China 2020 Research Digest

> "We possess all things. I set no value on objects strange or ingenious, and have no use for your country's manufactures."
>
> – Qianlong Emperor

So doomed the Macartney Embassy, Britain's first trade mission to China, and the court of the Qianlong emperor. Nowadays, things may have changed – though there are likely a fair number of trade functionaries and diplomats who would sympathise with the frustrations felt by George Macartney and his ill-fated trade mission – as China appears to be opening up its estimated USD 45tr financial market, which is estimated to derive nearly USD 10bn in profits by 2030[2], to foreign players.

This market, looming large as it does, remains segmented and split among its various components. This means that foreign financial institutions ("FIs"), whose operations in their home markets may be a seamless example of streamlined integration and efficiency, may find that whilst their overall ambitions for expansion in China are progressing, the individual components such as insurance, securities, banking, asset management, wealth management, pensions, etc, do not advance in unison.

Their staggered advances may be frustrating, but are not without reason. Furthermore, when the potential of China's financial market is finally prised open to foreign entities, such frustrations are likely to be forgotten.

This research digest will outline the progression and development of regulatory changes, the potential profits such an opening-up could present, and the outlook for foreign firms in this new market landscape.

What has changed / what will be open to foreign financial institutions in 2020?

The journey of reform began back in November 2017 with the joint statement, announced by the People's Bank of China ("PBoC"), China Banking Regulatory Commission, and China Insurance Regulatory Commission, stating the goal of unifying the fragmented regulatory standards for China's asset and wealth management industry.

The announcement outlined the twin overarching objectives of market reforms, namely:

- Preventing financial systemic risks and serving the real economy; and
- Preventing 'grey-rhino' and 'black-swan' events.

Additionally, draft provisions for the industry were included in the announcement and were open to industry comment.

The scope and scale of the proposed reforms were vast indeed, too vast for everything to be announced or enacted all at once. Accordingly, the nature of reform has been uneven, though not uncoordinated.

The first step was consolidation. In March 2018, China's banking and insurance regulators were merged into a 'super-regulator', the China Banking and Insurance Regulatory Commission ("CBIRC").

1 Bloomberg.

2 Ibid.

Following the initial announcement, further developments were unveiled at the Boao forum in Hainan in April 2018. Several of the announcements were continuations from earlier and some were new efforts to further China's commitment in opening up its asset and wealth management industry. Some specific examples of the provisions included:

- Clarification on the definition of FIs;
- The explicit statement that FIs were not allowed to use asset management products to invest in commercial banks' credit assets or provide channel services in an attempt to bypass the new regulations;
- Forbidding FIs from conducting asset pools to manage funds raised through asset management products;
- Allow the PBoC to control leverage levels for asset management products in order to curb asset bubbles;
- That FIs must make provisions and set aside 10% of their management fee income from asset management products as risk reserves;
- That FIs providing implicit guarantees on products will be punished; and
- Prohibit non-FIs from issuing or selling asset management products.

Following the creation of the regulatory body to drive reform, the "Guidance Opinions Concerning Standardisation of Asset Management Operations by Financial Institutions" were announced on 27 April 2018. This was in direct response to comments received following the initial announcement in November 2017, and covered 5 points:

1. Extending the transition period of the reforms, initially slated to be completed as of 30 June 2019, to the end of 2020.
2. Eliminating the implicit guarantees prevalent across China's wealth management products.
3. Standardisation of investment in non-standard assets.
4. Standardisation of leverage in asset and wealth management products.
5. Prohibition of 'nesting' – when asset and wealth management products invest in other asset and wealth management products which invest in other asset and wealth management products and so on and so forth – beyond one level.

Following the release of measures in November 2017 and April 2018, the reform programme China was undertaking gained its title: Super Guidance.

After the initial announcements and release of measures for the asset and wealth management industry, the banking sector, which is now under the new super-regulator CBIRC, announced updated measures. Released in September 2018 and followed by further measures in October 2018, these new measures incorporated comments and feedback received from the earlier release, targeted at the Bank Wealth Management Products ("BWMPs") favoured by Chinese investors and beloved of China's commercial banks due to the fee revenue they derived.

