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China's equity index futures market is poised to take off

Nomura Research Institute, Ltd.

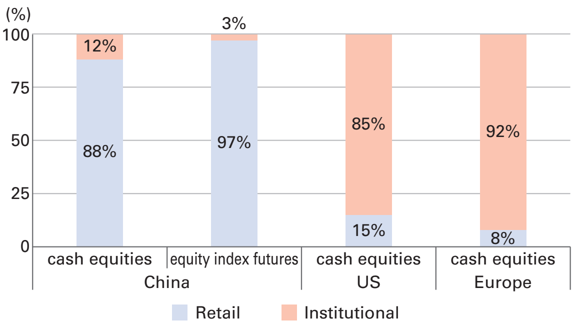
China's equity index futures market, launched in April 2010, is currently dominated by retail investors but it should evolve into more of an institutional market once regulations are eased and additional products introduced. Futures brokers are engaged in fierce competition that has driven down their profitability. Almost all of them, however, including non-Chinese brokers, are willing to temporarily endure subpar profitability in hopes of tapping into the market's enormous growth potential.

Market participants: now mostly retail but institutional participation should increase over time

China's first equity index futures market opened in Shanghai in April 2010. Its advent is part of a strategy to transform Shanghai into an international financial hub by 2020 and also one step in the China Securities Regulatory Commission's (CSRC) plan to gradually open China's financial markets.

China's equity markets differ markedly from markets elsewhere in the world in terms of composition of market participants. By our estimate, cash equities brokerage revenues in China total US$14 billion[1] versus global wholesale brokerage revenues of $40 billion from cash equity markets. However, 90% of this $14 billion is derived from retail accounts. Retail accounts account for a similar share of trading in the new financial futures market also. The recently launched CSI 300[2] futures generate brokerage revenues of $0.8 billion, equivalent to one-tenth of global brokerage revenues from listed equity derivative products. Retail accounts' share of this $0.8 billion is 97%. Of over 60,000 index futures trading accounts opened in China, only 1,000 are institutional accounts. The remainder is all retail accounts.

Exhibit. Composition of market participants: comparison between China and US/Europe (2010)



Retail (China): Individual investors and underground hedge funds[9]
Institutional (China): Cash equities brokers, asset management firms, QFIIs[10], and other authorized companies[11]
Institutional (US & Europe): Asset management firms, hedge funds, and high-frequency traders
Source: NRI America estimates based on interviews

China's equity index futures market is currently open to institutional investors and qualified retail investors, who must meet minimum requirements in terms of sophistication and financial resources. Specifically, retail investors must pass an examination about derivatives trading and meet a minimum initial margin requirement of RMB500,000 (approximately US$77,000) to qualify to trade equity index futures. This qualification system aims to not only protect retail investors from the risk of leveraged futures trading but also to safeguard the new market against turmoil. The CSRC apparently considers the enormous number of retail speculators active in China's cash equity market–which, by contrast, is open to anyone–to pose a risk of unwelcome volatility in the equity index futures market.

Among institutional investors, public mutual funds managed by asset management firms have already received CSRC authorization to trade equity index futures, but they generally have yet to do so for several reasons. First, they are subject to position limits and activity restrictions[3]. Second, they must revise their existing prospectuses to add equity index futures trading to their investment mandates. Third, the prevailing mindset among asset managers takes time to change. Equity index futures constitute a challenging new product for equity portfolio managers that have been long-only investors for their entire career to date.

The CSRC plans to relax restrictions on institutional investors' participation in the equity index futures market once the market has gained stable footing. The market will therefore not be dominated by retail investors much longer. Private funds[4], launched as a pilot program in July 2010 for qualified asset managers wishing to target high-net-worth clients, provide asset managers with an opportunity to gain experience trading equity index futures. Asset managers are also preparing to launch new public funds with mandates that permit utilization of equity index futures. Meanwhile, the CSRC just issued new guidelines to allow Qualified Foreign Institutional Investors (QFIIs) to trade Chinese equity index futures[5]. QFIIs should help the equity index futures market grow and become more institutionally oriented, given their sophistication and extensive experience in developed markets.

