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Promoting the Shift from Indirect Financing to Direct Financing in China

Introduction

China's financial structure has been transformed significantly since the country started the process of market-oriented reform and opening up to the world in the late 1970s, but direct financing through capital markets is still playing a lesser role than indirect financing through banks. As a result, it has failed to meet the diverse needs of investment and funding, especially in supplying risk capital to technologically innovative firms needed to promote industrial transformation and upgrading. Overreliance on indirect financing has also increased systemic risk through the accumulation of debts owed by firms to banks.

To solve these problems, the government has positioned the shift from indirect to direct financing as a priority for financial reform. In the 14th Five-Year Plan (2021-2025), it has pledged to (1) fully implement a registration-based initial public offering (IPO) system and expand financing channels through direct financing; (2) improve the multi-layered capital market system and inclusiveness of direct financing; (3) improve the quality of listed companies and strengthen the basic system of direct financing; (4) promote innovative development in the bond market and enhance direct financing tools; (5) accelerate the development of private equity funds; and (6) promote the entry of long-term funds into the market and enhance the sources of direct financing. Among these initiatives, improving the quality of listed companies is the key to the healthy development of direct financing.

China's Indirect Financing-Centered Financial Structure

Direct financing refers to an economic entity raising funds through financial markets (stock markets, corporate bond markets, etc.), while indirect financing occurs when it raises funds through borrowing from banks and other financial institutions that collect deposits. China's financial structure is dominated by indirect financing, and this can be confirmed by checking the composition of financial assets of the household sector and financial liabilities of the nonfinancial corporate sector.[1]

First, looking at the composition of the household sector's financial assets, the share of cash and deposits in China reached 58.8% (at the end of 2018), higher than in developed countries and regions such as Japan, the United States and the euro area (all at the end of March 2021), while the share of debt securities (bonds) and equities, etc. is low (Figure 1).[2]

Next, looking at the composition of financial liabilities in the nonfinancial corporate sector, in the case of China, the share of loans is 54.2% (end of 2018), which is higher than in Japan, the United States, and the euro area (all at end of March 2021), while the share of equities and other assets is lower (Figure 2).

