# lakyara

2012

Kyara, which means "precious" in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
"lakyara [la-kǽla]" aims to deliver the same quality as Kyara together with
NRI's endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.135 (12.March.2012)

## Key issues facing China's fund industry in 2012

Nomura Research Institute, Ltd.

In 2011, Chinese securities investment funds performed poorly amid a decline in equity prices, revealing the fund industry's shortcomings in bold relief. In response, initiatives are afoot to diversify sales channels and improve fund companies' corporate governance.

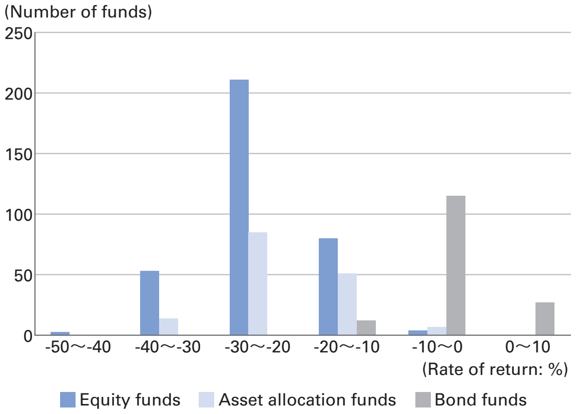
## Adverse market environment highlights fund industry's shortcomings

Falling stock prices made 2011 a difficult year for China's securities investment fund[1] industry. The adverse market environment also revealed shortcomings that the industry should rectify going forward.

In 2011, the Shanghai and Shenzhen Composite Indexes respectively fell 21.7% and 32.9%, resulting in a RMB2.81 trillion[2] reduction in the aggregate tradable market capitalization of stocks listed on the two exchanges. Against such a backdrop, publicly offered funds as a whole incurred investment losses of nearly RMB500 billion in 2011[3]. While bond funds' average 2011 return was positive, equity funds and asset allocation funds' average returns were -24.1% and -21.6%[4], respectively (Exhibit 1). Meanwhile, the total number of securities investment funds grew to 915 at year-end from 704 a year earlier[5], an increase of 211, as fund companies launched new funds in response to a rise in redemptions in existing funds. However, fund sales were hurt by the decline in stock prices. Average initial fund size apparently decreased in 2011.

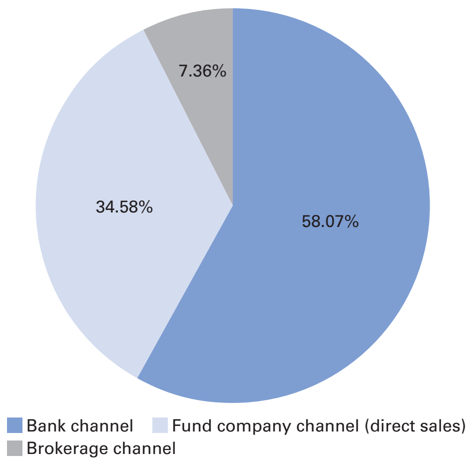
As investment performance worsened last year due to the equity market slump, pre-existing challenges facing the fund management industry became more conspicuous. One such challenge is competition with other industries. In the first half of 2011, sales channel competition with other financial products intensified amid monetary tightening. Banks offered high-yielding wealth management products to attract deposits in response to tightening of deposit-loan ratio restrictions. Banks sold trust companies' investment products also[6]. Such sales activities were detrimental to fund companies that rely mainly on banks to sell their funds (Exhibit 2). With banks, brokerages, and trust companies all focusing on building their asset management businesses, competition for experienced fund managers also emerged. Turnover of talented personnel is another problem for fund companies.

Exhibit.1 Distribution of open-end funds' 2011 rates of return




Note: Returns of 661 funds for which the requisite performance data are available.
Source: NRI, based on data from Hexun.com

Exhibit.2 Breakdown of open-end fund sales by sales channel (2010)




Source: NRI, based on Securities Association of China data

A second issue is fund companies' corporate governance. In December 2011, China Securities Regulatory Commission (CSRC) Chairman Guo Shuqing spoke about deficiencies in securities brokers, fund companies, and futures companies' corporate governance. Specific issues cited by Mr. Guo include (1) insider control risk due to deficiencies in some companies' oversight and assessment mechanisms, (2) lack of long-term investment principles, leading to severe earnings volatility and loss of senior personnel with specialized expertise in some cases, and (3) a regulatory prohibition against employees directly owning stock in their employer, which makes it difficult to develop effective incentives and restraints on a long-term basis[7]. These issues are also partly to blame for the fund management industry's inability to develop innovative new products, recurring legal violations (e.g., front-running), and high turnover of fund managers.

