China further opens up financial sector

Summary

At a press briefing on 10 November 2017, China’s Vice Finance Minister Zhu Guangyao announced plans to remove caps on foreign ownership in Chinese financial institutions. Foreign investors now have indicative timelines showing when they will be allowed to take controlling stakes in the Chinese financial institutions.

We believe it is a major step forward by the Chinese government showing its determination and confidence in further opening up of China’s financial services sector. There are challenges along with the opportunities for the foreign players. Changes may not be happening overnight but they are affecting all financial sectors and they will be seen to be significant over time. We expect the detailed rules to come out shortly.

Greater foreign ownership could bring in greater competition as well as the potential to build a more robust, transparent financial services sector. It would also lay out a solid foundation for the globalization of Renminbi, the development of the bond and capital market, and relaxation of capital inflows and outflows in the future.

We expect that many foreign players will be considering expanding their investment in China’s financial sector in the near future. However, given the huge investment cost that may incur in obtaining control over a large bank, we expect that more acquisitions in the banking sector will be targeted at the small-sized city commercial banks and rural commercial banks. On top of the normal financial and legal due diligence, we believe that proper commercial diligence on the business model of these banks will be critical. We also expect to see some of the foreign partners of securities joint-ventures seek to increase their stake soon. Fund management companies and distressed asset management companies could also attract foreign investment because of the good growth prospect.

This Point of View highlights the blueprint and EY’s perspectives.
Our point of view

On 10 November 2017, the State Council Information Office of the People's Republic of China held a briefing to discuss the economic outcome resulting from the Beijing meeting between the Chinese and US Presidents. Zhu Guangyao, China's Vice Minister of Finance, explained the specific points of the agreement in the economic field which had emerged from the consensus reached by the two government leaders.

In order to implement the opening-up initiatives put forth at the 19th CPC National Congress, China will liberalize the foreign ownership limits for institutions in the financial services sector.

- Foreign investors will be allowed to own as much as 51% of shares in a joint venture in securities, fund management and futures companies. And the cap will eventually be phased out in three years.
- Current foreign ownership restrictions in Chinese banks and financial asset management companies will also be removed.
- After three years, foreign investors will be allowed to own up to 51% of shares in joint ventures in life insurance and with the cap removed in five years.

We see this move as the most significant break-through in recent years, showing that the Chinese government has decided to massively open up its financial sector to foreign investors by allowing the latter to take controlling stakes in Chinese financial institutions with indicative timelines.

Since China's accession to the WTO in 2001, China has gradually relaxed restrictions on foreign financial institutions relating to establishment type, geographical location and business scope. According to the data published by CBRC, CSRC and CIRC, by the end of 2016, foreign-funded banks had established 1,031 outlets in 70 cities across 27 provinces in China and held 1.3% of the total assets in the domestic banking system. Among securities companies in China, Sino-foreign joint ventures accounted for 10% by number. Foreign-capital and Sino-foreign joint ventures together accounted for nearly one third of total insurers. Meanwhile, Chinese-capital financial institutions have also actively deployed international strategies, both domestically to attract foreign strategic investors, while in other countries pursuing a "go global" strategy through mergers and acquisitions, equity holdings and establishment of new operating presence. With antennae stretching across the globe, they are engaged in diverse operations bringing them together with more and more financial institutions worldwide.

As of 2016 year-end, a total of 22 Chinese-funded banks commanded 1,353 branches in 63 overseas countries and regions.

As foreign investors take larger stakes and gain more decision-making power, they will have larger influence over the big decisions of product innovation, market building, business models and management expertise. With China's growing middle-class and aging population, the greater market access will offer foreign institutions a great opportunity in wealth management, private banking, and retirement business. Further liberalization of the financial sector also can drive the creation of a stronger and more competitive financial industry in China.

The increased competition will push Chinese financial institutions to become more efficient in how and where they lend and invest money. They will have a chance to replicate the technology, legal frameworks and expertise concentration from their foreign investors. Competitive strengths and market opportunities will continue to guide foreign banks to evolve and choose different paths of expansion. While some are building a retail presence and expanding their networks, others focus on narrow market niches.

