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Deregulation of China's securities industry is accelerating

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Executive Summary

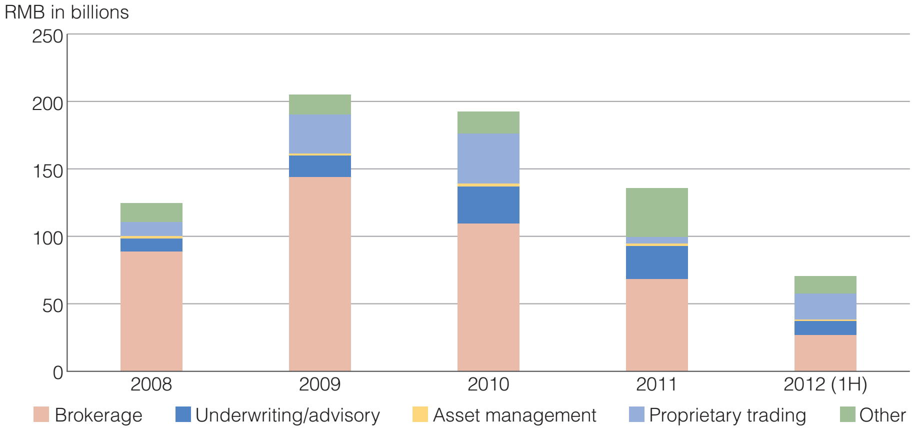
Reform is accelerating in China's securities sector. At an industry conference in May 2012, regulatory authorities unveiled plans to promote diversification of securities firms' operations through deregulation. They have recently started to announce specific deregulatory measures.

Conference on Innovation and Development of Securities Companies

Reform of China's security sector has gained pace since Guo Shuqing became chairman of the China Securities Regulatory Commission (CSRC) in October 2011. At a May 2012 Conference on Innovation and Development of Securities Companies sponsored by the Securities Association of China (SAC), the CSRC unveiled a draft plan to promote securities industry liberalization and growth. Comprising 11 measures, the plan is a blueprint for near-term reforms. Although an official version of the plan had yet to be released as of end-August, the CSRC has started to launch individual measures in accord with the plan.

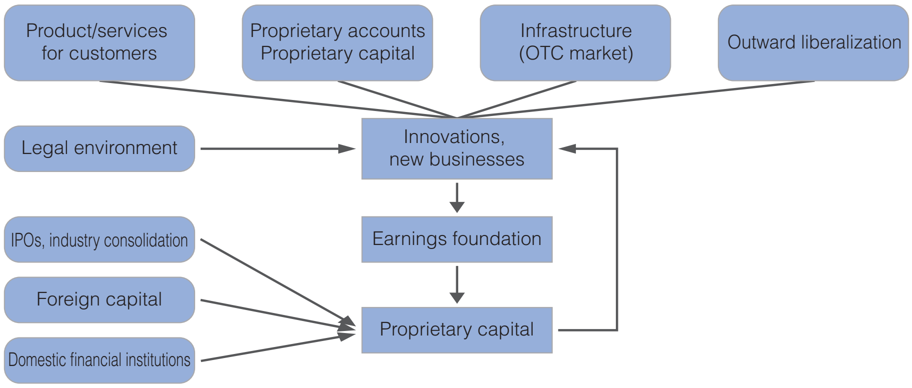
The reform plan was drafted in response to securities firms' weak business foundations and their earnings' still-heavy dependence on equity market

Exhibit 1: Chinese securities firms' operating revenues



Notes: Number of companies differs from year to year.
Source: NRI, based on SAC data

Exhibit 2: Conceptual diagram of deregulation



Source: NRI

conditions. Although securities firms' profit structures have improved somewhat, they remain basically dependent on the brokerage business. Revenues have recently been deteriorating in parallel with market performance (Exhibit 1).

Against such a backdrop, the CSRC's reform plan aims to promote diversification and stabilization of securities firms' operations through deregulation (Exhibit 2). More specifically, the CSRC aims to make it easier for securities firms to innovate and diversify into new businesses. However, as the CSRC implements the new reform measures, its existing policy of giving preferential treatment to elite securities firms will apparently remain unchanged[1]. The CSRC hopes to foster a virtuous cycle whereby innovation and new businesses drive earnings growth and, in turn, strengthen securities firms' capital bases.

The CSRC will also promote IPOs, industry consolidation, and foreign investment in the sector to strengthen securities firms' capital bases. From a longer-term perspective, the CSRC appears to also be contemplating "inward liberalization," meaning that leading securities firms would build financial conglomerates by acquiring controlling or minority interests in other types of domestic financial institutions.

New businesses

In broad terms, the innovations and new businesses that the CSRC is seeking to promote are (1) diversification and augmentation of services offered to customers, (2) expansion of proprietary account businesses, (3) development of market

NOTE

1) Since 2007, Chinese securities firms have been classified into five classes and 11 tiers based on their risk management capabilities measured based on proprietary capital and other benchmarks. The top-tier firms are the first permitted to sell new products. Recently, the CSRC has reduced the risk capital reserves required for individual businesses to enable securities firms to engage in more businesses with the same amount of capital (April 2012).

infrastructure, and (4) outward liberalization.

