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vol.130 (10.January.2012)

Financial regulation in China after upcoming leadership transition

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China has appointed new heads to its three core financial regulatory agencies (CBRC, CSRC, and CIRC) ahead of the next autumn's scheduled leadership transition. Chinese financial regulators are expected to place priority on risk management and consumer/investor protection going forward.

Securities markets aim to rectify overemphasis on funding function

On October 29, 2011, China appointed new heads of the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). The new CSRC and CIRC chairmen are Guo Shuqing and Xiang Junbo, respectively. Mr. Guo's predecessor, Shang Fulin, was appointed CBRC chairman. The appointment of new leaders to China's three key financial regulatory bodies ahead of next autumn's scheduled Communist Party personnel reshuffle implies that regulation of the banking, securities, and insurance sectors will generally maintain its existing course, unaffected directly by the upcoming leadership transition.

The CSRC made news in November, shortly after its leadership change. By way of background, the CSRC has already embarked on implementation of nearly all provisions of the State Council's nine-point blueprint[1)] for securities market reform dating back to 2004. It has currently entered a phase of delving deeper into specific reforms.

Against such a backdrop, the CSRC announced several initiatives at a November press conference. First, it requested that publicly traded companies improve their dividend policies and methods of determining dividend payouts, set dividend policies scientifically, increase dividend payout ratios' transparency, and refrain from arbitrarily changing their dividend policies. Second, the CSRC will henceforth require that dividend and other shareholder-return policies and dividend plans be prominently disclosed in IPO prospectuses. Third, the CSRC is studying dividend taxation. It aims to rationalize dividend taxation to increase publicly traded companies' propensity to pay cash dividends. Fourth, although large-cap IPOs decreased in number in 2011, the CSRC plans to warn prospective issuers and IPO underwriters of the risk of market volatility affecting major IPOs on both the issuance and underwriting sides of the transaction.

The CSRC revealed that it is also discussing with the securities industry whether new stock issuance should be subject to an approval or registration process and preparing to improve laws regarding IPOs and other equity offerings, mainly in the aim of upgrading the quality of information disclosure[2)].

The CSRC is thus placing priority on strengthening regulatory oversight of how publicly traded companies' determine dividend payouts and pay dividends.

Some publicly traded companies seem to be indifferent to paying dividends. Many have never paid any dividends since their IPOs[3)]. Companies' failure to disclose their dividend policies/plans and their general deference to the will of major shareholders have been cited as problems. Meanwhile, investors have historically not placed much importance on dividends. Instead, their main focus is prospects for share price appreciation.

In response to the CSRC's initiatives, companies that have floated IPOs since mid-November have included mandatory dividend disclosures in their prospectuses. Specifically, five companies' prospectuses issued in mid-November included major disclosures on post-IPO dividend policies. The specific policies included cash dividend payout ratios of 10% or more[4)]. Such disclosure requirements may be applied to already-listed companies in the future. Additionally, the CSRC appears to be in the process of reforming dividend taxation, including double taxation of cash dividends (i.e., dividends are paid from after-tax earnings and then taxed again as personal income of their recipients), an issue that came up at the CSRC's November press conference.

With retail investors increasingly becoming dismayed with securities markets, it is interesting that securities regulators that have long been criticized for being biased in favor of issuers have started to place more priority on investors' returns.

