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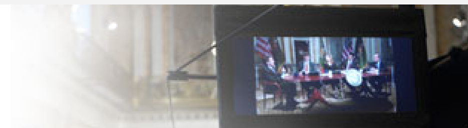

Remarks of Assistant Secretary for International Markets and Development Marisa Lago at the 2012 Caixin Summit

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As Prepared for Delivery

BEIJING, CHINA - It is such a pleasure to once again participate in the Caixin Summit, and to see so many familiar faces as well as some new ones. Thank you, Madame Hu Shuli for honoring me by inviting me to join the impressive list of participants. Your annual summit continues to set a high standard and all of us benefit from our discussions at this event.

The United States and China have a shared interest in financial reform and stability. Both of our nations recognize that, in an increasingly interconnected global financial system, it is essential that the world's leading economies enhance both the quality and the depth of international standards. In the United States, we have acted to strengthen financial regulation after the crisis. China also has taken a number of steps to accelerate financial sector reform.

I will focus my remarks on the cooperative work in the G-20, and the challenges that each of our nations face. I will then turn to China's reform efforts, their importance to China's future growth, and some key issues that we face going forward.

G-20

The United States and China are both active members of the Group of 20, or G-20. Over the past years, the G-20 has pursued an aggressive agenda of financial regulatory reform, aimed at strengthening the resilience of the global financial system and enhancing the global financial regulatory architecture. In the United States, we have enacted the Dodd-Frank Act, which implements many of these G-20 reforms. These G-20 reforms are increasingly important to China as its financial firms expand overseas and as its financial system becomes more and more interconnected with the global financial system.

I'd like to briefly mention a few of the key areas of G-20 concern: capital, shadow banking and resolution.

<u>Bank capital standards</u>

Both the United States and China are committed to implementation of the Basel III capital standards. These global standards call for large, internationally active banks to substantially increase the amount of capital that they hold, as well as enhance the quality of that capital. Global systemically important financial institutions (G-SIFIs) are called upon to hold higher levels of capital. This large and more resilient capital buffer means that our banks will be better able to provide credit to the economy and absorb potential future losses.

The U.S. banking agencies have issued proposed rules to implement Basel III, and the largest U.S. banks have already raised the capital that they need to meet these higher standards. In China, the authorities released updated Basel III regulations earlier this year, which will encourage banks to start phasing in the Basel III capital requirements in January 2013.

<u>Shadow Banking</u>

The G-20 is committed to addressing the potentially substantial risks posed by "shadow banking," which can be thought of as the extension of credit outside of the formal banking system. This work is being done by the Financial Stability Board, or FSB, which in many ways is the working arm of the G-20 on financial regulatory matters. The FSB has developed policy recommendations to strengthen the oversight and regulation of shadow banking, and has expanded monitoring of data about shadow banking.

In the United States, we have extended the perimeter of regulation to include hedge funds, and have also tightened regulation of money market funds. The Dodd-Frank Act established the Financial Stability Oversight Council (Council), chaired by the U.S. Treasury, which has the authority to designate a non-bank financial firm for prudential supervision. The Council also continues to push for stricter rules to address the risks to financial stability posed by money market funds.

In China, financial intermediation outside of the regulated banking system has grown rapidly over the past few years. This poses new challenges to financial stability. Controls on interest rates have resulted in negative real deposit rates for Chinese households for much of the past several years. As a result, Chinese investors have sought higher yields in less regulated products, particularly wealth management products. Analysts have raised concerns about the strains that these wealth management products can put on banks' funding and liquidity. This is a special concern for smaller banks that have narrower deposit bases and more limited access to interbank credit. Many small and medium enterprises (SMEs) that do not have access to lending from regulated banks have turned to informal lenders, which charge much higher interest rates and often involve complicated loan guarantee schemes.

In the United States, we have seen that regulation can often be behind the curve of financial innovation, and we learned that our regulation did not keep up with the pace of financial intermediation outside of the formal banking system. We welcome innovation, but we learned that it must be coupled with safeguards – such as enhanced risk management practices, increased transparency and measures to limit contagion – all of which can improve the resilience of the financial system.

I understand that Chinese regulators are also focused on managing the heightened risks posed by these particular institutions and financial products. This is a welcome development, and as our experience shows, shadow banking is a phenomenon that merits close attention. As long as interest rate controls exist alongside financial innovation, both investors and borrowers will continue to seek out riskier, less regulated and innovative financial products.

<u>Resolution</u>

Recognizing that the failure of a systemically important financial institution can pose a serious risk to financial stability, the G-20 has called on its members to strengthen their resolution regimes. The United States has done so by enacting the Dodd-Frank Act and amending the Federal Deposit Insurance Act. The Dodd-Frank Act provides for enhanced supervision of

SIFIs, and gives U.S. supervisors appropriate tools to facilitate their orderly liquidation in the event of failure. Eleven of the largest U.S. bank holding companies have submitted so-called "living wills," which lay out contingency plans for an orderly bankruptcy. Crisis management groups are being formed. And while cross-border resolution is a complex and difficult terrain, these steps will surely help cope with any adverse situation that may arise.

In China, a more comprehensive resolution regime is needed to provide regulatory authorities with the operational autonomy and legal authority to intervene promptly in weak or nonviable financial institutions. We appreciate that China has been working carefully on the introduction of an explicit insurance deposit scheme, and we believe that China's work in this area is a valuable part of providing a structured safety net. Such a formal safety net would replace the current blanket government guarantee for depositors, an implicit guarantee that carries significant moral hazard.

The reforms that we have put in place have already made our financial systems less vulnerable, but we all have more to do.