The key theme of these releases pertained to how China's BWMPs would be permitted in the market, and these specific points included:

- Allowing BWMPs to invest directly in shares as opposed to through mutual funds or other products.
- Expanding the sales channels available to BWMPs to include financial institutions approved by CBIRC.
- Reversed the initial regulation which prohibited issuing ranked BWMPs, provided that relevant regulations were observed and followed in issuing ranked BWMPs.
- Established that Chinese commercial banks should establish wealth management subsidiaries ("WMAs") to manage their BWMPs and allowed for domestic non-financial institutions and foreign financial institutions to be shareholders in these new wealth management units. The minimum registered capital of these units was set at RMB 1bn and the measures stipulated that no more than 20% of their registered capital could be invested in permitted BWMPs.

The China Securities Regulatory Commission ("CSRC"), China's securities and asset manager regulator, also issued a series of measures in October 2018. These measures, while not appearing to be directed at the Private Fund Manager ("PFM") entities in China, nevertheless appear to have a direct impact on the scope and scale of their Chinese operations. This was important as an increasing number of foreign-backed PFMs were establishing operations on the Mainland.

The specific provisions of the CSRC measures included clarifications on:

- Which sources PFM products could receive investment from;
- Who PFMs could offer advisory services to; with CSRC adopting the 3+3+1 rule[3] for PFMs to qualify to offer said services; and
- Investment levels in underlying assets that PFM products invested in (product 'wrapping').

The key aspects of which were:

- Domestic Chinese banks being required to establish their own wealth management product arms;
- Changes to the QFII and RQFII cross-border investment programmes;
- Increased activity among PFM and Qualified Domestic Limited Partner ("QDLP") WFOEs; and
- Foreign asset and wealth managers taking controlling stakes in onshore public fund management companies ("FMCs").

The next source of progress came from the 10th U.K. – China Economic and Financial Dialogue in June 2019. Among the agreements reached and market-openings allowed were:

- The broadening of the scope of permitted PFM business, including providing investment suggestion services to affiliated companies or third parties.
- Clarification on the process for PFM WFOEs to convert to public FMCs, and the allowance for business continuity during the conversion process.
- Provisions for qualified FIs to be registered as WFOEs or joint PFMs to engage in the business of investment suggestion service providers, fund accounting and transfer agency private fund service providers.

In addition to the above, entity-specific allowances were made for certain U.K.-headquartered firms operating in China.

3 This rule states that PFMs should:
Have been registered with the Asset Management Association of China ("AMAC") for at least one year with no record of major violations of laws and regulations, and still hold the AMAC registration, and have at least three investment managers with more than three years of continuous and traceable performance in securities or futures investment management, and have no bad practicing record.

In July 2019, China's State Council's Office of the Financial Stability and Development Committee announced a further 11 measures targeted at further opening up the financial services sector to foreign participation.

The 11 measures announced were as follows:

1. Foreign-invested rating agencies can give ratings to bonds traded on China's interbank market and exchanges.
2. Foreign FIs are encouraged to participate in the establishment of, or investment in, the WMAs of Chinese commercial banks.
3. Foreign asset managers are allowed to partner with the subsidiaries of Chinese banks or insurers to set up asset management companies which are foreign-controlled.
4. Foreign FIs are allowed to establish or invest in pension FMCs.
5. Foreign investors will be given support to establish or invest in currency brokers.
6. The transition period for relaxing restrictions on foreign ownership in life insurance companies from 51% to 100% will be brought forward to the end of 2020 – it was previously slated for the end of 2021.
7. The ownership cap of 25% for foreign investors holdings in insurance asset management companies will be removed.
8. The 30-year qualification requirement for foreign insurers looking to invest in China will be revoked.
9. Foreign ownership restrictions in securities companies, fund management companies, and futures firms will end over 2020 – they were previously slated to be removed over 2021.
10. Foreign-invested FIs are allowed to obtain type-A underwriting licenses in the interbank bond market.
11. Additional measures will be implemented to further facilitate foreign institutional investors' investment in the interbank bond market.