Exhibit. Overview of 12th five-year plan for China's insurance industry

Basic view: China's insurance industry is still in an early stage of development and must transition to a new growth model.
(Contribute to socioeconomic development, ensure public welfare, and protect the interests of insurance consumers)
• Play a key role in socioeconomic development, including construction of new rural villages, expansion of domestic demand, development of an innovative society, and cultivation of strategic new industries. • Protect insurance consumers' interests. Make consumer recognition/satisfaction the standard for evaluating service level/quality.
(Structurally improve and upgrade insurance industry)
• Shift from extensional to intensive development strategy. Promote competition through differentiation. • Optimize insurance sales channels, diversify insurance products, and expand scope of services.
(Deepen reforms/liberalization and promote innovation)
• Strengthen the Chinese insurance industry's core competitiveness and international influence.
(Prevent/eliminate risks and improve regulatory oversight)
• Harmonize insurers' internal controls and external regulatory oversight.
Major objectives
(Achieve stable, relatively rapid development)
• Insurance premium revenues of RMB3trn, insurance penetration (premium revenues/GDP) of 5%, per-capita insurance premiums of RMB2,100, and total insurance industry assets of RMB10trn by 2015.
(Strengthen competitiveness)
• Increase insurance industry's share of financial sector's total assets. • Increase major insurance groups' competitiveness and international influence, promote smaller insurers' steady growth, and build competitive advantage through differentiation of specialized insurers. • Further expand insurance coverage's scope and diversify products and services.
(Augment insurance functions)
• Increase measures of insurance's contribution to the economy and society (e.g., ratio of insurance claims payments to casualty losses). Make insurance an important component of disaster relief and social security systems.
(Upgrade risk prevention capabilities)
• Prevent systemic risk through adequate solvency margins, improvement in the insurance industry's capital replenishment mechanisms, etc. • Further improve insurers' corporate governance structures and internal control mechanisms. • Improve regulatory oversight systems focused mainly on solvency margins, corporate governance, and market conduct. Build market exit mechanisms. Utilize insurance reserve funds for dealing with risks.
(Strengthen trust)
• Protect consumers' interests and reduce problems such as misselling and insurance claim difficulties.

Source: NRI, based on CIRC's Outline of 12th Five-year Plan for the Chinese Insurance Industry's Development (dated August 3, 2011)

Focus on lowering risk

The banking industry currently highly profitable and has a low NPL ratio[5]. Looking ahead, however, it must focus on controlling the risk of direct and indirect financing of local governments. Over the longer term, Chinese banks may confront the same challenges that Japanese banks have encountered since the 1980s. Bank profits have hitherto been dependent on a business model based on expanding lending to prime customers while earning a net interest margin of some 300 basis points by virtue of regulated deposit rates. If direct finance grows as the government intends, banks' prime customers will increasingly raise funds directly from securities markets. Additionally, if Japan's experience is any guide, Chinese banks' net interest margins will shrink as interest rates are deregulated in tandem with capital market liberalization[6]. Said otherwise, the pace of future capital market liberalization (or internationalization of the renminbi) is contingent on banks' transitioning to a business model able to withstand interest rate and exchange rate volatility.

Going forward, banks will likely shift their focus to asset-liability management, lending to SMEs, and fee businesses while regulatory authorities adopt a Chinese version of Basel III[7] and seek to control risk through such means as regulation of capital adequacy ratios.

The insurance industry is likewise under pressure to abandon its long-standing focus on expansion of scale. Since last year, life insurers' earnings have taken a turn for the worse, as payments of insurance benefits and policyholder dividends increased while investment performance deteriorated, leading to an increase in policy cancellations[8]. Against such a backdrop, the CIRC intends to promote reform of the overall insurance industry's growth model while adopting a risk-management regime with a continued focus on solvency margin in accord with the 12th five-year plan for the insurance industry (see accompanying table). The CIRC is also likely to adopt consumer protection measures in response to recent abuses, including misselling[9] and failure to pay insurance benefit obligations.

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Note

1) Its official title is the Guidelines on Promoting Reform, Opening-up and Steady Development of China's Capital Markets (January 2004).

2) The foregoing details of the press conference are based on media reports.

3) Of Chinese companies listed for 10 years or longer, 179 have never paid any dividends, including some companies with strong earnings (China Securities News, November 18, 2011, p.A03).

4) One company reportedly disclosed a policy of maintaining a cash dividend payout ratio of at least 25% (Jinghua, November 14, 2011).

5) In the third quarter of 2011, China's 16 publicly traded banks' net income grew 31.7% year on year to RMB691.5bn. NPL ratios as of September 30, 2011, were 0.9% for Chinese banks in aggregate, 1.1% for state-owned commercial banks, and 0.6% for joint-stock commercial banks.

6) During China's recent monetary tightening phase, off-balance-sheet transactions and underground lending became more prevalent. De facto interest rate liberalization is thus already underway in the form of circumvention of interest-rate controls.

7) See "China moves to reduce NPL risk and adopt its own version of Basel III" (http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011114.pdf).

8) Life insurance products lack diversity in China. In the first half of 2011, such policies that pay dividends accounted for 91.6% of life insurance premium revenues (as reported by former CIRC chairman Wu Dingfu at an insurance regulatory conference in mid- 2011).

9) See "Recent developments in China's bancassurance market" (http://www.nri.co.jp/english/opinion/lakyara/2011/pdf/lkr2011117.pdf).

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