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State of Chinese securities industry consolidation

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China's securities industry landscape is expected to change dramatically over the next several years. Until a new order led by several internationally competitive securities firms emerges, China will delay opening its securities sector to foreign competition. The course of Chinese securities industry consolidation therefore bears close watching.

Securities industry consolidation in China to date

China's securities industry is expected to undergo major consolidation over the next few years.

The China Securities Regulatory Commission (CSRC) has been promoting consolidation of securities firms since the early 2000s. At that time, the Chinese securities industry was heavily populated with companies lacking adequate management capabilities. In the wake of the equity bear market from 2001, the Chinese securities industry as a whole incurred losses for four consecutive years through 2005[1). Spurred by a sense of crisis, the CSRC liquidated and consolidated securities firms by administrative directive from 2004 through 2007. It did so mainly by placing troubled securities firms under the control of financially sound competitors or other financial institutions, which later absorbed the troubled firms. Some 30 securities firms were consolidated into other companies through this process[2).

Industry consolidation entered a lull from 2007. During this period, Chinese securities regulators' focus shifted from clean-up of past problems to risk prevention, quantitative risk management, industry self-regulation, and securities firms' self-management. Specifically, the CSRC adopted a supervisory regime that classifies securities brokerages into five tiers and 11 ranks[3) based on their risk management capabilities, taking into account their net capital among other factors.

When the Chinese securities industry introduces new products and services, it phases them in from the top-ranked companies downward. Currently, most securities firms are heavily dependent on the brokerage business. With commission rates declining amid intensification of competition, it is important for securities firms to branch into new businesses. When margin trading was legalized in March 2010, the CSRC granted margin lending licenses to top-ranked securities firms first. This approach is indicative of the CSRC's commitment to strengthening top-tier securities firms and weeding out poorly managed firms.

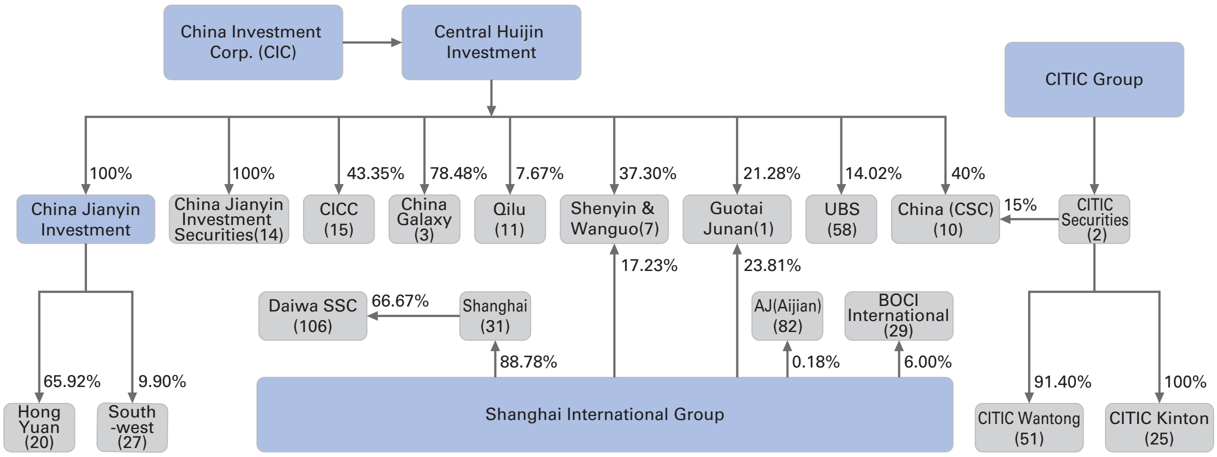
One-and-One Policy and China Huijin Investment's response thereto

Another factor that will play a major role in Chinese securities industry consolidation is the so-called One-and-One Policy adopted by the CSRC in 2008. The One-and-One Policy restricts any single shareholder's material ownership of securities firms to one controlling interest and one non-controlling interest (or two non-controlling interests). The policy is mainly intended to prohibit any one party from becoming an influential shareholder in many securities firms, thereby minimizing related-party transactions and conflicts of interest. The deadline for compliance with the One-and-One Policy was generally December 31, 2010, but some securities firms apparently failed to fully comply by the deadline.

Some securities firms are linked by a complex web of ownership interests, largely as a result of top-tier securities firms acquiring control of lower-tier competitors amid the previous wave of industry consolidation discussed above (see Exhibit). The One-and-One Policy will consequently spur further consolidation of Chinese securities industry.

