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# Characteristics and Impact of China's New Round of Financial Opening

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On top of steps China's regulators took in the past years to level the playing field between overseas and local firms, China has unveiled 12 new measures to further open up its banking and insurance sectors, announcing plans to remove limits on ownership in local financial institutions and scrap size requirements for foreign firms that operate onshore. This not only stimulates the enthusiasm of foreign financial institutions to participate in China's financial opening up but also helps bring foreign expertise and experience to domestic market, which helps promote China's financial supply side reform.

## Characteristics of China's New Round of Financial Opening

With three major characteristics listed below, the 12 new measures show that China's opening-up policy has shifted from earlier elimination of ceiling on foreign ownership in domestic financial institutions to the relaxation of size requirements and business limitation.

**1. Removing the restrictions on the total assets of foreign-funded institutions could attract smaller and niche players**

The new measures scrap the total asset requirements of US$20 billion for foreign banks to set up subsidiaries in China, and remove the requirement that foreign insurance brokerage companies must have assets of more than US$200 million to carry out related business in China. The door, this time, is opened wider not only to the biggest global firms, but also to smaller and niche players. The introduction of small and medium-sized foreign-funded institutions helps to satisfy the needs of private enterprises and small and micro enterprises (SMEs).

**2. Scrapping the ownership limits in Chinese commercial banks facilitates local bank acquisitions**

Scrapping the ownership limits in Chinese commercial banks could facilitate local bank acquisitions and enable local medium and small banks to diversify their source of funds. Foreign capital showed great interests in China's banking industry over the period of 2004-2009, during which the average and median of capital adequacy ratio of Chinese banks increased by more than 2 percentage points, indicating that foreign capital helps to enrich the capital strength of Chinese commercial banks.

**3. The principle of equal national treatment for foreign and domestic investment is emphasized**

The new rules emphasize the principle of equal national treatment for foreign and domestic investment and remove approval procedures for foreign banks to conduct RMB business. That means foreign banks will no longer need approval in conducting RMB businesses and will be eligible to carry out RMB businesses upon their establishment. Looking ahead, foreign banks will have the same market access as local banks in conducting business.

The National People's Congress of China adopted the new Foreign Investment Law on March 15, 2019, aiming to unify and streamline the foreign investment framework. The Foreign Investment Law will go into effect on January 1, 2020. By that time, the Foreign Investment Law will replace the PRC Law on Sino-foreign Equity Joint Ventures, the PRC Law on Wholly Foreign-owned Enterprise and the PRC Law on Sino-foreign Cooperative Joint Ventures, which could provide a more open and transparent environment for foreign investors by emphasizing equal national treatment of foreign investment.

## Measuring China's current financial openness

Though China has stepped up measures to ease barriers of entry for global firms, the competitive landscape would likely remain unchanged in the short term. In China's financial sector, local firms still dominate with more than 90 percent of market share while foreign financial institutions have weaker profitability. In the future, China's financial market will be further opened to put foreign investors on equal footing with domestic investors.

**1. Market share of foreign financial institutions remain limited**

Currently, in terms of total assets, the shares of foreign-funded banks are merely 1.64 percent in China, far lower than the average level of 10 percent of OECD countries, while the shares of security firms and insurance companies registered 1.1 percent and 6.36 percent respectively. Banking industry was first opened to foreign investment among the financial sectors. The foreign banks have operated as branches, strategic investors, and finally as independent legal entities. Foreign investment in China's banking industry peaked during 2004 to 2009. However, after the financial crisis and the 2009 European debt crisis, foreign financial institutions were faced with greater financial difficulties, while the ceiling of foreign ownership restricted their financial autonomy. As the foreign banks adjusted their strategies, there was a shrinking trend of foreign investment. Insurance industry is the most open financial industry. Though foreign insurance companies face fewer restrictions in regards of business in China, their competitiveness is limited because of small market share. In terms of security firms, business scopes of foreign investors are limited. After 2008, joint venture securities firms could hardly obtain securities brokerage licenses and were only engaged in investment business.

**2. Foreign institutions display weak profitability with hidden barriers to market access**

Due to restriction in attracting deposits, expensive capital costs, insufficient branches, and lengthy and opaque application processes, foreign banks still find it difficult to compete with Chinese banks. By the end of 2018, large commercial banks and joint-stock commercial banks accounted for

52 percent and 21 percent of total net profit in China's banking sector, while foreign banks took only 1 percent. In addition, ROA of large commercial banks and joint-stock commercial banks registered 1 percent and 0.84 percent, both higher than foreign banks' 0.75 percent. In regards to security firms, average ROE of joint venture securities firms ranged from -2 percent to 8 percent, lower than average industry level of 5 percent to 16 percent.

