finance Professionals**

Many of the respondents also agreed that Shanghai must increase its supply of high-quality financial professionals and create an environment that attracts them. International financial centers require a culture of innovation and the ability to bring in global talent

acts as a catalyst for that. One banker said that while there are some high-quality professionals in the market, most sit in the regional offices of universal banks where they are heavily compensated. Smaller firms offering market rates simply can't afford these professionals. The banker offered five ways to reform China's talent market: (1) Institute specialized training for new employees. This is already being done in other financial centers; (2) establish and nurture more finance-focused R&D centers; (3) continue working to create a level playing field; (4) open capital accounts; (5) publicly push for stronger forms of governance and ethics.



Except for risk analysis skills, most respondents felt that the skills Shanghai's financial workforce most lacked were communication/presentation skills and cross-cultural understanding. In interviews, however, some bankers said that cross-cultural understanding had improved, particularly in Shanghai and Beijing financial circles. Some respondents suggested that the Shanghai government should sponsor the establishment of a financial skills center in Shanghai's Lujiazui Financial District, with risk analysis training a key part of the center's mission.

A final issue raised by interviewees was the need to inculcate Shanghai financial services workers with ethics training. As of now, ethics training, where it exists, does not adhere to global best practices. Indeed, one banker opined that many local employees have little idea what it means.

## Conclusion

For Shanghai to become a financial center with the influence and reputation of London or New York, much needs to happen. China should remove capital controls, allow the renminbi to trade freely and widen internationalization of the currency. It should let market forces determine the rise and fall of the Shanghai and other Chinese stock markets. It should strengthen rule of law and make judicial decisions transparent. And it should dispense with its "parcel logic" – the approach of opening various parts of

the financial market in a slow and gradualist way, but which can be paralyzing as foreign financial institutions must continually adjust to and reassess the ways in which they can bring capital to China and remove it.

Several respondents also raised the issue of data localization requirements, describing them as an unnecessary duplication of costs. China's internet restrictions severely handicap Shanghai's global financial center ambitions. Said one interviewee: "The continued strengthening of the Great Firewall, where local citizens lose access to Google and other sources of information means that China becomes more insular and unaware of what's going on. And since financial services thrive not only on the free flow of capital, but also the free flow information, I think that will be a major impediment to any aspiration for Shanghai to be a financial market."

None of the above is necessarily impossible. A well-functioning capital market is needed to fund the next generation of growth; and pressure to reform China's capital market may come from companies that need risk capital – the sort of companies to which the four big state banks are unwilling or ill-prepared to lend. There are also signs that the government may soon open a new Shanghai exchange for high-growth companies that will use a registration approach.

The government, after all, moves with

alacrity when it sees a need. Take, for example, the issue of capital gains tax for foreign owners of Chinese stocks, which held up the Stock Connect program and the long-awaited MSCI inclusion. In those instances, various tax and financial bureaucracies worked together to not only understand foreign investors' concerns but also to find a workable solution that permitted policy-driven priorities to come to fruition. Such practicality was also evident in the regulatory response to institutional investors' concerns about market volatility at the end of trading days, by introducing an end-of-day auction process. Yet China's government continues to place hurdles in Shanghai's way.

Indeed, a pessimistic reading of the government's policies suggests that it may not even wish for Shanghai to become one of the world's three most important financial centers, merely the leading domestic financial center. Another view, while a little more optimistic, and reflected in the words of one interviewee, is that the goal may be years away:

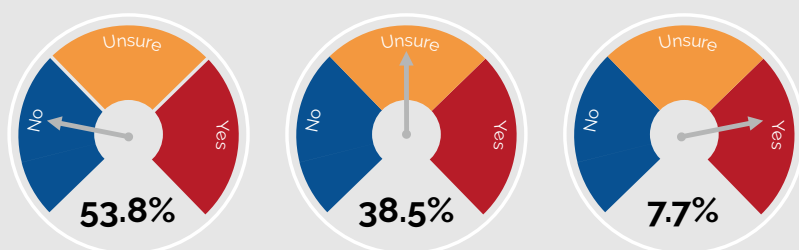
"Shanghai is on course, but it's not smooth. Eight to 10 years ago it had strong intent; that intent has gone by the wayside, and Shanghai is subject to the whims of the central government."

