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China's retail brokerages aim to change the rules of the game

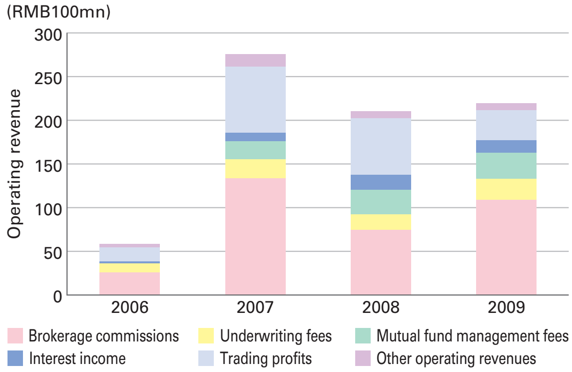
Nomura Research Institute, Ltd.

Chinese stock brokerages face a war of attrition in the retail market segment, which accounts for most of their operating revenues, amid intensification of competition to capture new customers and undercut rivals with lower commission rates. In response, some securities brokerages have recently started to pursue new business models.

The Chinese equity market has overtaken its Japanese counterpart in terms of trading activity. In March 2010, the Shanghai and Shenzhen Stock Exchanges' combined trading volume substantially surpassed the Tokyo Stock Exchange's trading volume in value terms[1].

Exhibit 1 plots the consolidated operating revenues of the CITIC Securities Group, a major publicly traded Chinese securities brokerage, broken down by source. The CITIC Securities Group derives most of its operating revenues from brokerage commissions and trading profits from proprietary dealing, as would be expected given the magnitude of the Chinese equity market's trading volume in value terms. Following is a report on the market structure in China's retail brokerage sector, which accounts for the bulk of Chinese securities brokerages' operating revenues, and the state of competition among Chinese brokerages.

Exhibit 1. CITIC Securities Group's consolidated operating revenues broken down by source



Source: NRI, based on CITIC Securities' publicly reported financial statement data

Chinese retail brokerage industry's market structure

Exhibit 2 provides an overview of Chinese retail brokerage business models from the standpoint of types of retail investors, and products and distribution channels suitable for each type of investor. In Japan, retail brokerages have traditionally grown by focusing on providing individualized advice to investors seeking to accumulate wealth and investors that demand expert advice (gray-shaded area of Exhibit 2). Over the past decade, however, the DIY (do-it-yourself) investor market (pink-shaded area) has gained prominence as online trading grew in prevalence.

In China, the DIY investor market is the predominant market segment. Trading activity in the Chinese equity market did not begin to pick up in earnest until the latter half of the 1990s, by which time online stock trading and self-service trading terminals in brokerage branches were already widely

Exhibit 2. Chinese brokerages' products and channels by retail investor type

Type of investor	Suitable products	Suitable channels
DIY investors who gather information and make investment decisions themselves in pursuit of high returns	High-volatility products, including stocks (frequent trading), mutual funds, and futures	Online trading, mobile trading, self-service trading terminals at brokerage branches
Wealth-building investors who want to steadily accumulate assets for the future by investing in stable, profitable investment products	Bond mutual funds, stock accumulation products (renminbi cost averaging programs), employee stock ownership plans	In-branch consultation booths, sales personnel that make sales calls in the local community or at customers' workplaces
Investors expecting expert advice to help them preserve and manage their relatively large asset holdings	Pooled investment products, individually designed products (e.g., structured bonds), limited investment opportunities (e.g., IPOs)	Visits and telephone calls from specialized sales personnel (mostly permanent employees) with a high degree of financial knowledge

Source: NRI

prevalent. Chinese retail brokerages' product offerings consist almost entirely of domestic cash-market equities and therefore do not adequately meet diverse asset management needs. The Chinese retail brokerage industry's market structure thus differs from Japan's.

Battle of attrition is brewing

Given the market structure described above, Chinese brokerages compete with each other in terms of (1) capturing new accounts, (2) helping customers select stocks (providing investment information), and (3) pricing (i.e., lower commission rates).

