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Accelerating the External and Internal Opening Up of China's Securities Industry

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Now we have set the economic development objectives. But how are we going to achieve them? Well, we need to abide by the principles of social and economic development and pursue two 'opening-ups,' that is, opening up to the outside world and opening up within the country itself. Opening up to the outside is important, because no country could develop by isolation. International communication and transference of expertise, technology and capital from the outside is all necessary. Opening up within the country means reform.

—Deng Xiaoping (April 1985)

Inadequacies of the Current Policy on Opening Up the Securities Industry

The current arrangement for opening up the securities industry is part of China's World Trade Organization (WTO) commitment. It now seems that there are some major oversights in the arrangement:

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> A foreign securities firm can set up operations in China, but only in the form of a joint venture, of whose shares it can hold no more than 33 percent. This restriction has turned away many world-class securities firms. The key reason is that as a minority shareholder, a firm cannot control the joint venture and thus subject its highly valued business reputation to the risk of mismanagement by the joint venture (JV). Moreover, its status as a small shareholder limits its economic incentives in the joint venture, which in turn prevents it from adequate involvement in the institutional and long-term development of the JV company. Perhaps, by opening up, China seeks to attract management expertise rather than capital. However, without a certain percentage of equity investment, the foreign partner's concern about the management of the joint venture will be too limited to have any meaningful influence.
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> The business scope of a JV securities firm is extremely limited. Currently, a JV securities firm can obtain a license to become an underwriter and/or a financial advisor, but cannot operate as a broker or engage in proprietary investment or portfolio management. The extremely limited business scope for these joint ventures reduces foreign companies' willingness to come to China and hurts the competitiveness and long-term earning potential of an existing JV company, depriving it of the opportunity to provide a full spectrum of services.
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> Domestic partners for a JV securities firm are limited to existing Chinese securities firms. This restriction severely limits the choice of potential domestic partners for a joint venture, especially when we consider that many Chinese securities firms are not well run. Potential competition between the JV company and the parent domestic securities firm is another drawback. The current solution is to segregate business between the two, with the joint venture specialized in underwriting and the parent firm engaged in proprietary investment, brokerage, and portfolio management. However, this has to some extent given rise to two incomplete companies and has served only to postpone rather than to solve the potential conflict of interest.

Indeed, opening up the securities industry has been painfully slow. Foreign investment is limited. The firms that are attracted are not the most competitive. The performance of the few joint ventures that have formed is unsatisfactory. Goldman Sachs adopted an ultra-complex model to ensure management control over its joint venture, but we have to wait to see whether the arrangement works. By contrast, foreign investors in the Chinese insurance industry can hold up to 50 percent of the equity in a joint venture life insurer and controlling equity in a property insurer. As a result, many JV companies have partnered with first-class international insurance companies. In the banking industry, foreign commercial banks are allowed to have wholly owned operations in China. The banking industry will be entirely opened up at the end of the WTO grace period in December 2006. By that time, foreign commercial banks will be able

to conduct any banking business anywhere within China. It is not hard to imagine that foreign investment in the banking sector will be all the more vigorous then.

Unfounded Concerns About Opening Up the Securities Industry Faster

The purpose of accelerating the opening up of the securities industry is to enhance its overall competitiveness and strength. A frequently mentioned concern about opening up is that major international players would squeeze the less competitive domestic counterparts out of business. An often-cited example is the British securities industry; its key domestic companies were almost all acquired by stronger foreign rivals (mostly American firms) following the opening up of the industry in the mid-1980s, though London's status as an international financial center was consolidated as a result. Surely, the British experience is an important precedent for China to consider. However, the opening up experiences in Japan, Korea, and Taiwan Province of China have been very different. Even after these markets were fully opened up, domestic companies maintained a considerable market share advantage over their international counterparts.

The question is then, what will happen to China after it opens its securities markets? The answer is almost certain. The British and U.S. business communities share the same language and a similar culture. Domestic firms have little advantage over their foreign counterparts. However, the Chinese business environment is distinctly different from that of Britain, and is close to those of Japan, Korea, and Taiwan Province of China. In addition, China is a big market. It is quite impossible for a handful of international players to monopolize this market.

We should have confidence that Chinese firms will do well in the Chinese market because financial services contain so many local elements. China's telecommunications equipment and household appliance industries survived and thrived following the opening up of their markets. The insurance industry offers a more applicable experience. When American International Assurance Company entered the Shanghai market in 1992, it grabbed considerable market share from local companies with its unique method of managing sales. However, domestic companies learned quickly and recovered their lost market share shortly.

Even for Britain, had it not opened its securities market in the 1980s and made itself home to major international players, British firms would

not have been able to keep London a global financial center—Frankfurt or Amsterdam could have overtaken London to become the new financial center in Europe. India offers another positive lesson for opening up. The Indian securities market opened in 1992 with no restrictions on foreign shareholding or scope of business. Today, the Indian market is considered on a par with those of developed countries, though foreign companies account for no more than 40 percent of the market. Moreover, as time goes by domestic companies are likely to grow in relative strength.

A second concern about opening up is that China would be deprived of a chance to build its national brand names in the securities industry. A commonly cited example is the Chinese auto industry. However, the real reason that China has no leading brand names in cars is not because the industry was opened up too quickly, but because foreign auto builders were allowed to enter into partnerships with only Chinese state-owned enterprises. These state-owned firms have neither urgency nor long-term incentives for innovation. From the 1950s through the 1980s, the auto industry in China was totally closed. Had foreign car makers been allowed to team up with top private companies in China, Chinese brand names would have been established by now—only wholly private brands can bring in strong profits.