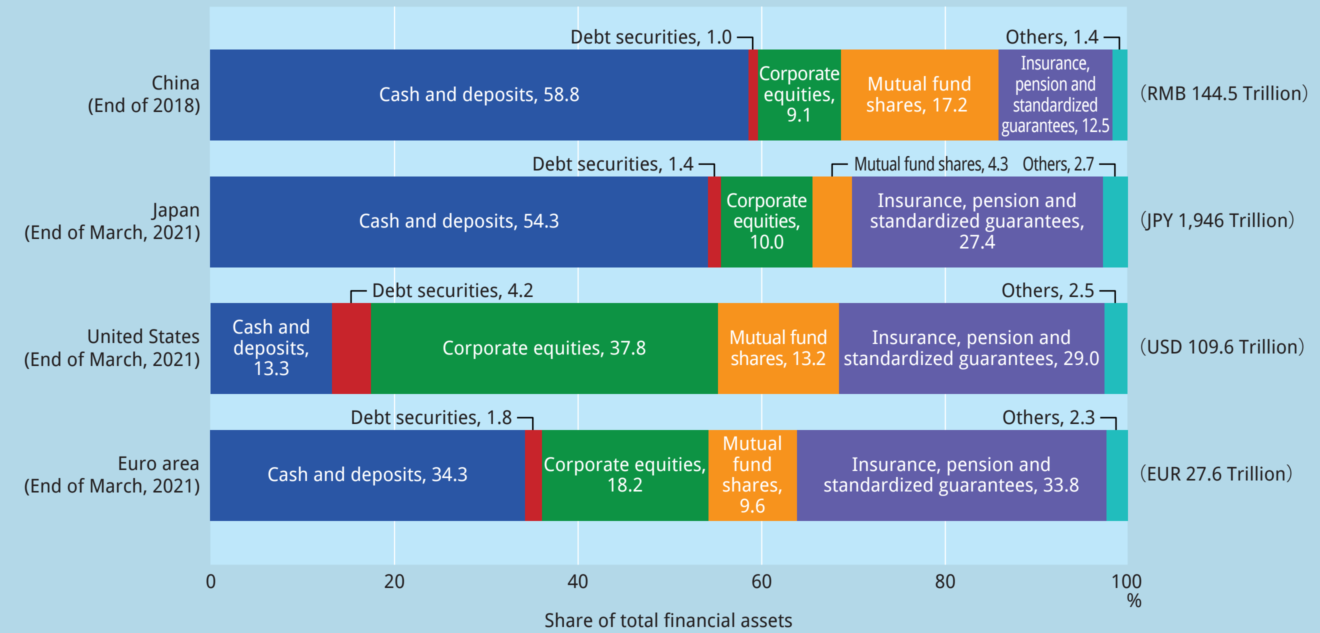
Aims of Promoting Direct Financing

The development of direct financing should contribute to industrial upgrading, a shift of funds from deposits to securities, and financial system stability.

Industrial upgrading

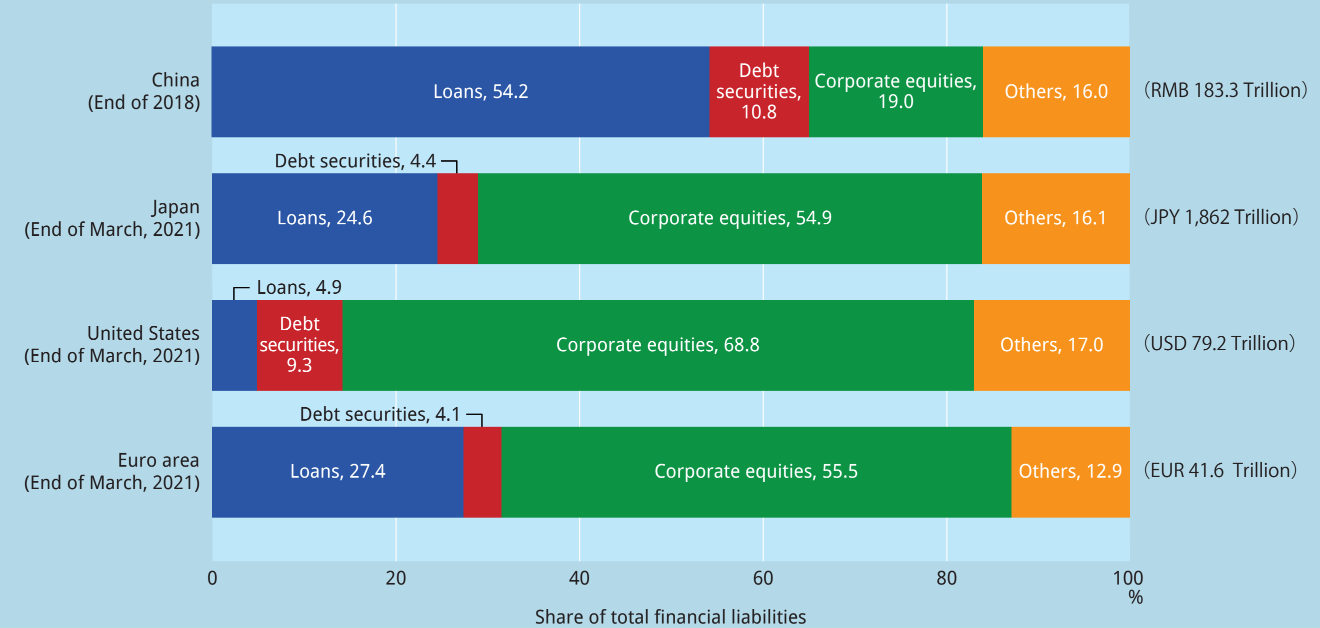
As shown by other countries' experience, indirect financing, mainly through borrowing from banks, is better suited to mature, traditional manufacturing and real estate industries, whereas direct fi-

Figure 1: Composition of Financial Assets of the Household Sector in China: Comparison with Japan, the U.S., and the Euro Area