Because China has a designated brokerage system[2)] for equity trading, brokerages lose the opportunity to earn commission revenues from a customer if they fail to capture the customer's account before another brokerage does. All brokerages consequently place heavy priority on gaining new accounts through both direct and indirect methods. Specifically, Chinese brokerages employ large numbers of commission-based sales personnel who specialized in directly recruiting new customers to open accounts. Indirect methods include advertising or offering various services in the aim of attracting new customers. Specific approaches differ among brokerages, but the lack of significant inter-company variation in product offerings precludes substantive differentiation among brokerages.

Second, brokerages aim to promote trading by their existing customers through such means as employing famous economists or analysts and actively publishing investment research. These measures likely help somewhat to attract new customers, but the Chinese equity market's main driving force is retail investors pursuing gains from short-term price appreciation. Demand for fundamental research is inherently weak. Instead, technical analysis tools are popular. Investment information issued by famous analysts is not yet an effective means of attracting and retaining customers.

Consequently, all Chinese brokerages today are aggressively reducing commission rates, a strategy that can be called a last resort for securing revenues. China has already liberalized stock brokerage commissions (in May 2002), subject to a cap of 0.3% of trade value. In actual practice, Chinese brokerages lower commission rates on a customer-by-customer basis at the branch manager's discretion to retain important customers, according to interviews with industry insiders. In extreme cases, brokerages reportedly offer commission rates as low as 3 basis points.

In pursuit of a new business model

With Chinese brokerages yet to make much progress in diversifying their product offerings or establishing non-brokerage business models, they essentially have no means to differentiate themselves. Despite such a competitive environment, Chinese brokerages have hitherto operated profitably by virtue of growth in trading volume and a steady influx of new customers. However, competition among Chinese brokerages is evolving into a battle of attrition, where brokerages are unable to maintain their existing market shares without resorting to reductions in commission rates or heavy spending in the form of selling, general and administrative expenses.

In response to this dilemma, certain Chinese brokerages companies have started to proactively pursue new initiatives in the aim of avoiding a war of attrition in addition to maintaining existing sales efforts.

One such approach is business model diversification. One mid-tier brokerage is heavily promoting pooled investment products, an area in which it has more experience than other brokerages. Specifically, the brokerage assembles a pool of funds from customers and invests the funds in stocks selected by in-house portfolio managers. Pooled investment products are one of the few fee-based businesses in which Chinese brokerages are currently involved. Branching into such fee-based businesses is a strategy that aims to stabilize operations by reducing even slightly dependence on brokerage commissions, which tend to vary in parallel with equity market movements.

Meanwhile, some brokerages are seeking to revolutionize the brokerage business itself. These brokerages aim to cultivate the market segments represented by the gray-shaded portion of Exhibit 2 based on research into how the retail brokerage industry developed in advanced economies. Specifically, these brokerages aim to provide more and better asset management advice by assigning advisors (called account managers) to existing customers in addition to expanding their aforementioned customer recruitment staff.

Faced with a cutthroat war of attrition, Chinese brokerages are thus starting to try to change the "rules of the game." Business innovations in the Chinese retail brokerage industry will be a key focal point going forward.

Note

1) March 2010 trading volume was valued at RMB2,529.4bn on the Shanghai Stock Exchange and RMB1,882.0bn on the Shenzhen Stock Exchange. Converted to yen at an exchange rate of ¥13 to the renminbi, the Shanghai and Shenzhen exchanges' combined volume in March 2010 exceeded ¥57,000bn, well above the Tokyo Stock Exchange's March 2010 volume of ¥31,164.7bn.

2) In Japan, it is not unusual for retail investors to have accounts at multiple brokerages (e.g., one account at an online brokerage and another at a full-service brokerage), but Chinese retail investors must designate a single brokerage as their broker to trade stocks listed on the Shanghai Stock Exchange. Although this requirement does not apply to stocks listed on the Shenzhen Stock Exchange, customer information in account databases at the China Securities Depository & Clearing Corporation (CSD&C) can be modified through any brokerage. Securities brokerages do not possess customer information exclusive to themselves.

Author's Profile

Hajime Minamimoto

Senior Consultant
Asia Financial Business Department

E-mail : kyara@nri.co.jp

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

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