## Recommendations

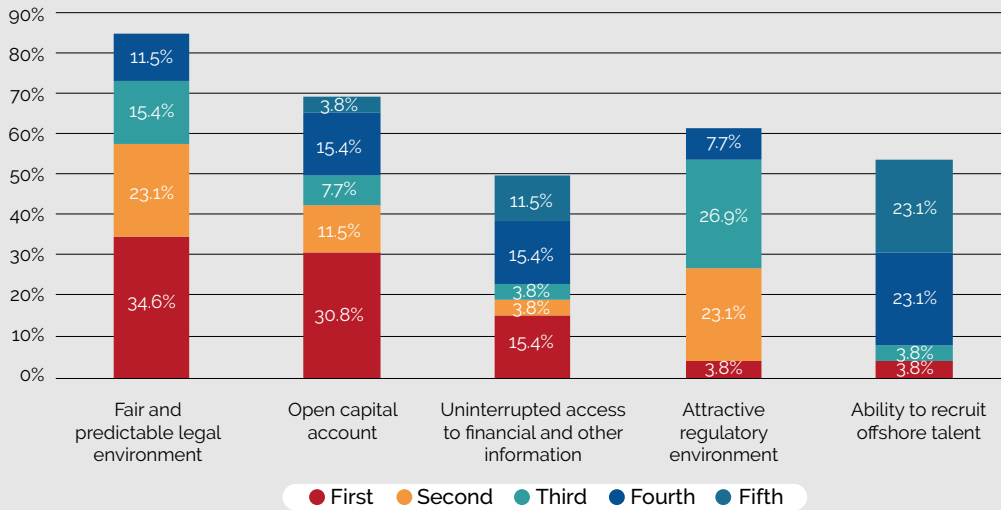
For Shanghai to become a global financial center on par with London or New York, we recommend:

- 1) Removal of capital controls
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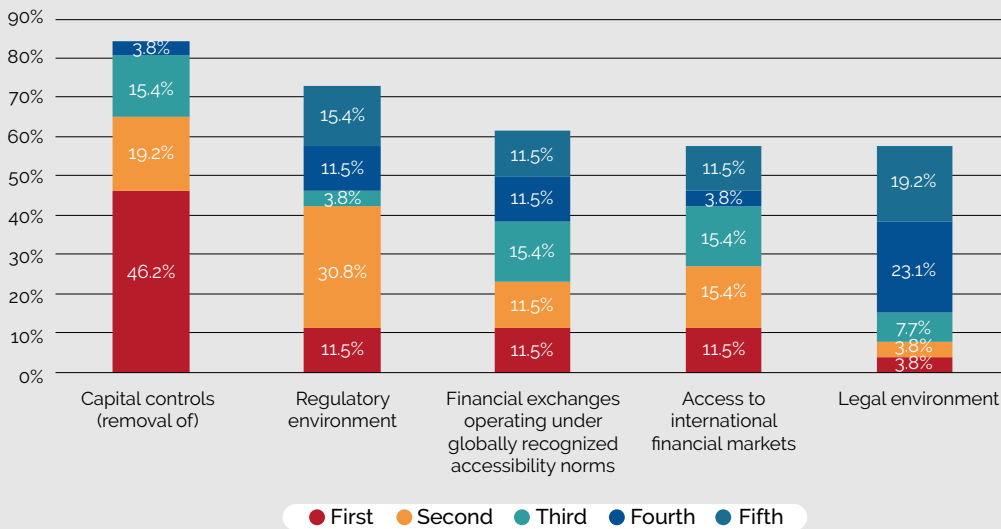
### Is Shanghai en route to becoming a global financial center by 2020?



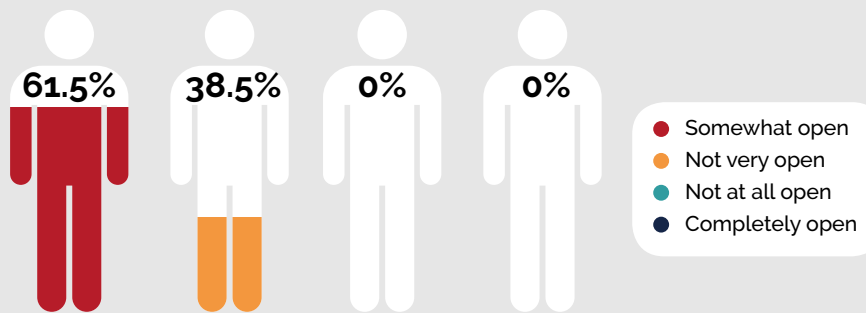
**Rank the FIVE most important attributes of a world-class, fully operational and globally integrated financial center.**