Source: Compiled by Nomura Institute of Capital Markets Research from Yi, Gang, "Reconsidering China's Financial Asset Structure and Its Implications for Policy," People's Bank of China Policy Research, People's Bank of China, First Quarter 2020, and Bank of Japan, Research and Statistics Department, "Comparison of Flow of Funds between Japan, the United States and Europe," August 20, 2021 (original source: Bank of Japan, Flow of Funds Statistics [released June 25, 2021], and Federal Reserve Board (FRB), Financial Accounts of the United States, First Quarter 2021 [released June 10, 2021]; European Central Bank (ECB), Euro Area Accounts [released July 28, 2021])

Figure 2: Composition of Financial Liabilities of the Nonfinancial Corporate Sector in China: Comparison with Japan, the U.S., and the Euro Area



Source: Compiled by Nomura Institute of Capital Markets Research from Yi, Gang, "Reconsidering China's Financial Asset Structure and Its Implications for Policy," People's Bank of China Policy Research, People's Bank of China, First Quarter 2020, and Bank of Japan, Research and Statistics Department, "Comparison of Flow of Funds between Japan, the United States and Europe," August 20, 2021 (original source: Bank of Japan, Flow of Funds Statistics [released June 25, 2021], and FRB, Financial Accounts of the United States, First Quarter 2021 [released June 10, 2021]; ECB, Euro Area Accounts [released July 28, 2021]) nancing, mainly through issuing equity shares, is an important channel for raising funds for emerging industries.

For banks, companies in mature traditional manufacturing and real estate industries, which have large amounts of tangible assets, are low-risk borrowers because they can provide collateral such as land, and their earnings are relatively stable. In contrast, innovative companies in the high-tech and modern service industries are high-risk borrowers to avoid because the difficulty of assessing the value of their core assets, such as human resources and intellectual property, makes it difficult to use them as collateral, and because these companies also have difficulty turning expensive research and development (R&D) investments into profits in a short time.

On the other hand, direct financing, which provides products that can be priced commensurately with the risk, can provide an efficient route to the procurement of risk capital for innovative firms, thereby promoting R&D and, ultimately, industrial upgrading.

Shift of funds from deposits to securities

For households, deposits provide low-risk, low-return investment vehicles, while securities such as stocks and corporate bonds provide high-risk, high-return investment vehicles. In China, which has experienced rapid economic development, the household sector is becoming more risk tolerant when investing its funds as the size of its assets grows, leaving more room to shift funds from deposits to securities.

However, against the backdrop of an aging population, investable funds are increasingly concentrated among the elderly, who have low risk tolerance. In order to channel the funds that they have from indirect financing to direct financing, there is a need to develop financial products that reduce risk through diversified investments, such as mutual funds.

Financial system stability

For a long time in China, under a financial structure centered on indirect financing, corporate financing has been overly dependent on bank loans, leading to the accumulation of financial risks by banks. Moreover, as symbolized by the expression "too big to fail," there is an expectation that the government will bail out banks in financial crisis, and this encourages moral hazard. As emphasized by Guo Shuqing, Party Secretary of the People's Bank of China and Chairman of the China Banking and Insurance Regulatory Commission, the development of direct financing is not only expected to improve the allocation of funds in a way that meets the diversified needs of fund providers and fund users, but also to contribute to financial system stability by reducing corporate reliance on bank loans and improving corporate financial conditions.[3]

Measures to Increase the Share of Direct Financing

In the 14th Five-Year Plan, increasing the share of direct financing has been identified as a priority for financial reform. To achieve this, the following issues must be addressed, according to Yi Huiman, Chairman of the China Securities Regulatory Commission.[4]

Full implementation of a registration-based IPO system and expansion of direct financing channels

First, by referring to successful examples from overseas, reflecting China's characteristics and stage of development, and based on the trial experience of the Shanghai Stock Exchange Science and Technology Innovation Board (STAR Market) and the ChiNext Board, a registration-based IPO system focusing on information disclosure should be implemented in all domestic stock markets. In addition, basic institutional reforms regarding issuance, listing, trading, and ongoing supervision and management should be promoted to ensure that each related party can fulfill its respective responsibilities, the market pricing mechanism can function more effectively, and more and more promising companies can grow through capital market financing.

