

Key features of the new financial regulation in the Mainland and its impact on Hong Kong

Economist, Tianjiao Jiang
Economist, Jianghui Chen

On 13 September, the State Council officially released the “Decision Concerning the Implementation of Financial Holding Company Entry Regulation”, authorizing the People’s Bank of China (PBoC) to carry out market access management and organize supervision of financial holding companies. On the same day, the PBoC released “Trial Measures for the Supervision and Management for Financial Holding Companies” (hereinafter referred to as the “Measures”), setting clear regulations on a series of key issues such as access conditions, corporate governance, regulatory system, and internal coordination for financial holding companies. The “Measures” is conducive to further regulate behaviors of financial holding companies in which non-financial companies act as controlling shareholders or actual controllers. The “Measures” will come into force on 1 November, marking that the development of mainland financial holding companies will enter into a new stage. Meanwhile, plenty opportunities and challenges will also be brought to Hong Kong. Timely adjustments are needed in Hong Kong in order to accelerate its pace of transformation.

1. Five key features of the new financial regulation

In recent years, some non-financial companies in the Mainland have invested and controlled more than one type of financial institutions, becoming the de facto financial holding companies. Among them, those comply with regulations have improved their ability to serve the real economy by optimizing resource allocation and reducing financing costs. However, there are also a small number of companies that blindly expanded into the financial industry without enough isolation mechanisms, leading to cross-transmission of financial and industrial risks, resulting in risk accumulations. Therefore, The PBoC formulated the “Measures”, aiming to fill the gaps in supervision of financial holding companies, promoting the financial industry regulatory framework, and enhancing the ability of financial industry to serve the real economy while preventing and resolving financial risks. In sum, the “Measures” have the following five important features:

First, the “Measures” clarified the definition of financial holding companies. This is the first step in implementing effective supervision. The “Measures” provided a clear definition to a financial holding company for the first time, that is, a financial holding company must meet two requirements: one is to own or actually control at least two different types of financial institutions,

and the other is that a financial holding company is not allowed to directly engage in commercial business activities except for equity investment management. The “Measures” released this time is applicable to financial holding companies whose actual controllers are domestic non-financial enterprises or natural persons. For financial groups formed through cross-industry investment by financial institutions, specific rules will be released separately.

Second, the “Measures” established the entry threshold for financial holding companies. Previously, due to the lack of clear entry threshold, a large number of so-called “financial holding” companies emerged in the market, but some of them did not comply with regulations. Regarding this, the “Measures” set clear access requirements for financial holding companies in terms of asset size, shareholder qualifications, and funding sources: (1) The “Measures” put forward certain requirements on the asset size of financial holding companies and the financial institutions that they actually control. For example, to establish a financial holding company, the paid-up registered capital shall not be less than RMB 5 billion; if commercial banks are under actual control, the total assets of all financial institutions under control should be no less than RMB 500 billion; (2) The “Measures” required that major shareholders, controlling shareholders or actual controllers of financial holding companies should have a prominent core business and have a good credit record as well as financial status. It is worth noting that the definition of major shareholders in the “Measures” has a broader scope than other financial institutions. For instance, a major shareholder of a securities company refers to the shareholder who holds more than 25% equity of the securities company or the largest shareholder who holds more than 5% equity. However, in the “Measures”, shareholders holding more than 5% of financial holding companies are all regarded as major shareholders; (3) The “Measures” required shareholders to invest in financial holding companies with legally self-owned funds, which shortens the capital chain and is beneficial to control the spread of risk to a certain extent.

Financial holding companies that meet the access requirements should submit application to the PBoC within the 12-month transition period from the date of the “Measures” implementation. A financial holding company approved by the PBoC should include the word “financial holding” in its company name. Those do not meet the access requirements or have not obtained a financial holding company license issued by PBoC are forbidden to use “financial holding” or “financial group” in their names.

Third, the “Measures” required financial holding companies to strengthen internal governance and manage overall risks in a consolidated manner. Efficient internal corporate governance can further prevent financial risks from the origin, as unclear equity structure and related transactions of internal institutions are breeding grounds for risks. The “Measures” started with improving equity structure and business transparency of financial holding companies, reducing the layers of benefit transmission, preventing the cross transmission of risks within the group, and strengthening the risk “firewall”. On one hand, the shareholder structure of a financial holding company should be clear. The levels of legal persons of the newly-added financial holding company and financial institutions it controls shall not exceed three in principle. The institution being held

shall not hold reverse shares or cross shares. On the other hand, financial holding companies are required to establish a comprehensive risk management system for consolidated balance sheet management, and an overall risk isolation mechanism for the group. The “Measures” set up eight negative lists of related-party transactions to avoid risk spreading to the entire group.