Recent Progress on Chinese Financial Sector Reform

In addition to working cooperatively in the G-20 and Financial Stability Board, the United States and China have a robust bilateral relationship on financial regulatory matters. This relationship benefits from frequent interactions, such as the very useful discussions that I have had with my government counterparts in Beijing this past week. These candid discussions give the U.S. financial regulatory community a better appreciation for China's financial sector development, and provide us with an opportunity to share lessons that we have learned.

We have seen a number of welcome developments and reforms in China's financial sector during the past year.

- China has taken initial steps to liberalize bank lending and deposit rates. This movement towards more market-determined interest rates is central to bringing about macroeconomic rebalancing and improving the allocation of capital within China's economy. It will also require improved credit analysis and risk management by Chinese banks.
- China's domestic bond market has grown rapidly, and is now becoming an important source of financing for Chinese businesses and an alternative to bank lending. China's regulators have taken steps to streamline the approval process for the issuance of bonds. They are also allowing domestic and foreign institutional investors to have greater access to fixed income products. A well-developed bond market will lower the concentration of risk in the banking sector, will reduce the incentives for firms to self-finance investment, and will provide a greater range of financial instruments, and financial returns, to Chinese households.
- There has been significant progress in developing China's futures markets. This is important, since efficient futures markets will help Chinese enterprises hedge risk.
- Finally, Chinese authorities have taken steps to establish a nationwide over-the-counter (OTC) equities market and a high yield bond market. Both of these will create more financing channels for small- and medium-sized firms.

Effective implementation of these reforms will be essential for China to reach the next stage of development: developing the new firms and industries that will be critical to China's future, while successfully shifting towards balanced, sustainable, domestic consumption-led growth.

While significant progress has been made, China's financial sector remains dominated by state-owned banks, and subject to extensive government controls on the price and quantity of credit. This favors large existing enterprises, many of them state-owned, but it starves the new, small, private firms that will be China's future. More work is needed to channel China's savings efficiently to its most productive firms and sectors, and provide Chinese households with a broader range of financial products that meet their financial goals and insure against life's risks.

Going Forward: Information Disclosure and Cross-Border Cooperation

We have observed a renewed commitment to transparency by Chinese authorities. After undergoing an IMF-sponsored Financial Stability Assessment Program, or FSAP, China has published its FSAP, including its full Detailed Assessment Reports. This has helped promote transparency and provided a deeper understanding of China's financial system.

Chinese regulators have also undertaken certain measures to strengthen information disclosure and corporate governance in financial markets. To enhance the role that securities markets play in China's economy, it is essential that investors have access to reliable and high-quality information. It is in this area that we would hope to see continued progress in China.

In the U.S. we have a painful portrait of what happens when investors doubt the quality of information that is provided to them. After the scandals of Enron and WorldCom, investors lost confidence in U.S. accounting practices. This raised the cost of capital for many companies, including some that were well-managed and rule-abiding. Recently, serious questions have arisen about accounting practices at some small Chinese companies that were listed in the United States and elsewhere. This has led overseas investors in both equity and debt markets to lower their confidence in Chinese firms, pushing up their cost of capital.

In the U.S., the Sarbanes-Oxley law responded to our earlier accounting and corporate governance scandals. Sarbanes-Oxley established a system that requires the inspection of the auditors of all companies that are listed on U.S. exchanges, regardless of the country in which a listed company is located. These inspections of auditors give investors confidence that the accounts of companies listed on U.S. exchanges are stated accurately. To carry out these inspections, U.S. regulators have developed cooperative agreements with their counterparts from all major financial markets, except for China. I hope that our respective regulators can continue productive discussions, so as to reach a cooperative agreement.

Going Forward: Financial Market Opening

We are confident that greater participation by foreign firms can play an important role in China's financial sector reform and broader economic development. Financial opening will support more competition and help improve Chinese households' access to a broader range of financial products. Indeed, through our Strategic and Economic Dialogue, the United States and China have held lengthy discussions about the contribution that financial opening can play in China's development. We richly value the constructive role that Chinese authorities have played in these discussions and the important commitments that have been made.

The United States, like other countries, benefits tremendously from the participation of foreign firms in our financial sector. Today, foreign banks control more than a 20 percent share of total assets in the U.S. banking system.

Chinese firms are increasingly expanding overseas. In recent years, Chinese banks and securities firms have opened bank branches in the United States, a Chinese bank purchased a U.S. securities firm, and just this past May, a Chinese bank received approval from our Federal Reserve Board to acquire majority ownership and control of a U.S. bank.

As China's financial institutions follow their Chinese corporate customers overseas and seek to become global leaders, their aspirations are increasingly inconsistent with the protections that these Chinese institutions enjoy – and often lobby to maintain – at home. Among G-20 countries, China stands out as having among the most restrictive policies, which sharply limit foreign investment and participation in China's financial sector.

China has taken important and welcome steps this year, such as raising the foreign equity cap for securities joint ventures, expanding the QFII program and opening up mandatory auto insurance to foreign-invested firms. China's current policy of restricting foreign partners to minority joint venture stakes, however, has limited foreign firms from fully contributing to the

development of China's financial sector. For the next stage of reforms, and for foreign firms to invest significant resources and know-how that will benefit China's financial system, it will be essential for China to allow foreign investors to take majority, controlling stakes and to establish wholly-owned subsidiaries – something that Chinese firms are able to do in markets overseas.

I hope that these remarks have conveyed the importance that the U.S. Treasury places on our cooperative relationship with our Chinese counterparts – and our commitment to work with them towards an open, dynamic, strong and stable financial sector, that benefits both of our nations.

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