Improvement of the multi-layered capital market system and the strengthening of the inclusiveness of direct financing

In order to increase the share of direct financing, it is necessary to establish a multi-layered capital market system that is highly inclusive and able to respond to the diverse financing needs of different types of firms and stages of growth (Figure 3). Toward this end, the reform of the main boards in Shanghai and Shenzhen should be promoted. At the same time, through innovations in the basic system, STAR Market should be further developed, while the characteristics of the ChiNext board should be utilized to support the growth of technologically innovative enterprises. Furthermore, the New Third Board should be further reformed to strengthen its ability to meet the needs of small and medium-sized enterprises (SMEs), while at the same time normative off-exchange markets, such as regional over-the-counter markets should be developed. The financial derivatives markets should be reformed and their risk management mechanisms should be improved.

Improving the quality of listed companies and strengthening of the basic system of direct financing

First, mechanisms for secondary offering, mergers and acquisitions, and equity compensation should be improved to support the transformation and upgrading of listed companies. In addition, the delisting system should be further improved, various exit routes should be developed, a permanent mechanism for delisting should be established, and the mechanism of natural selection should be strengthened. Furthermore, corporate governance reform of listed companies should be promoted and transparency in information disclosure should be enhanced. Companies leading in innovation and their industries should act as role models for others to follow. More and more companies should be encouraged to use direct financing as a means to achieve high quality development.

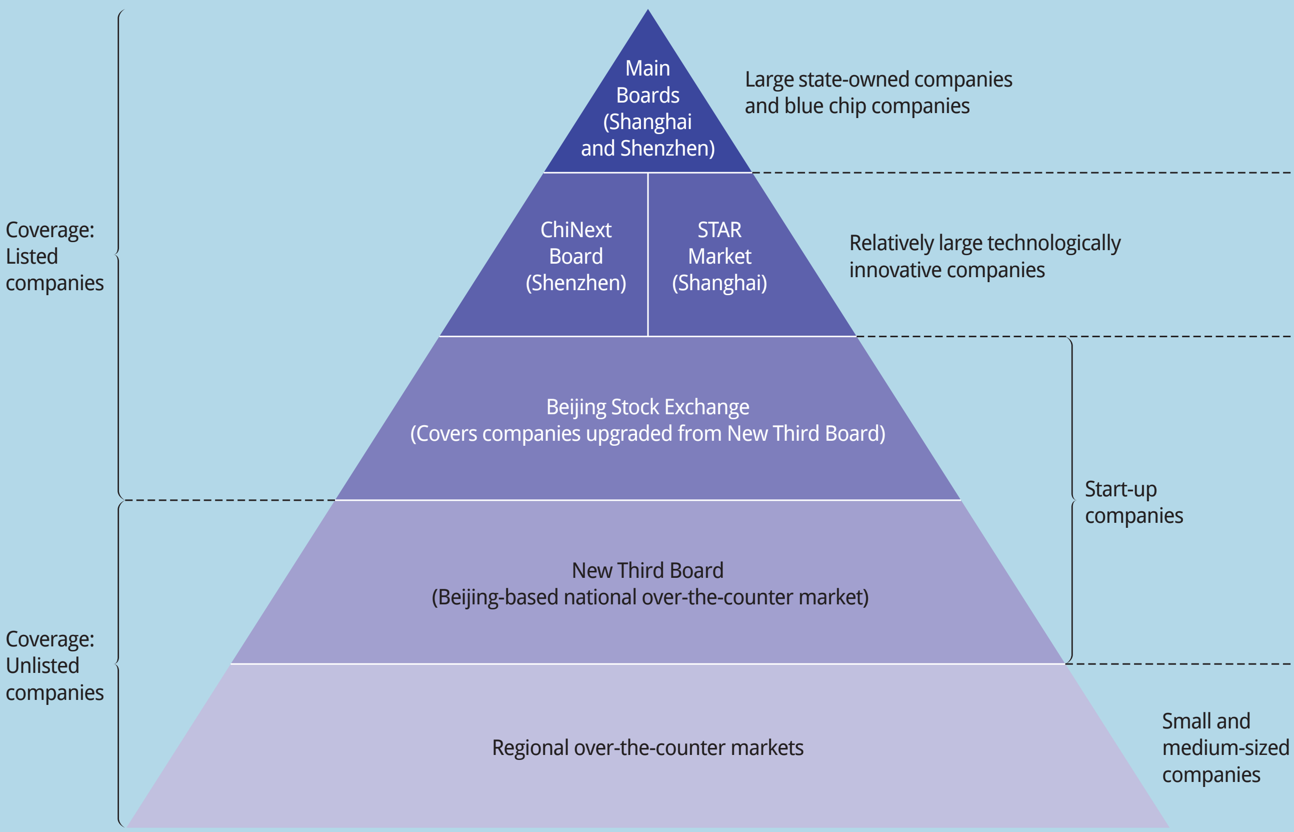
Promotion of innovative development in the bond market and enhancement of direct financing tools