A third concern about opening up is that the Chinese securities industry may end up at a disadvantage if that opening up is unilateral while other markets fail to give Chinese firms equal access. We believe, however, that the primary issue in making the policy decision is whether opening up is beneficial to our own industry. If the answer is yes, we should pursue it. Whether or not we will receive equal treatment in a foreign market is a separate issue. In addition, we think that Chinese securities firms are not yet ready to test themselves in a market such as New York or London. When China National Offshore Oil Corporation failed in its bid for Unocal, some people suggested that we should slow down the opening up of China's financial industry.

Recommendations to Accelerate Opening Up the Securities Industry

The necessity of opening up is well argued by Deng Xiaoping as quoted in the beginning of this essay. The three restrictions listed in the first part are China's minimum WTO commitments, but we have never said that opening up our securities industry could not go beyond our commitments or proceed faster than we had promised. Considering the current

conditions of our domestic securities companies, a preferred model for accelerating opening up would be to allow foreign companies to acquire for a fee domestic securities firms that are on the brink of bankruptcy. After acquisition, the foreign company would inherit the business licenses of the acquired domestic firm and obtain controlling shares within the new firm. This model is attractive to foreign companies because it allows them a full license, control over the new company, and access to the expanding Chinese market, at the limited cost of compensating for the historical losses (or even part of the losses) of the acquired domestic firm. At the same time, the model reduces the financial burden on the Chinese government to bail out failing securities firms. The new companies formed by such an acquisition will usually improve their management and competitiveness.

Acceleration of Opening Up Internally

Deng Xiaoping pointed out as early as 1985 that to open up within the country is to adopt reform. Almost all securities firms in China are still state-owned or state-controlled. It was not until a few years ago that some private companies became the controlling shareholders in a couple of securities firms. However, driven by majority shareholders' short-term interest in an environment of weak regulation, these privately controlled companies (such as Fuyou, Deheng, and Hengxin Securities) committed a series of violations. I believe, however, that these violations should not be a reason to slow down reform. In light of the shortage of regulatory capacity in the near future, effective reform can be achieved in the following manner:

> Make senior and departmental managers shareholders of their own securities companies. One proposal is to start with management acquiring some company shares with their own cash. Later, they could increase their shares by converting part of the incremental net assets of the company into equity. This approach is probably the best way to heighten securities firms' risk awareness and increase their competitiveness against foreign rivals.
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> Allow securities professionals of Chinese citizenship from within or outside China to establish new firms. Licensing can start with brokerage-only firms for which limited capital investment and a few key sponsors are required. The success of a securities firm depends on quality professional leadership. Over the past few years, the Chinese securities market has seen a number of well-qualified professionals with extensive operational experience. If these people are allowed to set up their own firms, no doubt some high-quality companies will soon emerge.

We are looking forward to domestic securities firms (and asset management firms) holding a majority market share in a fully opened Chinese securities market. For this reason, we have to carefully plan for the pace of the opening up process so that domestic companies will be able to maintain their advantages. We believe that each year it is appropriate to admit three or four foreign-controlled securities firms to the Chinese market and to restructure or newly establish six or seven new firms controlled or managed by Chinese professionals.

Harms of Opening Up Slowly

The foremost harm of opening up slowly is entirely losing the market. Refusal to open up will save us some weak securities firms at the cost of losing the whole securities market. A Shanghai Stock Exchange survey shows that by the end of 2004, the aggregate floatable market capitalization of Chinese companies on overseas markets had exceeded the total market value of the two domestic stock exchanges in Shanghai and Shenzhen, and that the difference was expanding. Although Chinese issuance on overseas markets quickened during 2005 with the recent listing of China Construction Bank and Bank of Communications, new issuance on domestic markets has come to a full stop. Equity derivatives based on Chinese stocks are being developed in both Chinese and overseas markets. We cannot help but wonder which of these derivatives will be more representative of the Chinese economy or be better risk management instruments for investment into China—no doubt the foreign ones. Liquidity, which is the essence of a financial market, will be hard to recover once we lose it. It is highly urgent that we accelerate reform and opening up and improve the capabilities of securities firms and other financial intermediaries operating in the domestic market, to maintain the Chinese securities market. When the market is gone, how are Chinese securities firms going to survive?

It has become a consensus that the Chinese securities industry lacks innovation. Innovation in the Chinese market is, at best and mostly, a slight adjustment of products and ideas that have been well tested in overseas markets. However, if our market were filled with first-class investment banks from abroad, the innovation situation would be very different. Product innovation with regard to asset securitization is a good example. In spite of the restrictions in laws and regulations, China International Capital Corporation Limited (CICC) (a joint venture with Morgan Stanley) delivered the first Chinese asset securitization product

(Unicom Rental Scheme), now listed on the Shanghai Stock Exchange. But even after CICC made this breakthrough, other Chinese securities firms have exhibited neither efficiency nor momentum in following its example. Why? The innovative capacity of CICC lies in its incentive and risk control mechanisms and the talents it has attracted, which domestic firms lack. This example shows another harm of opening up slowly, namely, lagging behind the innovation frontier of international markets and the service demands of domestic companies and investors.

Conclusion

The Chinese experience of reform and opening up in the past 27 years has shown that diminished effort in these areas slows the development of an industry. In today's globalized world, an industry of a country that refuses to open up to competition will save a few weak players but lose the market as a whole. During his meeting with the president of ABN-AMRO Bank in April 2004, Vice Premier Huang Ju (who is in charge of the financial portfolio) pointed out that the opening up of China's capital market should be accelerated promptly and used as a spur to internal reform. It is time that we implement his advice.

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