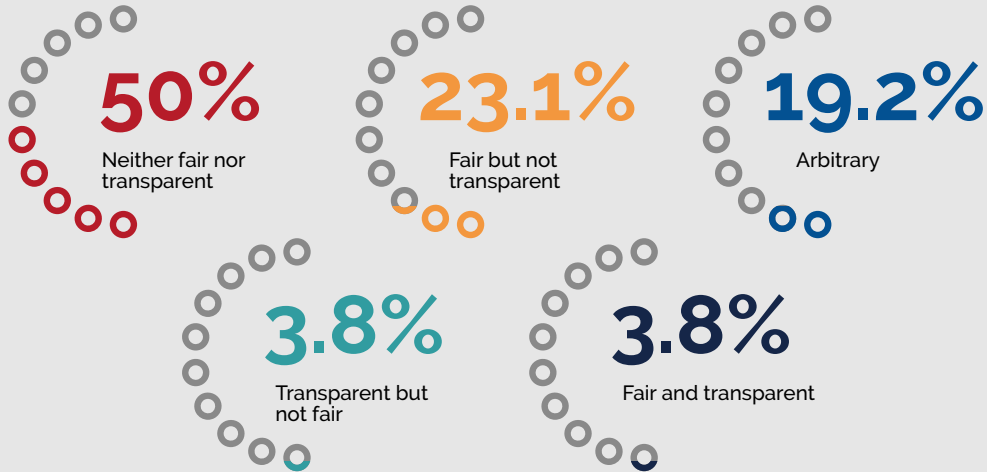
**Rank the top FIVE areas that Shanghai needs to improve to become a world-class, fully operational and globally integrated international financial center.**



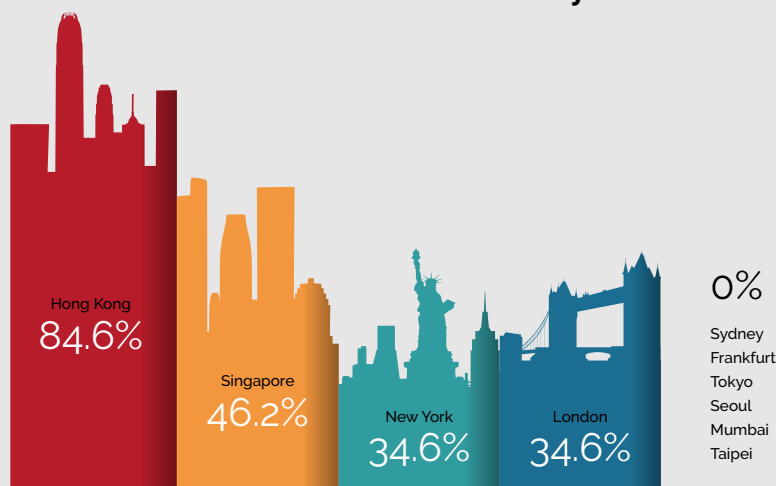
**How open to foreign financial institutions (banks, insurance companies, asset managers, investment banks, PE/VC funds, etc.) do you consider Shanghai?**



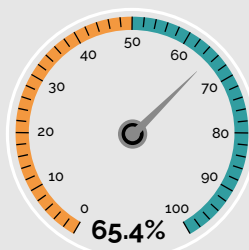
Compared to other global financial centers, how would you describe China's commercial dispute resolution mechanisms (i.e. litigation, arbitration, mediation, or other alternative dispute resolution tools)?



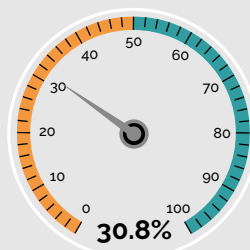
Select from this list the TWO international financial centers that Shanghai should emulate to best serve your needs.



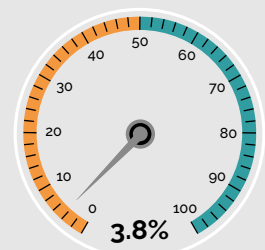
Do you believe that the communication of window guidance to banks in China:



Favors Chinese banks



Treats Western and Chinese banks equally



Favors Western banks



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The American Chamber of Commerce in Shanghai (AmCham Shanghai), known as the “Voice of American Business in China,” is the largest American Chamber in the Asia Pacific region. Founded in 1915, AmCham Shanghai was the third American Chamber established outside the United States. As a non-profit, non-partisan business organization, AmCham Shanghai is committed to the principles of free trade, open markets, private enterprise and the unrestricted flow of information.

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