First, the registration system for bond issuances should be improved, the interconnection of exchanges and interbank bond market infrastructure should be strengthened, and bank participation in bond trading should be supported. Development of asset securitization products should also be focused on. In the infrastructure sector, the scope of publicly offered real estate investment trusts on a trial basis should be expanded to establish a successful example as soon as possible. Furthermore, the scope of intellectual property securitization should be broadened to promote the practical application of scientific and technological achievements.

Acceleration of the development of private equity funds

First, sources of funding should be actively developed, barriers to each pro-

Figure 3: China's Multi-layered Capital Market System



Source: Compiled by Nomura Institute of Capital Markets Research from various sources

cess should be eliminated, including recruitment, investment, management, and exit, and private equity funds should be encouraged to invest in small, start-up, and high-tech companies. An administrative interim ordinance on private equity funds should also be issued, guiding them to continuously improve their professional operation and compliance awareness. Furthermore, cooperation among government agencies and between the central and local governments in dealing with risks should be strengthened, misconduct related to private placements should be eliminated, and the normative and healthy development of the industry should be promoted.

Promotion of market access to long-term funds and enhancement of direct financing sources

First, in order to secure long-term funds, the capacity of specialized asset management institutions should be enhanced, and efforts should be focused on developing mutual fund products that invest primarily in equities to promote the entry of medium- to long-term funds into the capital market. In addition, policies and guidance should be strengthened to increase the number of long-term oriented institutional investors and prompt a return to the key philosophy of value investing. Furthermore, outstanding foreign securities firms and asset management companies should be encouraged to enter the Chinese market in order to promote healthy competition in the industry.

Improving the Quality of Listed Companies

Among these measures, improving the quality of listed companies seems to be the key to promoting the development of direct financing. To this end, state-owned enterprises with lackluster performance should be delisted and the new listing of dynamic private companies should be actively promoted.

In China's stock market, many listed companies are state-owned, with more than half of their outstanding shares held by the government or by state-owned companies. Corporate governance of these companies is usually weak, and as a result profitability is poor. Despite the implementation of "non-tradable share reform" in 2005, which aimed to eliminate the distinction between non-tradable shares owned by the government and state-owned companies and tradable shares owned by other investors, the situation has not changed significantly.

Moreover, the Communist Party has tightened its control on listed companies, including private ones by promoting "party building" in these companies. According to the "Governance for Listed Companies" issued by the China Securities Regulatory Commission, organizations of the Communist Party should be established in listed companies in accordance with the Company Law to conduct the Party's activities. In addition, state-controlled listed companies should incorporate requirements related to party building into their articles of association.

The role of Party organizations in listed companies has extended beyond the traditional scope, which was limited to the supervision of enterprises, to decision-making.[5] As a result, the authority of the board of directors has weakened, while shareholders have lost some legal rights prescribed by the Company Law, including the rights to make important decisions and to elect managers, which they previously exercised in accordance with the size of their shareholdings.

On the other hand, to avoid tight regulations in the Chinese market, many fast-growing private companies, including such high-tech giants as Alibaba and Tencent, have chosen to list their stocks on overseas markets, including in the United States. Under the current regime of capital controls, Chinese investors are deprived of the option to buy shares of these companies.

Reflecting this phenomenon, which could be called "bad money drives out good" (Gresham's law), domestic stock prices have been stagnant for a long time and stocks have failed to attract investors, despite the high growth of the Chinese economy.