Although relaxed foreign-ownership limits for financial institutions represent an important step forward in opening up the financial services sector. Foreign investors are able to obtain controlling stakes in these financial institutions through acquisition or increasing their existing equity holding, the changes won't come easy. Some of observations and initial thoughts below might be worth considering:

1. The announcement leaves some questions unanswered, such as the explicit date when the liberalization would become effective and how it would be implemented. But it is foreseeable that this will be announced in the near future.
2. The timelines for liberalization vary by sector:

I. Banks and asset management companies

The current foreign ownership caps in these companies (individual foreign shareholder: 20%, all foreign shareholders: 25%) will be removed. Foreign shareholders will be subject to the same restrictions as the local shareholders. It is expected that foreign investors will be able to take a controlling stake through new acquisition or increasing an existing equity holdings from the effective date for this group of financial institutions. Factors to be considered:

- The big-5 state-owned commercial banks (tier 1 banks) and some of the joint-stock national banks (tier 2 banks) as well as some of the city commercial banks and rural commercial banks(tier 3 and tier 4 banks) are listed in Hong Kong, which requires that any acquisition / increase in existing equity holdings in these banks to 30% or more must include a mandatory general offer to all incumbent shareholders, which would imply huge investment cost. But, more importantly, this would facilitate foreign investors' strategic move to gain entry or increased footprint in mainland China;
- Most of the tier 3 and tier 4 banks tailor their operations to the local conditions of the host city or region. In view of the differences in market maturity, culture, risk characteristics and potential between cities/ regions, on top of the normal financial and legal due diligence, we believe that commercial diligence on the business models of these banks will be critical;
- Commercial banks in mainland China have been facing severe competition and disruption from the Fintech giants such as Alibaba, Tencent and the non-bank financial institutions that employ advanced technology in providing banking services. As a result, there is urgency for traditional commercial banks to drive in-depth transformation to keep pace with the competition and disrupt the disruption, this may mean continuous heavy investment in technology over the next couple of years.
We don’t anticipate immediate acquisitions by foreign financial institutions in the near term, but that banks with existing presence in mainland China will refine their strategies and may make future investments to grow their footprint in strategic regions.

Foreign investors are expected to gain greater access to the distressed assets market and participate in the competition as the foreign ownership in asset management companies are relaxed, thus increasing the market efficiency.

II. Securities firms, future traders and fund/asset managers

Foreign investors will be able to increase their equity holdings in financial institutions under this category to 51% on the effective day (the current cap is 49% and might be raised to 51% under CEPA arrangement); three years after the effective day foreign investors will be allowed to increase their investment to 100% - in other words, these financial institutions would be completely liberalized to foreign investors after three years.

Financial institutions in the mainland in this category are facing similar challenges as the commercial banks. We believe that some foreign financial institutions with existing stakes in mainland securities firms will look to increase them in the near term upon liberalization.

We believe the opening up of the securities industry will be beneficial to the growth in China’s capital market. It will not only improve brokerage, investment banking and other securities services by introducing foreign competition, but also facilitate the attraction of global capital investments into A-Share markets. We foresee a new era of growth for China’s capital market and the securities industry in the medium term.

III. Insurers

Foreign investor will be able to increase their equity holdings in life insurers to 51% three years after the effective day. These would be completely liberalized to foreign investors after five years. As the life insurance business is the last business which has not been liberalized, the insurance sector will be fully opened to foreign investors after five years.

This may not have immediate impact on the insurance landscape as most large insurance players already have presence in China. In the longer term as far as 3 or 5 years of time, certain foreign players may be interested to increase their stakes in their insurance JVs or acquire those stakes from their current JV partners. Some large foreign insurance players might also consider to invest in leading asset management companies to elevate their investment capabilities and increase investment returns.

We may also see large reinsurance companies expand their presence in China through investment, partnerships, alliances or even acquisitions in the long term.

Conclusion

China’s move to further open up the financial sector presents both opportunities and challenges for foreign investors. Getting the selection, timing and approach all in alignment for an investment into a financial institution involves in-depth consideration of due diligence results, investment strategy, licensing/ incorporation and special audit, etc., each of which can influence the transaction in a different way. Therefore, the most successful foreign investors will be those that get well-prepared in all the related aspects along this journey.