The latest bout of reform and acceleration of previous measures occurred during the USA-China trade deal in 2019 and shortly thereafter.

Some of the provisions in the trade agreement allowed for:

- Expanding the scope of business activities foreign banks can undertake in China, namely in the fund custody services and the underwriting of non-financial debt instruments.
- Foreign fund managers to establish foreign-controlled wealth management J.V. with WMAs and subsidiaries of Chinese insurance companies;
- Improved foreign asset managers' access to China's equity and bond markets, expanding the investment scope they were able to access; and
- Foreign firms to invest in Chinese distressed asset management space, giving access to China's vastly increasing pile of non-performing loans

Shortly after the signing of the USA-China trade deal, Chinese regulators accelerated their timetable for securities firms taking 100% control of existing securities J.V.s in China – bringing the deadline forward from the end of 2020, to 1 April 2020. Additionally, foreign securities firms could take majority control of their securities J.V.s since 2018.

Interspersed among these headline-grabbers have been various regulatory updates and clarifications provided by AMAC and others which have served in providing a practical implementation of policy announcements, clarifying specific elements, or providing detail to policies.

While these announcements and policy developments may appear to overlap with one another, they do demonstrate a consistent approach to implementing the stated goals of authorities in Beijing.

Further, despite ongoing geo-political and trade tensions, Chinese regulators have continued to apply the reforms and developments, and have stated that they will treat foreign players equally in their applications for access to the newly opened areas of China's financial markets. What is most surprising, is China's actual follow through.

As the situation stands at the time of writing this digest, these goals and announcements have manifested themselves in different ways across the various component players within China's financial services sector. The results they may have on the outlook for foreign firms operating in or looking to enter the various segments of China's financial services sector are outlined in the following pages.

The figure was provided by the relevant industry association in China

Banks

2018	2030 Forecast
Profit: **RMB 1.83tr ^**	Forecast profits: **RMB 59.88bn+**
Foreign firms share: **1.4%+**	Foreign firms share: **1.8%+**

+ indicates the figure was provided by Bloomberg, ^ indicates the figure was provided by the relevant industry association in China

As of October 2019, there were 976 foreign-invested entities with combined assets of RMB 3.37tr. As points of comparison, Bank of Beijing and Bank of Jiangsu, the two largest provincial-level organisations, had 555 and 510 branches and assets of RMB 2.68tr RMB 2.07tr respectively as of 30 September 2019.

Outlook for foreign firms

Restrictions on foreign banks expanding their onshore presence have been lifted along with asset requirements, and the range of local Chinese shareholders in J.V.s have been expanded.
A significant driver of profits in the commercial banking sector were BWMPs. However, this is now deflating as a result of regulatory reforms. As of 30 June 2019, foreign banks had only issued approximately RMB 90bn in BWMPs, a distant fifth behind other product issuers. Thus, foreign players looking to enter the market, due to the lure of BWMPs to drive profitability, may be disappointed and would need to rely on traditional banking services instead.

However, given the resources required to compete in China's commercial banking space and the dominant positions local banks occupy in their respective market segments, foreign banks may not pursue this avenue as aggressively as other aspects of China's financial sector. Instead, they may focus more on the peripheral

services now open to them, like custodian services, in order to carve out their niche.

Insurers

2018	2030 Forecast
Profit: **RMB 289bn ^**	Forecast profits: **RMB 1.6tr+**
Foreign firms share: **1.8%+**	Foreign firms share: **12%+**

Foreign insurers are now able to apply to establish 100% owned domestic insurance units in China's life insurance market.

Outlook for foreign firms

China's insurance industry product mix is dominated by life insurance products, accounting for nearly 75% as of 3Q19. Within this group, China's six largest life insurers account for over half of all life insurance premium market share. Thus, competition could be tough for foreign players going it alone and establishing 100% controlled entities.