By improving the quality of listed companies, limiting the involvement of the government and the Communist Party in corporate decisions, broadening the channels for the listing of private companies on domestic stock exchanges through improving the multi-layered capital market system, and encouraging high-tech companies that are listed overseas to return to the Chinese market should promote the shift from indirect to direct financing in China.[6]

Notes

1 Regarding the shift from indirect to direct financing, while in Japan the focus is on the composition of the household sector's financial assets, as in the government's effort to promote shifting "from savings to investment," the Chinese government is more concerned with the structure of corporate funding.

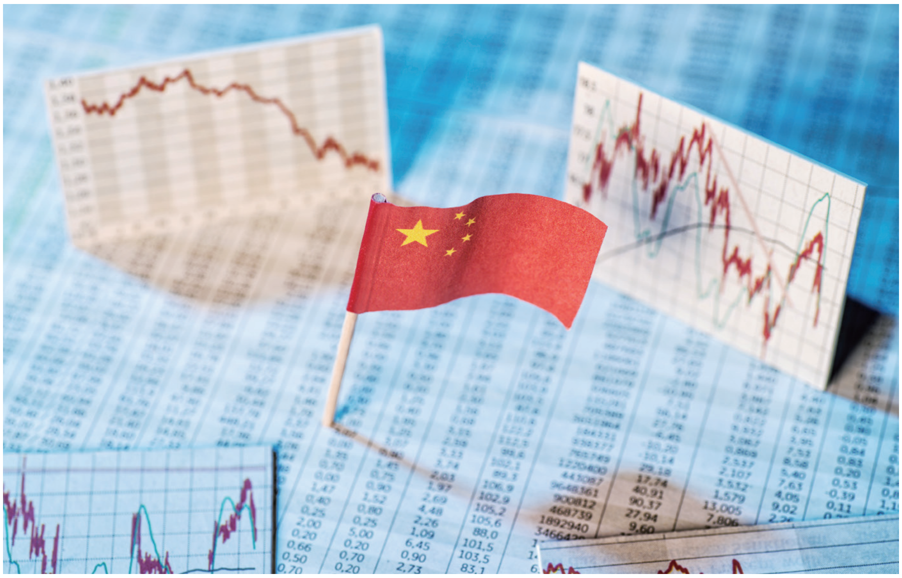
2 The asset composition of the household sector in China shows a high percentage of real assets, such as housing, and a low percentage of financial assets. According to the "2019 Survey on the Household Assets and Liabilities of Urban Households in China" (*China Finance*, 2020, No. 9), the average assets held by the urban household sector amounted to RMB3,179,000, of which real assets accounted for 79.6% of the total (of which housing accounted for 59.1% of the total), while financial assets amounted to RMB649,000 (20.4% of the total).

3 Guo, Shuqing, "Accelerate the Construction of New Development Patterns and Prevent the Re-Expansion of Financial Risks," Keynote Address at Lujiazui Forum 2021, June 10, 2021.

4 Yi, Huiman, "Raising the Share of Direct Financing," *Supplementary Readings of The Proposal of the CPC Central on the 14th Five-Year Plan for National Economic and Social Development and Long-Term Goals to 2035*, People's Publishing House, 2020.

5 See, for example, Livingston, Scott, "The New Challenge of Communist Corporate Governance," *CSIS Briefs*, Center for Strategic and International Studies, January 2021.

6 To encourage Chinese companies listed overseas to return to the domestic market, the State Council announced on March 30, 2018 a document titled "Several Opinions on Launching Pilot Project for Innovative Enterprises' Issuance of Shares or Depositary Receipts in Domestic Market." This document lays down new rules for domestic listings (on the A-Share sections of the Shanghai and Shenzhen markets) of red-chip companies already listed in overseas markets by issuing China Depositary Receipts (CDRs), which are backed by shares and other securities issued abroad. See Kwan, Chi Hung, "Reform of the Listing System for High-tech Companies: Opening the way for red-chip companies to issue CDRs," *China in Transition*, Research Institute of Economy, Trade and Industry, September 6, 2018.



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