Brokers are seeking first-mover advantage amid intense competition that has depressed profitability

While the emerging financial derivatives market's growth potential is obvious to all, China's equity index futures brokers (of which there are 137[6]) have seen their profitability eroded by fierce price competition. For now, brokers are sacrificing profits in pursuit of market share growth by charging sub-breakeven commission rates that in some cases do not even cover the trading fees charged by the exchange. Domestic cash equities brokers are permitted to wholly own futures brokerages since 2006. Some 60 cash equities brokers have acquired futures brokers in the aim of benefiting from the financial derivatives market's growth. The cash equities brokers act as introducing brokers for their futures broker subsidiaries. Through such arrangements, the futures brokers gain access to their respective parent companies' clientele. Futures brokers without access to a cash equities broker's customer base tend to focus on commodity futures brokerage[7] for the time being.

Foreign brokers also see opportunity in China's futures markets. They can participate in the Chinese futures brokerage business by acquiring a minority stake in a domestic futures broker[8]. As of year-end 2010, three foreign financial institutions had formed strategic alliances with Chinese futures brokers to gain entry to the market. Namely, JPMorgan acquired a 49% interest in the Zhongshan Futures Brokerage Co., Royal Bank of Scotland acquired a 16% stake in Galaxy Futures Co., and Newedge partnered with the CITIC Group to form CITIC Newedge Futures Co. with a 42:58 split respectively. Other foreign firms are distributing research reports on index futures trading strategies as a prelude to market entry. Whatever approach they choose to employ, foreign financial institutions are seeking to gain first-mover advantage accruing from two factors. First, once margin is deposited in the broker’s account, broker takes the control. Second, institutional investors generally prefer to do business with brokers that offer an integrated platform for trading multiple assets. Being the first to offer such services confers an advantage in terms of customer retention. It is therefore crucial for foreign brokers to enter the market early by building relationships with asset managers, thereby positioning themselves to offer more diverse and sophisticated products when regulations are eased. Foreign players' key competitive advantages are firsthand information in oversea markets, advanced trading technologies, and experience in the prime brokerage business. Domestic brokers, by contrast, aim to capitalize on their long-standing relationships, deep understanding of how Chinese financial markets operate, and privileged status vis-à-vis foreign rivals under current regulations.

Given retail investors' large presence in the market, we surmise that regulators are in no hurry to deregulate the market. Structural change will happen gradually. As it does, institutional participation in the market will increase despite the market's heavily speculative nature at present. Once asset managers and QFIIs become more active in the market, other institutional investors such as trusts, insurers, and pension funds will eventually be allowed to trade equity index futures, whereupon the market will develop an increasingly institutional character. While CSI 300 futures are the only product now available, we expect more derivative products to be launched once the CSRC deems the market to be safe and structurally sound enough to withstand new challenges. There is no denying the Chinese financial derivatives market's enormous growth potential.

Note

1) Including both wholesale and retail brokerage revenues.

2) A capitalization-weighted index comprising 300 A-share stocks listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange.

3) Public mutual funds are permitted to trade equity index futures for hedging purposes only, with their equity index futures positions limited to a maximum of 10% of their net assets. They are prohibited from engaging in speculation or arbitrage in the equity index futures market.

4) Private funds are not subject to the prohibition against speculation and arbitrage.

5) CSRC's "QFII Equity Index Futures Trading Guideline" dated May 4th, 2011 allows QFIIs to trade equity index futures only for hedging purpose via up to three futures brokers.

6) Per CFFEX (China Financial Futures Exchange) membership information.

7) Futures brokerages in China can trade in both index futures and commodity futures.

8) The Closer Economic Partnership Agreement (CEPA) limits Hong Kong companies' ownership interests in mainland joint ventures to a maximum of 49%.

9) Unregulated investment companies that serve high-net-worth individuals.

10) Qualified Foreign Institutional Investors: foreign investors licensed to trade A-share stocks on the Shanghai Stock Exchange and Shenzhen Stock Exchange under a program launched by China in 2002.

11) Including so-called sunshine hedge funds, which are funds offered by regulated investment companies through a trust company's platform.

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