To comply with the One-and-One Policy, CITIC Securities, a major Chinese investment bank that owns a 60% stake in CITIC Jiantou Securities, plans to divest CITIC Jiantou shares equivalent to a 53% ownership interest. As of December, it had decided to a 45% stake to a Beijing institution and an 8% stake to another institution[4).

Exhibit. Central Huijin Investment's affiliated securities firms



Note: (1) Gray shading indicates securities firms. Percentages are ownership interests. Numbers in parentheses are rankings by 2009 operating revenues.
(2) Shanghai International Group's affiliations were simplified due to space limitations. Ownership interests include indirect ownership (calculated based on parent's percentage ownership of intermediate subsidiary/affiliate).
Source: NRI Beijing, based on data from Century Weekly (23 August 2010 edition), Shanghai International Trust Corporation's 2009 Annual Report, Shanghai International Group's website, Securities Association of China's website, and other sources

Aside from divesting shareholdings, some securities firms are complying with the One-and-One Policy by limiting their own and their affiliates' operations to designated geographic territories[5].

Central Huijin Investment (CHI) counts many leading securities firms among its affiliates[6], as shown in the Exhibit below. CHI's compliance with the One-and-One Policy will consequently have a major impact on the Chinese securities industry landscape. It bears noting that CHI and China Jianyin Investment have been granted an extension until 2013 to comply with the One-and-One Policy. The extension was granted in consideration of the fact that these two institutions injected capital into and became shareholders of many securities firms at the behest of the regulatory authorities during the aforementioned CSRC-mandated consolidation phase. Put differently, the 2013 deadline suggests that the Chinese securities industry may undergo substantial consolidation over the next three years.

CHI has been taking additional steps toward compliance with the One-and-One Policy even recently. CHI holds minority stakes in Guotai Junan Securities and Shenyin & Wanguo Securities, both of which are also affiliates of the Shanghai International Group (SIG), owned by the Shanghai municipal government. The media have reported that CHI and SIG are talking with each other about exchanging shareholdings in these two mutual affiliates as one component of their respective One-and-One Policy compliance programs[7]. If they decide to proceed with a stock swap, the City of Shanghai would reportedly end up with ownership of CHI's entire stake in Guotai Junan Securities and CHI would end up owning SIG's stake in Shenyin & Wanguo Securities.

Possible scenarios include advent of financial SASAC and financial conglomeration

Looking ahead, two potential scenarios bear watching. First, the idea of creating a central authority to supervise state-owned financial institutions not already under the control of a State-Owned Asset Supervision and Administration Commission (SASAC) has been floated repeatedly in the past. Establishment of such a commission would have major ramifications for CHI.

Second, financial conglomerates may emerge in China. With financial products and services growing increasingly diverse even in China, regulatory authorities have been reassessing both segregation of financial services companies by business line and their silo approach to financial regulation. Future securities industry consolidation must be viewed from a broader perspective than the securities industry alone. In addition to these factors, it goes without saying that the strategic intentions of local governments that own local securities firms are also conducive to industry consolidation.

The interaction of such factors makes the future course of securities industry consolidation difficult to predict. Additionally, China will be reluctant to fully open its securities sector to foreign competition before industry consolidation has largely run its course and a new order centered around internationally competitive securities firms emerges. Future developments must accordingly be monitored closely.

Note

1) The losses were largely attributable to guaranteed-return discretionary accounts. For more details, see my paper (in Japanese) in the autumn 2008 edition of Chinese Capital Markets Research published by the Nomura Foundation.

2) Surviving securities firms numbered 104 at year-end 2006. The total has since remained above 100 (106 at year-end 2009). Some observers expect future consolidation to reduce the number of remaining firms by at least 20-30.

3) The five tiers (A~E) comprise 11 ranks: AAA, AA, A, BBB, BB, B, CCC, CC, C, D, and E. Companies ranked D and above are deemed to be soundly managed.

4) Additionally, Shanghai Securities News reported on 12 October 2010 that State Grid Corporation of China sold equity stakes in certain securities firms (e.g., Guotai Junan Securities) in September.

5) A case in point is Huatai Securities (parent) and Huatai United Securities (subsidiary), as reported by Shanghai Securities News on 14 October 2009.

6) CHI was established in December 2003 when the Chinese government recapitalized two state-owned banks with foreign currency reserves. It subsequently invested in securities firms and insurers also, becoming a major financial holding company. According to its website, CHI "has a mandate from the State Council to make equity investments in key state-owned financial companies."

7) The talks were reported by many media outlets, most notably Caijing magazine on 25 October 2010.

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