## Prospects for China's new round of financial opening up

Looking ahead, China will further open up its financial industry to improve business environment of foreign investors, which help boost the proportion of foreign capital.

### 1. China has the conditions to further open up its financial industry

At present, China is entering a stage of high-quality development. The 19th National Congress Report clearly delivered the idea of "building a modern economic system", with "accelerating the construction of an innovative nation" and "promoting comprehensive opening up" providing important supports. That means financial openness not only aims to promote "comprehensive opening" but also to match the development of an innovative economy.

In fact, the overall stable economy and financial system, the smooth market-based interest rate reform, and the orderly exchange rate reform lay solid foundation for further financial openness. In the future, China will step up effort to open its financial industry, to remove barriers for foreign investors in tapping into Chinese market, and to provide a fairer and transparent business environment. It is believed that the enhanced operational convenience will attract more foreign capital to China's market.

### 2. Market share of foreign institutions in China's financial market will further increase

Currently, China's financial market still has considerable attraction for foreign financial institutions. In banking industry, for example, the average ROE of Chinese commercial banks is 14 percent, which is higher than 9 percent in the US and 3 percent in Europe. Operating cost of Chinese banks also stays relatively low with operating cost/net assets at 13 percent, while the gauge of American and European banks is above 20 percent. Against this backdrop, further opening of China's financial industry will attract more foreign investment.

Referring to experience of Korea's financial opening up, proportion of foreign investment in China's financial market could reach 10 percent - 20 percent in the foreseeable future. After 1997 Asian financial crisis, Korea gradually removed the restriction on foreign ownership in domestic banking industry. By the end of 2004, average foreign ownership of Korean listed banks reached as high as 50 percent, much higher than the 16 percent at the end of 1997, and the market share of foreign banks reached 22 percent. Moreover, in the wake of financial openness, competitiveness of local financial institutions has been greatly enhanced with the injection of foreign capital. It is shown that the average ROE of joint venture securities firms is significantly higher than that of local securities firms. Therefore, it is believed that, with the deepening of China's financial openness, the participation of foreign investors in China's financial market will increase significantly in the future.

# Impact of the deepening of China's financial openness

**1. The entry of foreign investors helps to improve the supply structure of China's financial system**

As China's financial sector has long been dominated by the banking system, an indirect financing channel, reforming and fixing the banking system should be a top priority. SMEs have long faced financing difficulties due to their weak credit record and insufficient collaterals. Though small and medium-sized financial institutions such as urban and rural commercial banks have strong information advantages in specific regions and have natural advantages in serving local SMEs, assets of small and medium-sized banks account for merely 27 percent of the total assets of China's banking sector. The lack of small financial institutions to accommodate financing needs of small businesses results in mismatch between credit demand and supply.

Against this backdrop, it is important to develop small and medium-sized financial institutions. The introduction of small and medium-sized foreign-funded institutions is conducive to the enrichment of market entities and helps to satisfy the needs of private enterprises and SMEs. The entry of foreign capital can diversify the sources of funds of local small and medium-sized financial institutions and improve their corporate governance and operating efficiency.

**2. Chinese financial institutions should turn challenges into opportunities amid fierce market competition**

The deepening of financial opening to a certain extent will expose Chinese banks to fierce competition in market share, customer resources and high-end talents. At the same time, it also imposes pressure on Chinese banks' profitability. From the perspective of business, foreign banks take a lead in cash management and wealth management, which makes Chinese banks vulnerable to shocks in these business areas. From the perspective of earnings pressure, further financial openness may cause some small and medium-sized banks to be merged by foreign capital, which generally requires Chinese banks to have corresponding return rate and may grab part of the profits from the Chinese banks.

However, it is noteworthy that financial opening also brings opportunities for Chinese financial institutions. With obvious business and experience advantages, foreign investors can bring advanced management concepts and mature products to Chinese banks, thus enhancing their differentiated capabilities in providing SME loans, conducting wealth management business and risk control. Domestic commercial banks can widely participate in the international market by making full use of global network and cross-border service experience of foreign investors.

**3. Chinese financial institutions should improve risk management mechanism as financial openness strengthens transmission of market volatility**

With the deepening of financial openness and increasing foreign ownership, transmission of global financial markets volatility, liquidity of overseas assets, and the risks of foreign parent companies will inevitably have impact on China's financial industry. Therefore, Chinese regulators should constantly improve financial supervision system and enhance the supervision effectiveness to better defuse financial risks. When cooperating with foreign investors, domestic financial institutions should enhance their risk management ability by establishing a multi-level and all-round risk isolation mechanism.