Fourth, the “Measures” established a multi-level supervision system with the PBoC as the main body. From a supervisory point of view, the “Measures” highlighted the central bank’s overall prudential supervisory function on the basis of the existing supervisory framework, and built a more complete two-tier supervisory system than that in the past. Among them, the PBoC implements consolidated supervision of financial holding companies, the financial management department of the State Council implements supervision of financial institutions controlled by financial holding companies, and the Ministry of Finance is responsible for formulating and organizing the implementation of financial holding companies’ financial systems. The PBoC has also established an information sharing mechanism with other relevant departments.

Fifth, the “Measures” encouraged the establishment of an internal coordination mechanism in compliance with laws and regulations. At the same time of strict supervision, the “Measures” encouraged business collaborations between financial holding companies and their holding institutions, and among their holding institutions in sharing customer information, sales teams, information technology systems, operating backgrounds and business locations, in order to enhance the scale economy advantages of financial holding companies and improve the efficiency of overall resource utilization.

Summarizing the core content of the “Measures”, market access is the first threshold for risk prevention and control, strengthening corporate governance is a prerequisite for the healthy development of financial holding companies, the multi-level supervision system enables more penetrated supervision, and encouraging financial holding companies to establish internal coordination mechanisms helps to enhance the scale economy advantages and improve the efficiency of overall resource utilization. It can be said that the “Measures” provided financial holding companies with comprehensive and multi-dimension regulations and support, which is a key step for the continued healthy development of the financial industry in the Mainland.

2. Three positive effects on Hong Kong

Hong Kong has been, and will continue to be the most important international hub for Chinese institutions to deploy oversea markets. Chinese-funded enterprises in Hong Kong, especially financial enterprises, are not only big in number but also large in size. They are an essential part of Hong Kong economy and an important carrier for the implementation of the “Measures”. According to statistics in the “China Financial Regulatory Report (2019)”, there were about 80 financial holding companies and “quasi” financial holding platforms in the Mainland as of the end of 2018, among which a large proportion have established companies in Hong Kong. The release of the “Measures”

complements the shortcomings of the regulatory system and will benefit the healthy development of Hong Kong's financial market in general. Specifically,

First, it is conducive to further regulating the behavior of financial holding companies. For Chinese-funded institutions in Hong Kong, it is necessary to establish a financial holding company in accordance with regulations. Meanwhile, its shareholder structure should be concise, clear and penetrable, with a reasonable number of layers of legal persons, and commensurate with its own capital size, operational management and risk control capabilities. In the short term, some companies that have a certain gap with the regulatory requirements of the "Measures" need to be adjusted according to the requirements; For non-financial enterprises with core business, their financial business can serve the core business and industrial chain after obtaining financial licenses; For non-financial enterprises without a prominent core business or even without a clear industrial direction, they will not be approved by regulatory authorities to become controlling shareholders of financial holding companies.

It is worth noting that the "Measures" also strictly controlled the words "financial holding" and "financial group" in the company name. Those Chinese-funded enterprises who already carry similar words may need to change their names if they are not approved in the future.

Second, the "Measures" complements the shortcomings in current regulatory system and promotes the healthy development of Hong Kong's financial market. The "Measures" for the first time clarified the legal status, regulatory agencies, and access requirements for financial holding companies, and further regulated the behavior of financial holding companies in which non-financial companies act as controlling shareholders or actual controllers from the origin. It complemented the shortcomings of the regulatory system, and it's conducive to preventing systemic financial risks. In the past, some financial holding companies were descended to "cash machines" for shareholders due to their complex shareholders structure and chaotic risk management. The "Measures" will help maintain the professionalism and independence of financial institutions, and correct problems in a timely manner to avoid mutual transmission of real entity and financial risks.

At the same time, the release of the "Measures" also led to self-examination and self-regulation by Chinese-funded enterprises in Hong Kong as required, re-consolidation of capital strength, timely adjustment of financial business sectors that do not meet the requirements to minimize financial debt burden, reduction of the accumulation and occurrence of financial risks, thereby conducive to the long-term healthy development of Hong Kong's financial market.

Third, it complies with the trend of mixed operations in financial industry and improves Hong Kong's financial market structure. From the perspective of financial industry development, it is an inevitable trend for separate operations to move towards mixed operations. The permission for banks to hold brokerage license earlier is an example. With the advent of the era of mixed operations, super financial groups may continue to emerge, and the market share of leading companies in Hong Kong's financial market is expected to increase.

Another important meaning of the “Measures” is that Internet financial holding companies are now officially included in the regulatory system. The “China Financial Stability Report (2019)” issued by the PBoC in November last year pointed out that some large Internet companies have evolved into the de facto financial holding groups through new establishments, controlling or share participating in financial companies, but they are not directly regulated. In the future, as Internet financial holding companies are included in the regulatory system, there will be more room for Internet finance to develop under regulation. There will be a wave of large technology companies to establish financial holding companies, and technology financial companies will become a huge increment in the financial market and will gradually change Hong Kong’s traditional financial market structure.

3. The pace of adjustment and transformation needs to accelerate

From the perspective of original intention, the “Measures” mainly aimed at a small number of enterprises that blindly expand into the financial industry, lacking isolation mechanisms, and accumulating risks. The state-owned banks and other financial institutions which have formed comprehensive financial groups while carrying out their main businesses are already within the regulatory system. Therefore, it is believed that the Internet and private financial companies are the key targets of the new regulation. However, the financial industry in Hong Kong should still look at the new financial regulation from a more macroscopic and global perspective, be fully aware that it is a major move by mainland regulators concerning frequent chaos and regulatory gaps in related fields, to combine advanced international experience and China’s own circumstances, and to integrate reform, management and development. It is necessary to carefully study and understand the new financial regulation in the context of further acceleration of financial reform and opening up in the Mainland, and to cooperate with the relevant work.

On one hand, Chinese-funded financial companies in Hong Kong have strengths, with combined advantages of the Mainland and Hong Kong. Their compliance and risk control standards are not inferior to their peers, therefore their prospects are highly promising. However, some Chinese financial groups still have shortcomings in terms of shareholder qualifications, financial holding platform qualifications, and financial holding management systems. There are still some challenges to meet the regulatory requirements within the 12-month transition period. In the future, they need to strive to integrate resources to meet these requirements. If their resources are not enough, they must plan transformation as soon as possible. These integration and transformation are beneficial to Hong Kong in the long run, but it is still unknown whether they will bring short-term volatilities. How to effectively reduce the impact when implementing the “Measures” and guiding value and long-term investment raise a new challenge for Hong Kong.

On the other hand, Internet financial holding companies have been included in the regulatory system, marking a new era of competition among different types of financial holding companies. Currently, Ant Group and JD Digital are hitting the IPO market. With the implementation of the new

financial regulation, the fog on their compliance road has been fully lifted, and what follows will be further supervision on technology financial holding companies. At the same time, after the inclusion of Internet financial holdings into the regulatory system, a wave of technology companies applying for financial holding company licenses will be ushered in, and the supervision on Internet financial holding companies will gradually edge up in the future.

Finally, it should be noted that the “Measures” clarified a multi-level supervisory system with the PBoC at the core with cooperation among various departments. In the meantime, the “Measures” also put forward new requirements for strengthening supervisory cooperation between the Mainland and Hong Kong. Some analyses view that the “Measures” will accelerate the industry integration and restructuring in the short term, and will have a greater impact on financial institutions that involve in rectification. As an international financial centre, Hong Kong has gathered many international financial institutions and has accumulated a lot of experience in financial supervision and prevention of financial risks. In order to ensure the smooth implementation of the “Measures”, it is necessary for Hong Kong and mainland regulators to strengthen cooperation, to keep abreast of the responses and opinions from Chinese-funded financial institutions, to grasp the situation of enterprises affected by the new regulations in advance, and to assess the possible impact of their business integration and changes on the market, to provide more help for Chinese-funded financial institutions to prevent risks, optimize development, and form a more favorable corporate ecosystem through new regulations, and to jointly promote relevant local financial institutions to accelerate the pace of adjustment and transformation.