Life insurance leads the industry in terms of premium income, and as of 2019, premium income exceeded property, health, and accident premiums combined. Health premiums are growing rapidly, accounting for over 20% of market share, and thus foreign insurers looking to enter the life insurance market may seek to establish brand recognition ahead of additional market reforms which would enable them to enter the growing areas of China's insurance market.

Securities firms

2018	2030 Forecast
Profit: **RMB 1.23tr ^**	Forecast profits: **RMB 5.19bn+**
Foreign firms share: **0.4%+**	Foreign firms share: **1.7%+**

Several foreign firms have taken majority control of their securities joint ventures since they were allowed to in 2018, and a few have announced their intentions to take 100% control following the lifting of ownership restrictions on 1 April 2020.

Outlook for foreign firms

Securities firms in China have multiple service lines and are the 3rd largest managers of assets. The industry is widely seen as having too many smaller players and collectively, the assets of all 133 Chinese securities firms amount to around that of a major global player. Foreign firms entering this market are likely to be highly competitive, and Chinese regulators have issued statements on whether they believe their domestic champions can effectively compete against foreign interlopers. Currently, authorities are pushing for the merger of China's two largest securities firms in order to create an 'aircraft-carrier sized' firm which would be better able to compete against foreign firms.

Asset managers

Public

As of December 2019, China's public fund industry comprised 128 fund management companies, with 44 of these being Sino-Foreign joint ventures ("FMC J.V.s"), with a collective AUM of RMB 14.77tr[4]. While around half of the top-20 FMC spots are occupied by FMC J.V.s, usually where a Chinese partner is a large bank, the majority fall in the upper-middle ranking between places 21-64.

Since the initial announcement and acceleration of majority-control for foreign partners, one foreign asset manager has successfully bid for majority control, in what was essentially a solo-auction. In addition, another foreign asset manager has successfully bid to become the largest shareholder in a more competitive auction, albeit short of majority control. Yet another foreign asset manager has clearly signalled its intention to become the controlling shareholder – though as at the time of writing this digest the foreign asset manager in question had not yet accomplished this but reported it had "operational control" of its FMC J.V.

Outlook for foreign firms

Foreign asset managers looking to take majority or total control of an existing FMC will need to carefully consider what they can offer Chinese investors in a crowded market, ensuring that they have adequate financial and non-financial resourcing, and the steadfast commitment and dedication of head-office to stay the course.

The value proposition offered by foreign asset managers seeking to take majority or complete control will be especially important as the nature of competitors to these firms stands poised to be substantially altered in coming years with changes on multiple fronts. Firstly, as of April 2020, 18 banks had established WMAs and launched a total of 818 products between them. In addition to opening-up a new front of competition in the asset and wealth management space, the dominance of some of the leading FMCs, generally bank-backed, could be upended as Chinese banks switch their focus to their WMAs over their investments in FMCs.

Such a switch in focus, if it occurs, could deprive foreign parties to FMC J.V.s of critical support needed for the continued success of FMCs they are involved in or considering an investment in.

A second front that could open up is found in the plethora of PFMs who now qualify for a public fund license.

4 AUM.

The third front of competition which threatens to open is that of foreign PFM WFOEs which qualify to apply for a public fund license. Several firms have explicitly or implicitly stated their intent to transition their current PFM operations from PFM to public fund licenses.

Private

As of December 2019, China's private fund industry comprised 24,471 private fund managers with a combined 81,739 funds launched, comprising RMB 13.74tr in AUM[5]. While over half of the managers are registered as private equity firms and account for over half of AUM, the majority of funds are private securities funds.

Among this sea of PFMs, around 50 foreign entities have established PFM WFOEs, with around half of these receiving their PFM license and launching a collective total of 78 funds as of April 2020, with the top two players launching 15 funds and 10 funds respectively. Figures released by AMAC indicate PFM WFOEs managed collective AUM of RMB 7.88bn as of March 2020.