## Remedial measures

In response to such challenges, regulatory authorities first saw to promote diversification of fund sales channels to reduce the industry's current dependence on the bank channel. In October 2011, the Law Regulating Securities Investment Fund Sales was amended to lower barriers to entry to the fund sales business. Specifically, the amendment reduced the minimum number of licensed employees[8] required to be employed by independent fund distributors from 30 to 10[9]. This change applies to independent fund distributors only, not fund companies, banks, brokerages, or securities investment advisory firms. The amended law also permits fund distributors to charge investors for value-added services (i.e., services other than those required by law or the fund agreement) in addition to existing transaction fees (fees on purchases, redemptions, etc.). These changes are expected to lead to growth in fund sales through specialized fund distributors and stimulate competition among sales channels.

In terms of improvement in fund companies' corporate governance, CSRC Chairman Guo stated, "We must research and legalize employee stock ownership plans to improve brokerages and fund companies' long-term incentive and restraint mechanisms."[10] The CSRC is thus planning to permit fund companies to adopt ESOPs. This change may be incorporated into a long-debated amendment to the Securities Investment Fund Law. According to one report, a draft of the amended law is nearly finalized and slated to enter the formal deliberation process in 2012[11].

Regarding problems related to investor protection, such as front-running and insider trading, some have proposed aligning fund managers' interests with those of investors by requiring fund managers to own shares in the funds that they personally manage. Additionally, Mr. Guo has said that the CSRC is considering allowing asset management companies to be organized as partnerships owned by employees with specialized expertise.

Another issue that bears noting with respect to the fund management industry's future outlook is the recently hotly discussed possibility of investing social-security-related funds in capital markets. Mr. Guo has proposed investing public reserves, including local governments' pension funds, in capital markets[12]. This proposal was prompted by the National Social Security Fund's[13] favorable investment returns on a portion of its assets that are externally managed and invested in equity and other markets. Current proposals focus on investing the individual account portion of pension funds administered by local governments (mainly cities and provinces), but the Ministry of Labor and Social Security, National Social Security Fund, and local governments apparently disagree on the specifics of how to do so. The form in which this proposal is ultimately realized remains to be seen. Future developments with respect to this issue bear close watching from the standpoint of a number of government priorities, including cultivation of institutional investors, augmentation of a pension safety net, and development of bond markets.

## Note

1) Securities mutual funds (investment trusts) are called securities investment funds in China. Companies that manage such funds are called fund (management) companies.

2) According to CSRC data.

3) According to an article in the January 21, 2012, edition of Guangzhou Daily.

4) Unweighted average returns of 350 open-end equity funds and 157 open-end asset allocation funds, as calculated by Hexun.com.

5) According to an article in the December 23, 2011, edition of China Securities Journal.

6) See "Off-balance-sheet financing and disintermediation in China" (http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011126.pdf)

7) Comments by Guo Shuqing at a corporate governance seminar on December 19, 2011, as reported in the media.

8) Employees involved in fund sales, marketing, and certain other functions are required to be licensed.

9) Other revisions include permitting fund distributors to be organized as limited liability companies or partnerships and permitting natural persons to contribute equity capital (previously only incorporated entities could do so).

10) Comments made at the corporate governance seminar mentioned above.

11) According to comments by Wu Xiaoling, Deputy Director of the Financial and Economic Affairs Committee, as reported in the media (December 16, 2011)

12) According to an article in the December 16, 2011, edition of China Securities Journal.

13) The NSSF was established in 2000 to plug future Social Security Fund deficits. It is funded largely by central government appropriations and proceeds from the sale of state-owned shareholdings. Currently, its sole function is managing its assets.

## Author's Profile

Takeshi Jingu

Chief Researcher
Nomura Research Institute (Beijing), Ltd.

E-mail : kyara@nri.co.jp



Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara