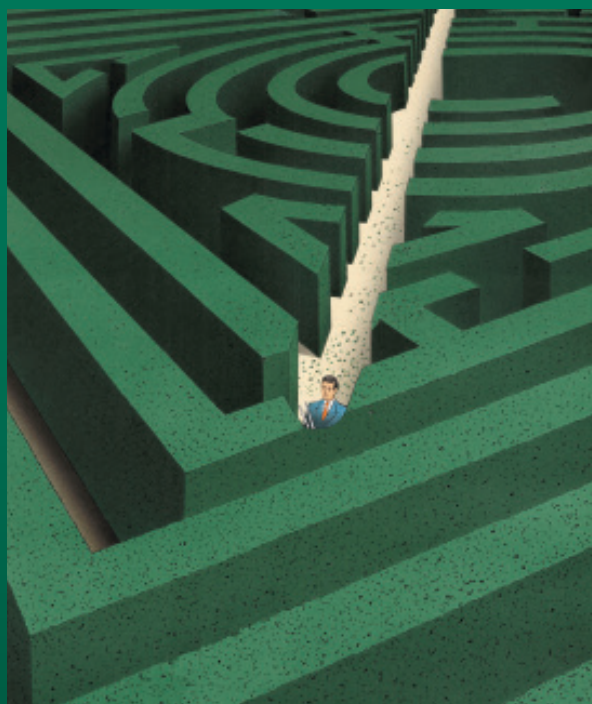


# ASIAN CAPITAL MARKETS

FULFILLING THE PROMISE



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# CONTENTS

|    |   |
|----|---|
| 3  | <b>INTRODUCTION</b>   |
| 5  | <b>ASIAN CAPITAL MARKET DEVELOPMENTS IN 2013 AND OUTLOOK FOR 2014</b><br>Sales and Trading Were Significantly Impacted by EM Volatility<br>Primary Business: 2014 Prospects Look Stronger<br>Asia's Local Market Dynamics Are Far From Uniform  |
| 9  | <b>ASIA'S CORPORATE BOND MARKETS</b><br>The Current State of Asia's Bond Markets<br>Why Does Asia Need Larger Corporate Bond Markets?<br>How Sell-side Institutions Can Benefit From the Growth of Asian Bonds  |
| 13 | <b>THE EVOLUTION OF CHINA'S SECURITIES INDUSTRY</b><br>The Chinese Regulator Is Supporting Industry Innovation<br>Chinese Securities Firms Are Reinventing Themselves<br>Chinese Securities Markets Are of Long-term Interest to International Players<br>Four Focus Areas for Foreign Firms to Improve JV Performance in China |
| 18 | <b>RENMINBI INTERNATIONALIZATION – PROSPECTS FOR 2015</b><br>Drivers of RMB Internationalization<br>2015 Revenue Pools for CNH Products<br>Becoming a Winner in RMB   |
| 22 | <b>FULFILLING THE PROMISE</b>   |
| 23 | <b>FOR FURTHER READING</b>  |
| 24 | <b>NOTE TO THE READER</b>   |

# INTRODUCTION

**O**PTIMISM ABOUT THE GROWTH of Asia's capital markets has given way to sober realism for most Capital Markets and Investment Banking (CMIB) industry players. Since the crisis, the region has continued to promise much and deliver little in profit terms: Asia accounts for approximately 20-25% of global firm's CMIB revenue pool, but only 10-12% of total profits. The historical regional revenue drivers in ECM and equity trading have slowed. Yet, the long-term story is intact: emerging Asia will continue to grow faster than Europe or North America, the buy-side client base is steadily expanding, and Asia's own sources of market liquidity are improving. Yet, the immediate future requires CMIB players to adapt to important structural changes in the regional capital markets landscape: profitable growth will remain elusive for many.

The structural changes include a mix of positive and negative factors. On the positive side:

- An ongoing shift toward bonds as an instrument of corporate finance, substituting bank loans as regional banks adopt more conservative capital and risk policies
- Further opening of China's capital markets and reform of its financial system, including securities product innovation and internationalization of the renminbi (RMB)
- Progress of several regionalization efforts: ASEAN moving toward ASEAN Economic Community (AEC), further integration of Greater China, and a growing engagement of Japanese institutions with the rest of Asia
- Local institutions gaining in stature, both as CMIB players and as increasingly important investors on the buy-side

On the negative side:

- The slowdown of emerging markets GDP growth, relative to the pace of recent years
- The expected "tapering" of the US Federal Reserve's bond-buying program, which may lead to liquidity outflows
- Continuing challenges and uncertainty posed by the complex regulatory landscape

Local institutions have targeted growth in the CMIB arena, expanding the competitor landscape and pressuring industry economics. They have invested heavily, organically and through M&A, to build regional presence. A period of reassessment may be approaching. Local player ROEs have, by and large, been similar to global peer ROEs, rarely exceeding the lower teens. Client relationships, the key source of competitive advantage for most local players, are slow to build overseas. 2014 will see more stringent judgments about the sustainability of their current strategies.

Global players have been cautious in their expectations for Asia since 2010. They are balancing carefully targeted investments in parts of their portfolio against tactical retrenchments in other areas, while optimizing their costs and operating model. There will be further bridge-building between capital markets, corporate banking and wealth/asset management businesses to drive client profitability on a firm-wide level. Investment is going into the platform: electronic trading systems, preparation for OTC derivatives clearing via CCPs, regulatory compliance, and operational efficiency.

In this report, BCG addresses the overall development trajectory of capital markets in Asia, with a particular focus on the largest emerging capital market, China, where the deepening of the capital markets is the most important long-term driver of regional CMIB industry development.

We examine four issues in detail:

1. **Asian regional capital markets developments and outlook:** a review of the key market trends in 2013 and the outlook for 2014
2. **Asia's corporate bond markets: financing the next wave of regional growth:** an analysis of the drivers, prospects for growth and actions that institutions can take to benefit
3. **The evolution of China's securities market:** an exploration of the regulatory innovation, competitive landscape and growth prospects for Emerging Asia's largest capital market
4. **Renminbi internationalization – prospects for 2015:** the drivers of development for the offshore renminbi market and the near-term revenue potential it offers for CMIB players

# ASIAN CAPITAL MARKET DEVELOPMENTS IN 2013 AND OUTLOOK FOR 2014

**2**013 has been a year of uncertainty for Asia in capital markets and investment banking. The overall tone has become more negative due to a number of concerns: slowing GDP growth, the end of the commodities ‘super-cycle’, and high levels of corporate and private debt. Speculation about the US Federal Reserve’s plans to taper its bond-buying program in May led to significant volatility in emerging Asian market bond and stock markets, with a knock-on effect on currencies.

## Sales and Trading Were Significantly Impacted by EM Volatility

In secondary markets, this volatility drove up trading activity levels in the first nine months of the year, to the benefit of some capital markets players. Using exchange-traded equities as a gauge, average monthly turnover in most Asian markets was 20-40% higher in the first nine months of 2013 versus 2012. Where equity markets did slow (e.g. Korea and India), exchange data show other asset classes, such as bonds and listed derivatives, growing instead. Unsurprisingly, Japan is the standout for the region: traded value almost doubled in US dollar terms as investors responded to the Bank of Japan’s USD 75B monthly bond-buying program.

Electronic trading and alternative venues are growing features, although their development

shows great diversity across Asian markets. Recent investor surveys suggest electronic trading in Asia is expected to pass 30% of trades across all asset classes by 2015: it is already over 50% of equities trading for many major banks. As in Europe and the US, electronification is driving margin compression. Low-touch commissions are at c.5bps for equities, or 25-30% of voice. High frequency trading now accounts for roughly 50% of equity trades in Japan and 30% in Australia, but transaction taxes and post-trade charges still limit it in other established markets (Hong Kong, Singapore, and Korea). And, despite increased regulatory scrutiny, new dark pools continue to proliferate in Australia, Singapore and in Hong Kong (where several institutions including HSBC, CLSA, and Macquarie launched in 2013). OTC clearing is now being implemented across the region. (See the sidebar “OTC Derivatives Regulation”.)

## Primary Business: 2014 Prospects Look Stronger

For Asia ex-Japan, the investment banking (ECM, DCM and Advisory) fee pool is likely to close 2013 at a lower level than 2012. Regional ECM fees in the first three quarters of the year were significantly down, due to the closure of China’s IPO markets this year (over quality concerns about a pipeline with over 700 applicants), but buoyed by a strong up-

## OTC DERIVATIVES REGULATION

OTC derivatives are a USD 320 trillion market in Asia (by turnover), with FX derivatives accounting for over 70% of volumes. Asian regulators are adopting central counterparty clearing houses (CCPs) as part of the G20 agenda for capital markets reforms. CCPs in theory reduce counterparty risk for OTC transactions, though potentially with increased systemic risk, should a major CCP fail.

However, the lack of regional coordination on CCP rules and proliferation of local CCPs has led to concerns being voiced, by HKMA and SGX among others, about fragmentation of liquidity. Individual markets are creating their own CCPs:

Australia, China, Hong Kong, India, Japan, Singapore and South Korea have all created or started to establish national CCPs. Global providers such as CME Group and ICE are also present in larger markets.

A second concern is raised by extra-territorial rules to be applied by US and EU regulators to Asian jurisdictions. These rules could require verification that the Asian supervisory regimes and market infrastructures are of equivalent strength to US/European markets. Without this equivalence, limitations would apply to US/EU institutions ability to conduct OTC business and liquidity in these markets could be significantly reduced.

swing in the fourth quarter in several markets, including Japan, Hong Kong and Australia. Pipelines into 2014 are strong and the Chinese regulator has signaled re-opening in January. DCM in the region, after a strong 2012 and active start in 2013, was disrupted by the summer volatility, though with some recovery in USD and high yield issues toward the years' end. M&A was ~15% down versus 2012 as a result of a slowdown in natural resource sectors and lower than expected deal-flow overall.

The growth of regional competition is evident from the increasingly common occurrence of mandates with more than ten, and occasionally more than twenty, book-runners. This fragmentation of the fee pool makes deal economics challenging for institutions not playing a leading role.

### Asia's Local Market Dynamics Are Far From Uniform

With marked diversity of scale, liquidity and maturity, it is no surprise that individual markets in Asia behave in idiosyncratic ways. Regional integration is slowly advancing in ASEAN and Greater China, but in most respects, Asia is still a collection of local markets with specific local themes. (See Exhibit 1.)

### AUSTRALIA: TURNING A CORNER?

In Australia, several international firms were loss-making in 2012, prompting further job cuts and a number of leadership changes this year. The outlook for 2014 is more positive: with the return of a strong IPO pipeline, and high cash balances among corporates that may drive M&A, significant activity in both primary and secondary markets is expected. However, the squeeze on costs is likely to continue.

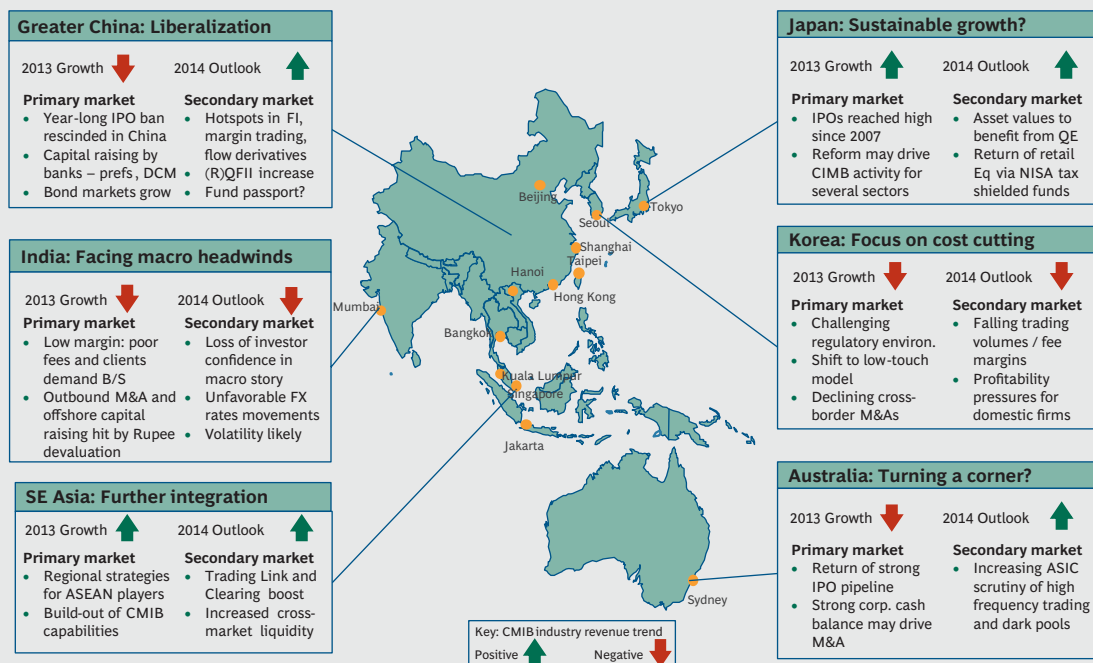
High frequency trading and dark pools have become areas of major scrutiny by the Australian Securities and Investment Commission (ASIC). Each generates close to 30% of equities turnover according to ASIC estimates and has been subject to new Market Integrity Rules. For high frequency trading, the aim is to reduce the incidence of 'false' trades (orders cancelled before completion), and make automated order systems more robust. For Australia's 20 dark pools, new rules require increased disclosure on crossing system functionality and a range of other measures to ensure 'fair' treatment of users. Regulators in other Asian markets are taking note and may emulate.

### CHINA: ON TRACK TO FURTHER LIBERALIZATION

The current administration is driving a shift in the financing model for the economy, away from bank lending and toward direct financ-



## EXHIBIT 1 | No Single Regional Story Across Asia



Source: BCG analysis.

ing in the capital markets. As a result, the CMIB industry is changing from its prior focus on Retail equity brokerage and ECM, which has been hampered by falling margins and the closure of onshore IPO markets in 2013. New hotspots have emerged including DCM (corporate bonds, private placement and ABS), fixed income trading, margin trading, and flow derivatives. The CMIB industry is recognizing the growing importance of domestic institutional investors and developing coverage models to serve them. New economic zones in Shanghai and Qianhai provide a liberalized testing ground for foreign and domestic firms for onshore financial innovation.

The increase of QFII quotas from USD 80B to USD 150B in June 2013, expansion of RQFII (from Hong Kong to London, Singapore and potentially Taiwan), and potential launch of a China/Hong Kong mutual recognition of mutual funds offer significant opportunities for foreign investors to access mainland securities. This in turn may drive further capital account liberalization. Recent estimates forecast QFII reaching 10% of mainland market capitalization within five years.

### INDIA: FACING MACROECONOMIC HEADWINDS

India has been the country most visibly impacted by the loss of investor confidence in its macroeconomic growth story. Historically it has not been a highly profitable market, particularly for foreign CMIB players, as margins are thin and clients often demand significant balance sheet commitment. This has translated to lower returns on capital than some global firms can sustain. Recent trends such as offshore capital-raising by Indian firms targeting overseas expansion, and outbound M&A, have been negatively impacted by unfavorable exchange rate movement and credit quality concerns. With a significant economic slowdown expected to persist in 2014 (with GDP growth falling from 9% in 2011 to 4-5% today), capital markets will likely remain subdued.

### KOREA: STAYING FOCUSED ON COST CUTTING

The Korean securities industry environment remains difficult. Domestic firms, who dominate the market, are struggling with profitability due to falling fee margins and trading volumes in retail brokerage. As traditional brokers attempt to migrate toward a broader

wealth management offering, a small number of online and discount players may thrive.

Low demand and intense competition is also pressuring institutional businesses. Players are adapting to a strong shift to low-touch models. Further consolidation and restructuring are expected. The regulatory environment remains challenging, particularly for players seeking cross-border sharing of operations and IT platforms. Korean firms are unlikely to seek cross-border expansion for the moment, having struggled in 2010-11 outside their home territory. The focus for 2014 will remain on cost reduction and quality improvements at home.

#### **JAPAN: HOPING TO ACHIEVE SUSTAINABLE GROWTH**

The recovery of the Japanese equities market since Q4 2012 has been a highpoint for the CMIB industry this year. Asset values in equities and real estate should continue to benefit from the Bank of Japan's loose monetary policy. The launch of the tax-protected Nippon Individual Savings Account may attract retail interest in equities. However, the sustainability of the rally, the impact of the inflationary policy on JGB values, and Japan's broader economic fortunes are not yet assured.

There has been a revival in primary markets to accompany the stock market rally: IPOs in Japan have reached their highest level since 2007. If the reform program is carried out, higher levels of CMIB activity are plausible for infrastructure, real estate, energy, health-care and agriculture sectors. Outbound M&A will continue to be a theme for corporates and financial institutions.

Further portfolio diversification out of JGBs and US Treasuries by institutional investors

may drive outward investment into other Asian markets, but this is tempered by the conservatism of Japanese institutions. The megabanks have announced long-term plans to expand their activities in Asia, in both banking and securities: the initial stages of these plans will become evident in 2014.

#### **SOUTH-EAST ASIA: STRONG GROWTH LIKELY TO CONTINUE, BUT WILL ROES FOLLOW?**

South-east Asia's capital markets will continue the positive growth trajectory of recent years. A range of ASEAN players, most notably Malaysian and Singaporean banks, are pursuing regional strategies. These envisage the continued build-out of capital markets and investment banking capabilities. However, as elsewhere in Asia, the business is highly competitive, and ROEs for many leading CMIB units and brokers in Southeast Asia have been at similar levels to global bank ROEs.

While the markets are still comparatively small (total ASEAN equity market capitalization is less than Hong Kong's), moves toward greater financial integration are accelerating. Singapore, Malaysia and Thailand established the ASEAN Trading Link in 2012, to provide a mechanism for transfer of orders across the three participating exchanges. This will expand in 2014 into a mutual framework for clearing and settlement.

Cross-border agreements for fund distribution are also under discussion. Both developments will help to drive greater liquidity and investor access. The creation of the ASEAN Economic Community (AEC) in 2015 will further drive intra-regional trade and capital flows.

# ASIA'S CORPORATE BOND MARKETS

## FINANCING THE NEXT WAVE OF REGIONAL GROWTH

Asia needs to deepen its local corporate bond markets to finance the next wave of economic development. We expect acceleration of bond market development in the coming 3-5 years. Both sell-side institutions and investors can take action to benefit from this secular growth.

Historically, Asia has been financed via banks (50-55% of financing in 2008-12) and via Equity (30-35%), with bonds contributing only 15-18%. However, bond markets are coming under the spotlight again, as the other forms of financing face constraints. This is especially true for China, India and Indonesia. For the next generation of Asian companies to receive sufficient financing, and to build the infrastructure necessary to sustain economic growth, bond markets need to provide a higher share of regional financing.

### The Current State of Asia's Bond Markets

Since 2000, many Asian countries have been developing the infrastructure to enable bond markets to grow: clearing and settlement systems, sovereign yield curves, pricing and credit rating mechanisms, and local intermediaries to provide market-making and liquidity. Initially this supported the emergence of government bond markets; now it is increasingly used for corporate issuance.

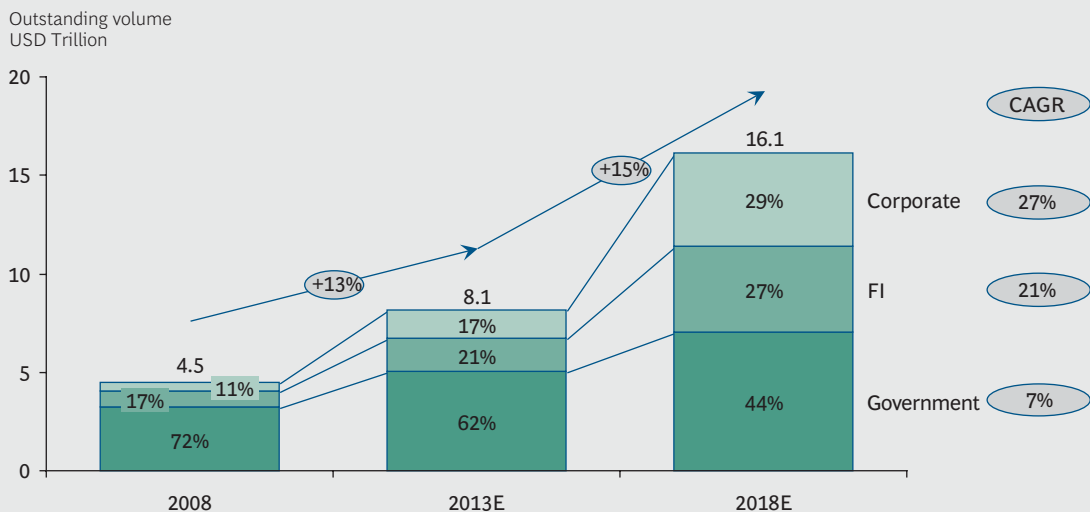
Asia's bond markets have grown at 13% annually for the past five years: by the end of 2013, the total outstanding volume of Asian local currency bonds, excluding Japan, will be nearly USD 8 trillion. Non-government volumes grew at more than double the pace of government bonds, rising from 28% to 39% of the outstanding volumes. (See Exhibit 2.)

However, the fast pace of growth masks significant unevenness in corporate bond penetration of different Asian markets. Several countries, notably South Korea, Malaysia and Thailand, have already built large local corporate bond markets serving a local institutional investor base. Others – notably China, India and Indonesia – still feature small corporate and non-FI bond markets, relative to the scale and potential of their economies. (See Exhibit 3.)

Estimates see East Asian (ex Japan) bond volumes reaching ~USD 16 trillion by 2018, with non-government issuers driving 75% of the increase. Regional economic growth means that hundreds of Asian companies each year reach the scale to be viable issuers of debt securities. As a result, corporate bonds are estimated to reach 29% of outstanding volumes in 2018, up from 11% in 2008. There is already a sizeable high yield market: from 20% of volumes in the H1 2013, this could reach 30-35% if Asian bond markets mature on a similar trajectory to the US and Euro-dollar markets. Finally, the financing of infra-

## EXHIBIT 2 | Asia ex Japan Bonds Expected to Double by 2018

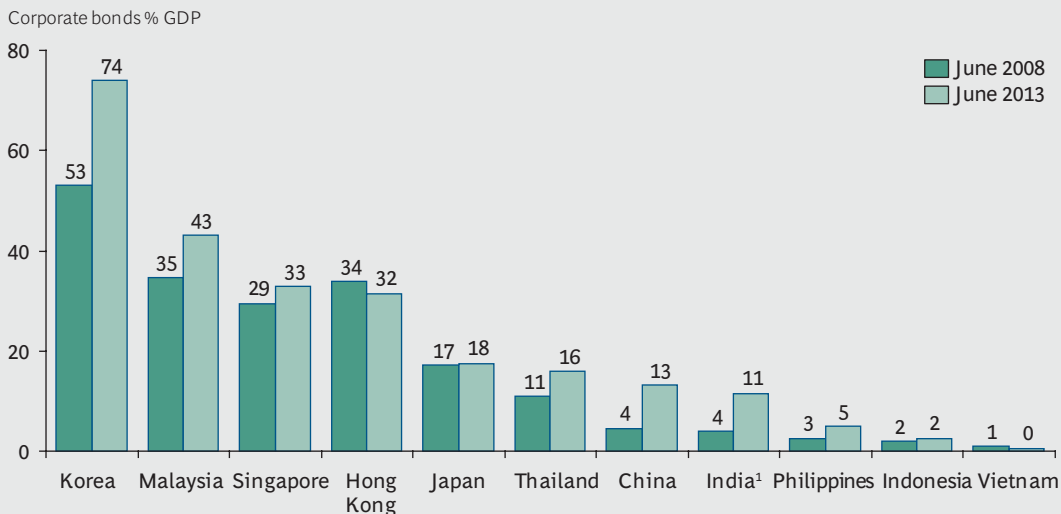
Local and foreign bond market growth in Asia 2008-2018



Source: ADB, AsiaBondsOnline, BIS, Fung Global Institute, Morgan Stanley, BCG analysis.  
Note: 2013 estimated based on June YTD figures. Excludes Australia and New Zealand.

## EXHIBIT 3 | Asian Bond Markets at Different Stages

Corporate bonds outstanding relative to GDP for Asian markets



Source: ADB, AsiaBondsOnline.  
<sup>1</sup>India data for Q4 2012.

structure needs, estimated at USD 8 trillion in East Asia this decade, will help to drive bond issuance.

### Why Does Asia Need Larger Corporate Bond Markets?

Asia cannot continue to rely on the same

financing mix as in the past. For the moment, the equity route is limited, since IPO markets remain sluggish compared with 2009-10. On the debt side, banks in many markets are moving to a more conservative stance after very rapid asset growth over the past decade, growing concerns about credit quality, and with the adoption of Basel III.

Even if lending appetite were unchanged, loans are increasingly inefficient as a form of financing: the ratio of credit per dollar of GDP growth has risen dramatically across most Asian countries, most notably China, where it rose from 1:1 in 2007-8 to 4:1 in 2013. The inefficiency arises from poor access to credit by smaller firms. Banks tend to favor large companies, which are often SOEs (state-owned enterprises), but the real engine of economic growth tends to be private enterprises and SMEs. To use China once more, SMEs receive only 30% of corporate loans: however, they generate twice the GDP and more than double the ROA of SOEs, which receive the bulk of bank loans.

Local bond markets offer a number of advantages relative to bank financing. These include:

- Freeing up of bank lending capacity for SMEs – creating a broader and more productive basis for economic growth
- Delivering more efficient financing for large-scale, long-term projects, e.g. for infrastructure: banks will be increasingly unable to sustain the maturity mismatch required to finance lengthy loan tenors
- Providing greater corporate and market transparency, through increased financial disclosures required by bond investors
- More efficient risk pricing, through this transparency, which enables lower funding costs for borrowers with demonstrably higher-quality credit
- Broadening the range of instruments available for local institutional and retail investors, hence improving capital market depth and liquidity

Lastly, local currency bond markets may help Asian economies to further reduce their vulnerability to external shocks, in times of volatility in dollar-denominated portfolio investments. This was a significant issue in 1997-8 and a major spur to building local bond markets subsequently. It was highlighted once more by Asian market volatility in summer 2013, in response to the anticipated tapering

of the US Federal Reserve's Quantitative Easing (QE) program.

## How Sell-side Institutions Can Benefit From the Growth of Asian Bonds

Both local Asian and global institutions on the sell-side are actively building presence in local bond markets, in anticipation of ongoing growth. Unsurprisingly, these markets are already highly competitive. Local institutions, which traditionally had an advantage in issuer relationships, are becoming more sophisticated and building out product capabilities. Global players are rethinking how to deepen presence in markets and segments that formerly they did not serve, while also leveraging their access to global buy-side and sovereign institutions. The large number of players in the market has caused price competition to intensify and this is unlikely to abate.

Overall, we see institutions taking five practical actions to sharpen their offering and competitive position:

1. **Client discovery with institutional investors.** The role and preferences of institutional investors differ significantly across Asian geographies and investor types. To serve them effectively, assess their wallet and needs for differing asset classes, investigate how they perceive the product/service offerings and capabilities of sell-side peers, and generate insight on where and how to compete. In particular, monitor developments in local pension and insurance sectors (the natural investor base for long-dated corporate bonds), to determine how their growth and (de)regulation will drive investment flows.
2. **Build selectively:** concentrate on specific industry sectors and geographies to develop relationships with issuers and investors, and to focus investments in research and risk management. In particular, examine potential niches for high-yield business, where fee margins (~100-200+ bps) significantly outstrip investment grade (~10-30 bps).
3. **Develop ancillary secondary market products,** as regulation allows, to encour-

age greater liquidity and investor participation, such as repo and securities lending offerings, swaps (including CDS), and other derivatives and hedging instruments. This is an area where global institutions, with their broader capital markets platforms, retain a significant advantage over local players.

4. **Extend market reach through cross-divisional cooperation:** strengthen cooperation between origination and distribution teams; and leverage wealth management/private banking relationships with entrepreneurs both as a source of origination and as a source of potential investors for placements.

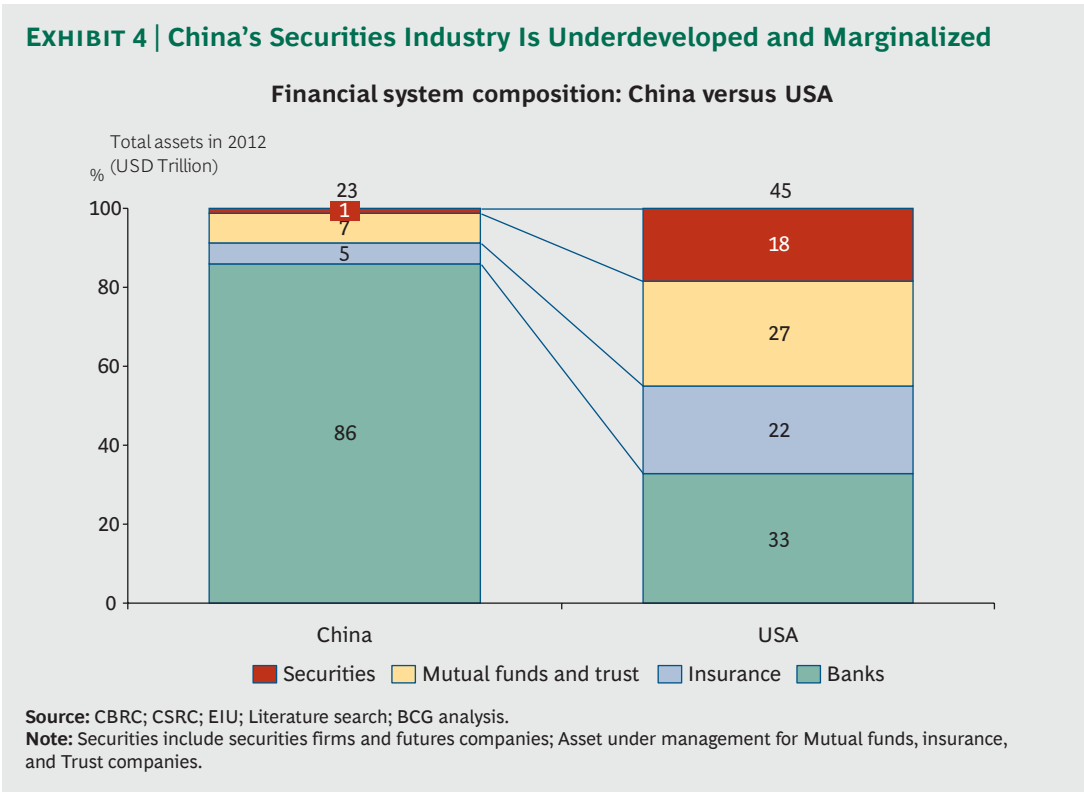
5. **Engage local regulators in a positive dialogue:** most regulators have a strategic goal to deepen financial markets, making this a mutually constructive topic for engagement, in the context of intensifying compliance and supervisory pressures.

Shocks aside, there are strong macroeconomic and public policy tailwinds supporting the growth of Asia's bond markets in the medium term. They have a potentially transformational role to play in the regional economy. Their growth will create value for issuers, investors – and for capital market intermediaries that build an effective business model to serve them.

# THE EVOLUTION OF CHINA'S SECURITIES INDUSTRY

China's securities industry is undergoing a major evolution: much larger and deeper capital markets are expected to better connect the funding and investment needs of the real economy in China. Currently, the Chinese securities industry (total assets USD 280B in 2012) is small in comparison to banks (USD 19.4T), insurance (USD 1.2T), and mutual funds and trust companies (USD 1.7T). (See Exhibit 4.)

How will this market grow? The IPO pipeline has stalled and deals are becoming smaller (150 IPOs raising USD 16.3B in 2012 vs 347 new listings raising USD 80B in 2010, and a regulatory freeze on IPOs in 2013). Equity trading is far below 2010 levels (total trading value at USD 6.5T by October 2013 and USD 5.2T in 2012, versus USD 9T in 2010). As a result, the revenues of Chinese securities firms





will be driven by other products, such as money markets, bond issuance (via growing direct financing and interest rate liberalization) and new businesses for securities firms including margin trading, futures, equity derivatives and asset management. Traditional investment banking (ECM, DCM & Advisory) and equity brokerage today constitute ~70% of revenues: by 2017 this is forecast to fall to less than 50%. (See Exhibit 5.)

## The Chinese Regulator Is Supporting Industry Innovation

The China Securities Regulatory Committee (CSRC) is instrumental to this evolution. A series of measures were launched in 2012 to fuel the growth of the industry, in particular in bond issuance, SME private bonds, asset management and OTC equity markets. More importantly, CSRC is changing its role. Previously it hand-held securities firms tightly, setting detailed guidelines for business conduct and focusing on ex-ante supervision. Now, CSRC is strengthening "stringent regulatory enforcement" and "ex-post supervision" and emphasizing the protection of investors. This will compel securities firms develop their own capabilities to survive in a more complex and "free" world.

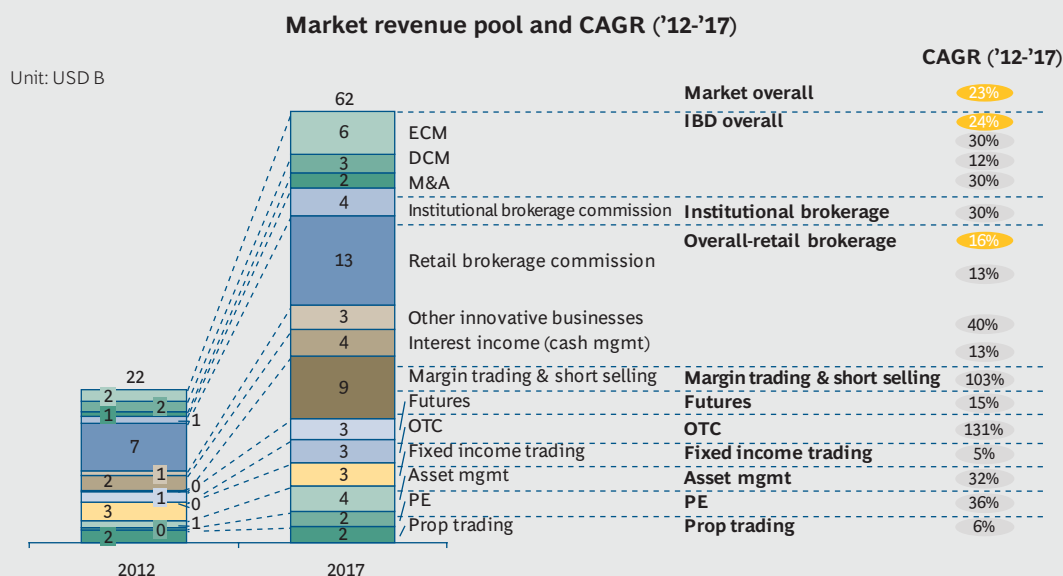
There is a clear agenda for CSRC to continue pursuing business innovation. It is raising the bar on the protection of small investors, information disclosure for IPOs, fraud prevention in trading, and other measures to promote a more transparent and healthy market. In addition, the Shanghai Free Trade Zone offers a series of liberalization measures, including RMB capital account opening, RMB convertibility, and preferential corporate income tax rates. Foreign institutions may use the Zone to experiment with product offerings, build client relationships and create stronger foundations for onshore operations.

## Chinese Securities Firms Are Reinventing Themselves

The Chinese securities industry is currently fragmented and crowded with homogenous players, often small provincial firms with revenue originating from their own province. (See Exhibit 6.)

Industry profitability has deteriorated since 2007: poor market performance has squeezed brokerage commission-dependent business. Low leverage (industry assets/equity ratio at 2.4x in 2012) has also limited the ROE. New businesses (e.g. futures, margin trading) will raise leverage and ROEs over time. (See Exhibit 7.)

EXHIBIT 5 | Industry Revenues Expected to Reach USD ~62B by 2017

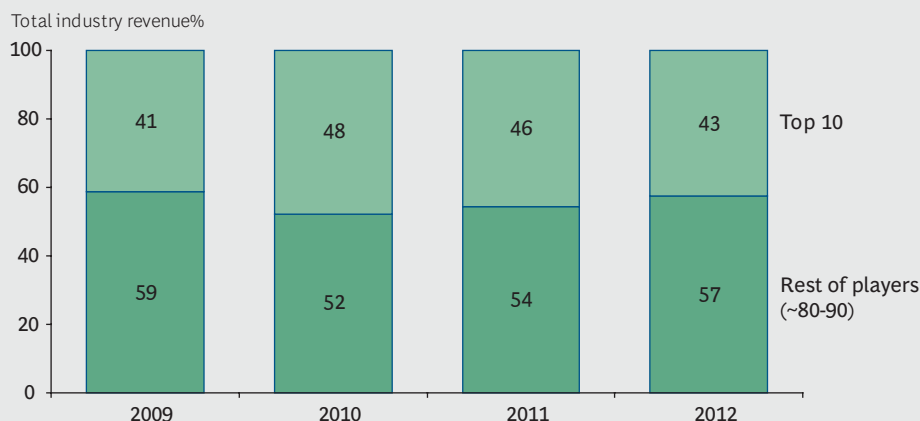


Source: Securities Association of China; WIND, client interviews; BCG analysis.



## EXHIBIT 6 | The Industry Remains Fragmented

Concentration of securities industry revenues 2009-2012



Source: SAC.

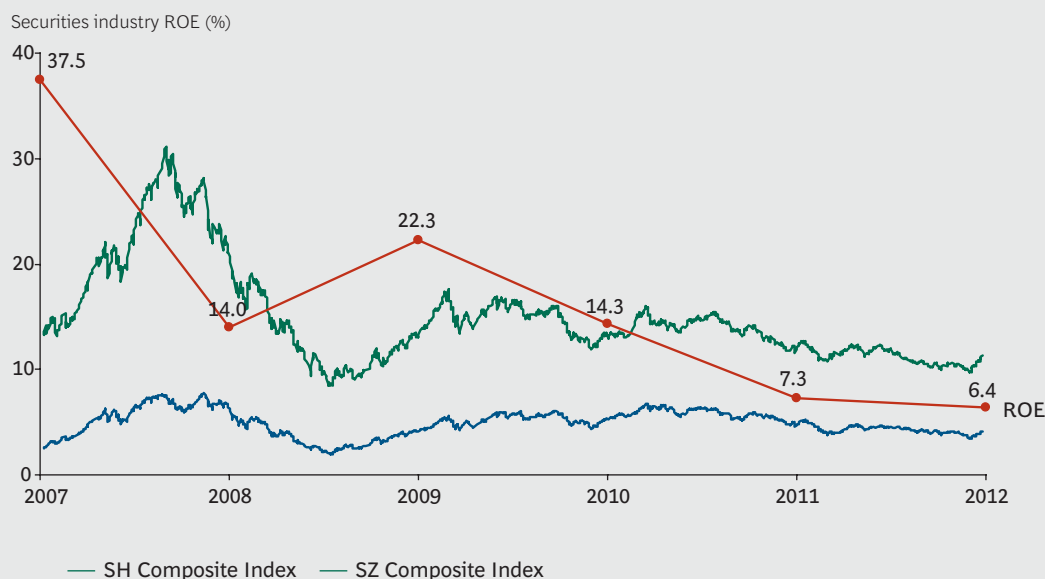
Despite the fragmentation and low profitability, significant industry consolidation is unlikely in the short term. Most of the small provincial firms are majority owned by provincial governments, who are reluctant to relinquish control over a financial institution that they regard as a local asset.

Many players are taking advantage of the push for industry innovation. Chinese securities companies aim high and are constantly reinventing themselves. BCG has closely ob-

served a number of major domestic players striving to generate superior returns through distinctive business strategies.

- *Pioneers*: some firms, such as Citic Securities, proactively changed their business mix ahead of competitors (e.g. investing in new business such as PE, futures, asset management), pursuing IPO and inorganic growth at an early stage to gain scale, and exploring overseas opportunities in Hong Kong, New York and Singapore.

## EXHIBIT 7 | Industry Profitability Deteriorated as China's Stock Markets Under-performed



Source: Securities Association of China, WIND, BCG database and analysis.

- *Domestic innovators:* other firms, such as Guosen Securities and Ping An Securities, have achieved strong growth with via their local know-how and adopting innovative business models, for example in online retail brokerage and targeting small- and mid-cap IPOs. Their profit-linked compensation system has helped drive performance, enabling them to top retail brokerage and IBD rankings despite limited physical outlet networks and limited connections to large SOEs.
- *Capital players:* a third strategy is to concentrate on capital-dependent business. For instance, Haitong Securities devotes a significant portion of capital to margin trading and proprietary trading business. It currently has RMB 58B net assets, the second largest in the industry after Citic Securities.

## Chinese Securities Markets Are of Long-term Interest to International Players

An onshore PRC securities platform is a critical component of any long-term set-up for Chinese and Asian capital markets. For those players who have an investment banking platform in Hong Kong, an onshore securities entity can offer benefits for client coverage, market intelligence and research. Moreover, there are clear benefits to building a long-term track record and trust with Chinese regulatory bodies and corporations. Consequently, a number of global firms are actively seeking to enter into equity trading and derivatives business to gain access to onshore markets. They conclude that, as new fields open, it is better to be present and engaged, than waiting on the sidelines.

However, international players have understandable reservations about investing in China's securities industry. Regulations limit the accessibility for foreign firms, including participation in some more lucrative business (e.g. equity derivatives). Although the ceiling on equity participation for foreigners has been raised from 33% to 49%, few securities firms are seen as compatible partners. Amongst the 11 Securities JVs that have formed between global and Chinese institu-

tions, relationship challenges can exist due to differences in management objectives and practices.

## Four Focus Areas for Foreign Firms to Improve JV Performance in China

Today, most foreign JVs struggle with profitability and scale – their recent performance has been particularly constrained by the shrinking pipeline of large-cap IPOs in China. We see four common areas to improve their performance and make the JV sustainable in the long-run:

1. **Align the business model with the market context:** Foreign shareholders need to clearly understand the role the Securities JV plays in their portfolio of entities on-shore, and how it enables them to create value both on- and off-shore. Most Securities JVs are geared to target large cap (SOE) IPOs. They are not properly equipped to serve the higher growth segments in smaller-ticket, mid-market transactions and privately owned enterprises. To succeed in future, they need to align their business model and resources to market demand. To grasp the opening of new capital markets product areas, particularly in secondary businesses, they need a clear understanding of how they can compete with local houses.
2. **Corporate governance:** The pressure on JV management teams and shareholders from Chinese partners is often high. Poor performance has driven some partners to seek radical changes in management and strategy. Often, the foreign and local partners have different expectations for the JV: they have differing views on the relative importance of top-line versus bottom-line growth, cost management, and the role of the JV Board. Trusted Chinese leaders, proper communication and alignment are essential to maintain mutual trust.
3. **Compliance:** The right level of oversight and empowerment of local compliance teams is an important lever for the business (defining which deals can be execut-

ed), and often an area of contention with Chinese partners. Foreigners are subject to global compliance policies. However, they may need to adjust processes and ensure a proper assessment of risk at the JV level, rather than attempting to steer decisions from the offshore platform.

4. **Talent:** the changes in the market will require different capabilities, for example, coverage for mid-caps as a client segment, and technical expertise to build secondary trading platforms. This is likely to result in increasing need to localize talent and hence, may require adjusting compensation schemes to be more in line with local competitors' practices, which are often more strongly performance-driven. Furthermore, staffing choices for the JV man-

agement team and Board of Directors are decisive in building credibility and maintaining a stable and smooth relationship with Chinese partners.

It is critical for the foreign institutions to decide on the main purpose of their JV: what is the balance between profit generation onshore, and supporting offshore businesses? This drives trade-offs in how to steer the JV, how to allocate resources to it, and how to prioritise clients. Once in a partnership, the foreign partner has little option but to make it work: a separation is a difficult prospect for commercial, brand and regulatory reasons. With growing signals of further liberalization, foreign firms that maintain good relationships with their local partners and regulators will be better positioned to benefit.

# RENMINBI INTERNATIONALIZATION— PROSPECTS FOR 2015

The Chinese government is actively preparing the renminbi (RMB) to be a global medium of payment, financing, investment, and ultimately a global reserve currency. The timeline for RMB to achieve this is a matter of debate: views range between five and twenty years. China is already in a leading position in world trade, with a rising share settled in RMB. An offshore RMB (CNH) deposit base and CNH bond market have developed rapidly, centered on Hong Kong, but with London, Singapore and Taiwan emerging as liquidity

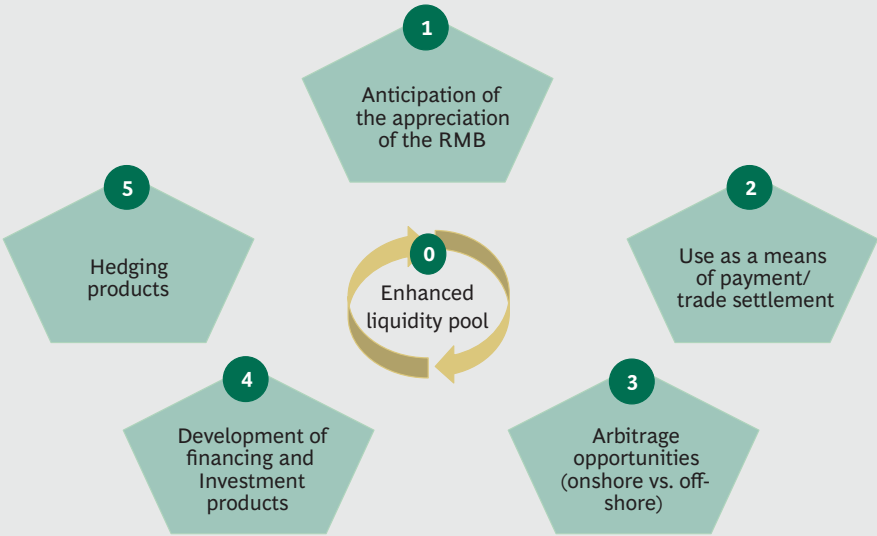
pools. Consequently, CMIB players are already building RMB capabilities to capture the revenue opportunities they present.

## Drivers of RMB Internationalization

There are 5 major drivers contributing to the development of an offshore RMB liquidity pool, which totaled USD 150B in July 2013. (See Exhibit 8.)

- 1. **RMB as an appreciating asset:** the expectation of RMB currency appreciation

EXHIBIT 8 | Drivers of RMB Internationalization



Source: BCG analysis.

has been the main driver of the offshore deposit base in the past, though this is giving way to a broader set of drivers.

## 2. RMB as a means of payment and trade settlement:

RMB trade settlements have grown rapidly in the past few years. RMB has risen from 20th to 12th place in share of world currency payments since 2011 and is now second place for letters of credit. Surveys by HSBC and BOC in 2013 on a sample of 3600+ companies indicate expectations that RMB payments will reach 20%-30% of China's trade (from 12% in 2012) within 3 years. Trade settlement in RMB and related transaction banking, financing and FX volumes will experience substantial increases.

## 3. Arbitrage opportunities:

most trading activity is driven by arbitrage opportunities, created by the regulated onshore interest rate/FX environment and the offshore market dynamics. This will continue to drive CNH FX and financing activities of Chinese and foreign companies, until the RMB becomes fully convertible, though continued deregulation of Chinese interest rates/FX will gradually diminish the level of arbitrage.

## 4. Development of financing and investment products:

CNH bonds comprised 75% of total CNH financing (USD 51B) in 2012: CNH bond issuance grew at 107% p.a. from 2010-12, to USD 39B. Nevertheless, the CNH bond market is still in infancy: most issues are high grade, short (1-3 year) tenor, and small (up to USD 320M). For CNH equity, there was only one issue as of Q3 2013. CNH fund and insurance products have yet to gather momentum, lacking a diversified pool of offshore RMB assets. The RQFII quota, allowing investments in China onshore securities via offshore RMB funds, has been raised to USD 44B in 2012 (RMB 270B). However, almost half of the quota was unused at the end of October 2013.

In the medium term, the financing and investment markets will gather pace:

- A tighter onshore credit environment could lead more Chinese issuers, particularly high yield and private enterprises, to

offshore capital markets. International disclosure requirements and sufficient issuance sizes will be key enablers for offshore offerings.

- Global investors could expand CNH asset demand substantially. Activity in CNH offerings has been limited by lack of liquidity, difficulty to hedge currency risks; and lack of a CNH Interest rate benchmark. The introduction of CNH HIBOR fixings in June 2013 enables currency hedging and relative value comparisons.
- Development of an active CNH loan market, including syndications, which to date has been rather small (USD 13B in 2012), helped by the establishment of CNH HIBOR.
- Emergence of a hybrid capital/mezzanine debt segment in CNH DCM, with higher fees than senior debt, driven yield-seeking institutional investors.
- The rise of CNH asset management, with utilization of RQFII and QDII quotas, and a positive outlook for the establishment of a fund passport scheme between Hong Kong and the mainland.

## 5. Hedging products:

CNH FX average daily volumes have grown rapidly to reach USD 31bn. Rising market liquidity has compressed bid-offer spreads. Spot and forward markets capture most volume, but swap markets in currencies and rates will grow as the introduction of CNH HIBOR fixings enables hedging activities (e.g. fix to float swaps). A more liquid FX market will drive growth in CNH options and derivatives. The CNY NDF will gradually phase out as CNH hedging instruments replace it.

## 2015 Revenue Pools for CNH Products

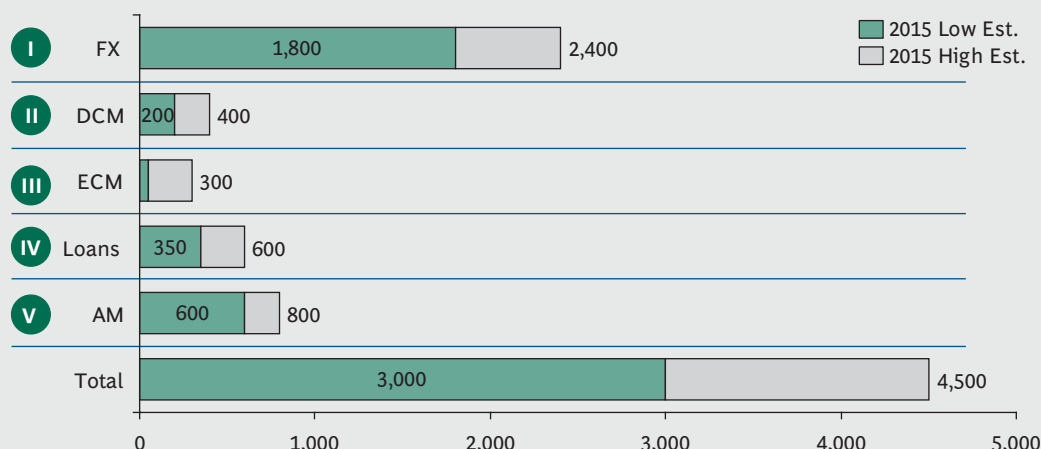
The short-term revenue opportunity for CNH is relatively small, but material. BCG conservatively estimates total revenues of USD 3.0-4.5B by 2015, broken down into the following major components. (See Exhibit 9.)

- *CNH FX and linked derivatives ranging from USD 1.8bn-2.4bn:* FX is the largest revenue

## EXHIBIT 9 | CNH Market Revenue Potential of USD ~3.0-4.5 Bn

Primarily driven by FX and linked revenues

2015 CNH revenue pool estimates (USD Mn)



Source: Industry expert, Greenwich Associates; SCB, HSBC report, EIU, Thomson Financial, Barclays, BOCHK report, China Securities Regulatory Commission, SAFE, PBoC, BCG analysis.

driver. While FX spot, forward and swaps contribute ~90% of FX volumes, ~40% of revenues come from currency swaps and derivatives due to higher margins (though needing more risk capital).

- *DCM revenue pool ranging from USD 200m-400m:* driven by volume growth of 25% p.a., albeit at lower than historical growth rates. While high grade is expected to drive 75-80% of CNH issuance volumes (it was 85% in 2012), the high yield segment is expected to be the major contributor to the revenue pool (~60%) given significantly higher fees compared to high grade issues.
- *ECM revenue pool ranging from ~USD 50m-300m:* this is expected to remain a small market, with some growth in CNH issuances at the expense of G3 ECM issuances.
- *Loans revenue pool ranging from ~USD 350m-600m:* loan volumes will more than double, driven by increased bank and syndicated loan activities, following the introduction of CNH HIBOR. Prerequisites for success in this space include access to CNH deposits, China credit appetite and expertise, and access to Chinese clients or MNCs with onshore operations.

- *Asset Management revenue pool ranging from USD 600m-800m:* driven by the growth of externally managed CNH AUM volumes to USD 80bn-100bn, predominantly CNH bonds, RQFII and QDII quotas. Institutional investors are expected to take the lion's share of AUM (~70%), but the retail segment will be ~60% of revenue, due to retail management fees of ~1.5% p.a. versus institutional fees of ~0.45% p.a.

There is considerable upside on these estimates if, for example, the RQFII quotas are significantly expanded, and major offshore deposit pools develop in Singapore, London and Taiwan to complement Hong Kong. This will drive the creation of a broader range of CNH investment products to absorb the additional liquidity.

## Becoming a Winner in RMB

There are differing responses by Chinese, regional and global banks to RMB internationalization. Each today uses their existing strengths to serve differing needs of their client bases:

- Chinese banks tend to focus on leveraging RMB clearing and settlement capabilities, access to CNH deposits, balance sheet, and access to Chinese clients

- Regional banks tend to promote an all-round RMB service offering for their APAC client base, spanning traditional banking and capital markets products
- Global banks are focused less on balance sheet-intensive offerings and more on strengths in capital markets (e.g. DCM, FX), primarily serving an offshore client base.

For CMIB players preparing for the offshore RMB opportunity, the following steps are essential:

1. **Set up an RMB competence center:** establish a cross-product center to drive the development of firm-wide efforts in offshore RMB research, product offerings and value proposition to specific client segments, market- and regulatory intelligence. The center should drive internal education and enablement for client facing teams to deliver relevant content, and encourage cooperation across business lines and geographies.
2. **Develop a clear value proposition:** the needs arising from offshore RMB differ for corporates and institutional investors. Corporates require transaction banking, financing, clearing and settlement, and hedging products. Institutional investors

focus on the landscape of CNH assets, how it fits in their portfolio allocations, and ways to mitigate idiosyncratic or currency risks from holding these assets.

3. **Engage clients to educate them and promote the value proposition:** many clients outside Asia region still have a limited understanding of how RMB internationalization impacts their business. Engage clients to educate and advise them, and plant the seeds for future business.
4. **Selectively build specific CNH product capabilities:** focus on expanding capabilities in established areas of strength, and advantaged access to a specific client base. For example, a top-tier G3 High-yield DCM player may focus on expanding research coverage, trading and risk management of Chinese HY corporates in anticipation of future CNH issuances.

RMB internationalization will change the banking and capital markets landscape in Asia and globally. Financial institutions must take an active stance now ensure it has positive impact on their business and for their clients. RMB will be an important domain to secure future market share in today's core CMIB businesses and capture new opportunities as China's capital markets continue to open.



# FULFILLING THE PROMISE

## MANY DIFFERENT PATHS TO SUCCESS

**F**or the capital markets industry in Asia, this is an exciting time. The underlying drivers are resilient: the growth of Asian companies into a new generation of multinationals, the broadening of the regional institutional investor base, the rising share of inter- and intra-regional trade and economic integration, and the growth of capital markets as a direct financing channel in place of bank lending.

Growth will not likely be smooth or easy. Economic cycles will impact the pace and trajectory of development, even as the broad direction remains intact. The global move back to higher interest rates and China's economic reform program may have unpredictable impact on Asian credit, liquidity and market risks. Creating value in Asia will remain challenging: the complex regulatory environ-

ment and intense competition will remain. For global firms, the old competitive model (a broad product offering and thin local market presence) is under pressure from local challengers.

For CMIB industry participants, there will be many different paths to success. A growing range of distinct business models and strategies will emerge, as each firm finds its own formula for its client franchise, balance sheet, operating model and geographic footprint. For a sustainable long-term growth agenda, firms must tackle two must-win strategic issues: finding a way to benefit from China's financial opening, and defining the right approach to serve regional institutional investors in the fixed income markets.

### A NOTE ON SOURCES

In addition to BCG proprietary analysis, this report draws on data from the following sources: Asian Development Bank, Bank of International Settlements, Bloomberg, Celent, China Securities Regulatory Committee, China Statistics Yearbook, Debtwire, Finance Asia, Fung Global Institute, Gavekal, Greenwich Associates,

Hong Kong Monetary Authority, The Securities Association of China, SWIFT, Tricumen, UBS, The Wall Street Journal, WIND, The World Economic Forum, and The World Federation of Stock Exchanges.

Exchange rate at June 2013, 1 USD = 6.1374 CNY.



# FOR FURTHER READING

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An article by The Boston Consulting Group, January 2013

**Risk Report 2012–2013: An Inflection Point in Global Banking**

A report by The Boston Consulting Group, December 2012

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