

Opening up China's financial sector

China is relaxing restrictions on foreign ownership of its financial services institutions. But what does this mean for investors?

The proposed easing of ownership limits in China's financial sector has aroused great interest among investors eager to gain a greater share of the world's second largest economy.

Following the November 2017 announcement, foreign financial companies and other interested parties are considering their next steps. This article looks at the changes and discusses the implications for investors.

A snapshot of the key changes



Securities, futures and fund management

Foreign investors will be permitted a 51 percent holding (up from 49 percent) in securities brokerages, futures companies and fund management companies. After a further three years, all such caps on investment are to be removed.



Insurance

The timescales for insurance are longer. In three years' time, the cap on investment in and establishment of Chinese life, health and personal accident insurance companies increases from 50 percent to 51 percent, and will be completely removed after five years.



Banking and financial asset management companies

The caps on single and collective foreign ownership of Chinese-funded commercial banks and financial asset management companies (which are now mostly tasked with processing non-performing loans), which are currently at 20 percent and 25 percent respectively, will be removed. The rules that govern foreign and domestic investment in the banking sector will become the same going forward.

Evaluating the impact

These changes are likely to affect different parts of the sector in differing ways, and we expect a variety of responses as firms re-appraise their China strategies:



Fund management companies

With 40 or so joint ventures already in place, some of those foreign players currently holding minority stakes may wish to renegotiate in order to gain a controlling position. The opportunity to take a majority slice may also stimulate increased interest in new joint ventures – possibly from investors that have previously been cautious – although we should not expect a huge spike.



Investment management wholly foreign owned enterprises (WFOEs)

Qualified WFOEs can already offer private fund products in China, but in three years' time, they might also be able to launch mutual fund products – so long as they meet certain regulatory requirements and obtain a mutual fund management licence. All of this makes the WFOE option more attractive – indeed, those investors yet to create a substantive footprint in China may increasingly choose this option.



Securities firms

The ownership restrictions will be relaxed in due course, but it is unclear whether any new joint ventures (created under the revised framework) will be able to widen their scope of activities. Joint ventures are currently limited to the underwriting licence at day one, except for certain securities joint ventures set up under CEPA10 (Closer Economic Partnership Arrangement).

Shareholders of existing securities joint ventures might be tempted to try to negotiate a new ownership structure – especially those with a call option for the foreign party.

The promise of greater control could increase the attractiveness of securities joint ventures for foreign securities firms yet to enter China, particularly those with broader, global businesses that include investment banking, brokerage and asset management. Discount brokerage companies – some of which already operate in Hong Kong – may also start to take an interest in the Chinese market.



Futures companies

Some of the more progressive securities firms have already taken strategic positions in the Chinese futures sector through joint ventures; the latest easing of restrictions are likely to stimulate further interest.



Life insurance companies

Given the ambitions of many insurance joint venture Chinese partners, there is a question mark over their willingness to reduce their shares in existing joint ventures to below 50 percent. Ultimately, the opportunities for foreign shareholders may depend upon the vision of their Chinese counterparts, the overall relationship between the two parties, and any subsequent negotiations. Despite such reservations, we should expect a resurgence of interest in mergers and acquisitions – albeit at a slower pace, given the longer timelines for regulatory change in this sector.

Although new entrants should be excited by the opening up of the insurance market, they must also decide whether to wait five years until full ownership is possible, or alternatively enter into a joint venture with the option to assume control in the future. Finding a Chinese partner with a shared vision is likely to be critical.

Some composite insurance groups may see the chance to rethink their overall China strategy, since it is now possible for them to set up life, property and casualty and asset management operations under a single, full ownership structure.



Banks

The 20 percent cap on foreign investment into Chinese banks may have been removed, but a general cap of 20 percent remains for all individual banking investors, domestic or foreign. However, there is some hope that the latest changes might be an overture to greater ownership for overseas and Chinese investors, given that the China Banking Regulatory Commission has been working on ownership structure of small and medium-sized banks.



Financial asset management companies (AMCs)

Now that the lid on ownership has been lifted, professional, foreign asset managers specialising in distressed assets are likely to approach potential targets with enhanced vigour – which could see ownership rising beyond the 20 percent level. That being said, several challenges remain: two of the so-called 'Big 4' AMCs have already gone public and may not be seeking another round of funding immediately. Furthermore, although provincial AMCs need to recapitalise, many are still mulling over the pros and cons of introducing a foreign shareholder. Such specialised managers may, therefore, continue their hedged strategy of creating a WFOE, while simultaneously seeking a stake in existing AMCs.



Rethinking strategies

The various regulatory changes in the Chinese financial services sector offer some potentially exciting opportunities, which calls for a revised strategy based on a greater market presence.

Any new joint ventures, for example, should focus on capturing commercial value, such as synergies between the two shareholders. Traditionally, joint ventures have offered a route to gain a foothold in China, and partners chosen based on their contacts with key stakeholders and ability to help with licensing applications. In the new world of growth and value, foreign investors now need to select partners based on the strength of their customer base, distribution power, capital and brand.

When it comes to existing joint ventures, the foreign party may be tempted to be more assertive over the daily management, especially where the Chinese shareholder does not have a financial industry background. Foreign partners looking to increase their stakes should carefully assess what value they can bring to their Chinese partners beyond money, such as additional operational benefits.

Very few life insurers or securities firms have developed a China strategy based on a WFOE platform. But independence brings new responsibilities, and less reliance on Chinese partners to navigate the vast market or build initial critical mass. Building a WFOE is likely to be more challenging and resource-intensive, requiring a highly rigorous business and operating model.

China's financial services industry is now approaching a point where all sectors will be fully open to foreign companies. Financial conglomerates that engage in multiple sub-sectors face additional coordination challenges. For instance, for a company with joint ventures in insurance, asset management and securities, there is no longer a regulatory firewall preventing it from conducting asset and wealth management businesses, which means they have to revisit their relationship with Chinese partners.

Success in China's financial services sector will not be easy, and is dependent on a strategy that aligns the goals and operations across different sectors. Moreover, it is not just about foreign investors. Chinese players will also be affected by the relaxed rules. They may need to closely monitor the strategies of their international counterparts in order to adapt to a more challenging environment and compete with new foreign entrants.

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