First, in terms of diversification and augmentation of services offered to customers, the CSRC first plans to deregulate securities firms' investment product offerings. Recognizing that securities firms are currently limited in terms of the products they are permitted to offer, the CSRC will allow them to design products that meet investors' needs and risk tolerances. Development of products for high-net-worth customers would be a natural response to the pernicious price competition currently plaguing the securities industry.

On August 22, the CSRC released a draft of proposed revisions to provisional regulations regarding securities firms' customer asset management businesses and related implementation rules[2]. The proposed revisions include four notable changes. First, regulation of pooled asset management plans[3] would be simplified from an approval system to an ex-post-facto registration system. Second, securities firms would be permitted to engage in margin trading and repo trades backed by asset management plans' securities holdings. Third, asset management plans for ordinary investors would be permitted to invest in medium-term notes and bank asset management products, including products with income guarantees and variable-income products with principal guarantees. Fourth, asset management plans for mid- and high-income investors would be permitted to invest in regulator-approved futures products (e.g., commodity futures), interbank market products (e.g., interest-rate swaps, interest-rate forward contracts), securities firms' specialized asset management plan products, and banks' asset management products and pooled trust products.

2) The CSRC solicited public comments on these drafts until September 21.

3) Pooled asset management plans are investment funds for which securities firms raise money from investors through private-placement offerings. They include large-group plans for ordinary investors, small-group plans for mid- and high-income investors, and individualized plans with investment mandates set by agreement between the securities firm and customer. Securities firms' specialized asset management plans include companies' asset securitizations.

On August 23, the CSRC released a draft of proposed regulations on sales of financial products by securities firms as distributors[4]. The proposed regulations would increase the number of financial products that securities firms are permitted to distribute[5]. The scope of financial products that securities firms would be permitted to sell as distributors would be expanded to include domestically originated financial products approved by (or registered with) financial regulatory authorities. This change would enable securities firms to sell commercial banks' asset management products, trust banks' trust products, and insurance products. Additionally, from the standpoint of investor protection, products eligible to be distributed by securities firms would exclude products deemed unsuitable for customers. Securities firms would also be required to monitor customer suitability.

4) The CSRC solicited public comments on this draft until September 7.

5) Products that securities firms have hitherto been permitted to sell include securities investment trusts and other securities firms' asset management plans.

Next, in terms of customer service, the CSRC plans to permit securities firms to offer online accounts on the assumption that they will provide investor education and prevent abuses. This measure would enable the advent of online brokers in addition to enhancing customer convenience and reducing costs associated with opening branch offices[6].

6) Currently, customers must visit a branch office in person to open a new account.

Second, the CSRC aims to promote expansion of the scope of investment in businesses conducted in securities firms' proprietary accounts. Examples of such businesses include margin trading and repo trading with customers. By engaging in repo trades with customers, securities firms would be able to offer cash management and short-term lending services to customers. Since January 2012, six securities firms are already offering repo-backed short-term loans to customers on a pilot basis[7].

7) The six are CITIC Securities, Haitong Securities, China Galaxy Securities, China Merchants Bank Securities, Guotai Junan Securities, and Guosen Securities. The first three have been offering short-term loans since January 2012; the latter three, from May 2012.

Third, the CSRC is seeking to promote development of market infrastructure. Securities firms could build an OTC market and issue, sell, and trade OTC products. Such products include SME bonds, which some securities firms have been selling through private placement offerings since June[8].

8) Between June and August 2012, the SAC granted 59 securities firms permission to underwrite SMEs' private-placement bond offerings on a pilot basis.

Fourth, the CSRC is promoting outward liberalization, including businesses related to Chinese companies' overseas IPOs and equity and bond financing for foreign companies in China. The CSRC is also promoting inward and outward portfolio investment. In August, the CSRC proposed raising the maximum foreign co-ownership interest in securities firms from 33% to 49% and permitting such securities firms jointly owned by domestic and foreign interests to expand their scope of operations after only two years of continuous operation (instead of five years, as is currently the case)[9]. These reforms were agreed to by China at the May 2012 US-China Strategic and Economic Dialogue.

9) On August 24, the CSRC published draft amendments to regulations regarding foreign ownership of newly established securities firms and provisional regulations regarding establishment of securities subsidiaries. It solicited public comments on the drafts until September 22.

10) The CSRC solicited public comments on this draft until August 17.

On 4 August, the CSRC released a draft of provisional regulations regarding listed companies' employee stock ownership plans (ESOP)[10]. In response, some listed securities firms are apparently considering adopting ESOPs. The measure aims to improve employee retention in the securities industry, where employee turnover is notoriously high, and may also be intended to help securities firms recruit personnel when branching out overseas.

Once these measures have been officially implemented, they should lead to diversification of securities firms' operations and improvement in their earning stability.

about NRI

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