Despite this flurry of launches, anecdotal evidence suggests that the largest fundraising by a PFM WFOE product amounted to less than RMB 200million. Apart from one or two players who have successfully created an in-demand value proposition for Chinese investors and managed their onshore operations exceptionally well, most PFM WFOEs manage less than RMB 500million in AUM.

When 'star managers' at Chinese funds are able to draw in several billion RMB in fundraising in a matter of days, this showcases some of the challenges of foreign firms going it alone in China.

Outlook for foreign firms

Despite the relative lack of success in the private fund space, many PFM WFOEs are now in a position to apply for public fund licenses. Having several years of hard-won experience in the Chinese market, albeit dealing with a dramatically different investor base than that of the public asset management companies, will likely prove invaluable when competing against foreign asset managers who lack said experience.

The value proposition for such firms looking to acquire a public fund license does not look particularly bright. As mentioned earlier, outside of a select group of PFM WFOEs, none have achieved spectacular success in reaching high levels of AUM, even with a relatively sophisticated investor base.

While the sheer number of investors that could be reached under a public fund license is vast, it remains to be seen whether these relatively unsophisticated investors will buy products from a company that many will never have heard of, particularly when they have domestic alternatives with much higher brand recognition.

Discussions with some industry players in China indicate that the ultimate goal of entities switching from a private fund license to a public one is to gain Qualified Domestic Institutional Investor ("QDII") quota which they can then use to leverage their offshore investing experience with Chinese investors seeking such offshore diversification.

This QDII strategy, combined with potential changes in other cross-border programmes which would allow PFM WFOEs to seed their products using QFII or RQFII quota, could be the key to creating a sustainable business model in China's fund space for foreign asset and wealth managers.

Allowing PFM WFOEs to seed their products with QFII or RQFII funds could prove a boon to the myriad of PFM WFOEs struggling with their domestic fundraising by providing, to the eyes of offshore investors, the best of both worlds – an onshore presence in China and a recognised brand, the latter being what the majority lack in their Chinese operations.

A shifting of the goal posts?

For the most part, the market reforms China has undertaken since November 2017 have been consistent with their stated objective of opening up their financial markets to increased foreign competition. Certain aspects of the reforms, however, carry a whiff of merely moving the goal posts.

Specifically, the requirements for Chinese commercial banks to establish independent wealth management subsidiaries and allow foreign FIs the ability to take controlling stakes in the subsidiaries of these subsidiaries.

5 AUM.

The argument that the measures supporting this are a moving of the goal posts are as follows:

Many Chinese commercial banks already had asset management arms in the form of FMCs and several of these were FMC J.V.s. Now, with foreign firms able to apply for 100% control of J.V.s or establish their own public fund management companies, Chinese commercial banks are establishing rival WMA units which will compete in this space.

Initially, the author of this digest believed that these new WMAs would start by launching products in the fixed-income space, mimicking the majority of BWMPs, and expanding their product offerings from there. This was quickly proven wrong as all WMA products initially launched were equity products focused on the new high-tech exchange board established in Shanghai. Further, Chinese commercial banks with FMC J.V.s are some of the most successful ones in the market, due largely to the tremendous distribution power of the domestic bank. With banks forced to establish WMAs, one cannot be certain that they will have the same level of interest in maintaining their FMC J.V. operation. If the bank is not willing to sell their stake to the foreign partner, as some have demonstrated, the foreign party risks being stuck in a venture lacking drive or needing to invest resources in buying into or establishing another venture.

As has been demonstrated time and again in dealings with China, going back to the Macartney expedition, if not earlier, foreigners may find that having successfully lobbied for the access and control long-desired, the real riches and access to them have moved, ever so slightly, along. Just out of their reach, until of course, they vigorously negotiate for access to the newly discovered and coveted sector.

Should Chinese regulators announce the name of the new Grand Choulaa for the financial services sector, matters would certainly get interesting.

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