

# The Private Wealth Management Industry in mainland China: 2013-2018

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## Abstract

The accelerated growth of the past 30 years has advanced the entrepreneurial sector in China. The surge in private wealth management services (PWM) has resulted in enhancing this segment's profile globally. The ensuing tension between demand and lagging development may force change to markets and regulations. It is therefore to be expected that the financial service providers (FSPs) will be prompted to follow suit. This essay seeks to analyze how FSPs and PWM firms will meet the demands of the private and public sectors alike. Furthermore, this essay seeks to provide insights that may benefit interested parties.

**Keywords:** China PWM industry, policy, financial market, financial service, clients, financial products.

## 1. Altered conditions resulting from the global economic crisis

### 1.1 The world economy has undergone tremendous change Since the global financial crisis (GFC)

The effects of the crisis will most probably shadow recovery and continue to influence markets, investors, regulators, as well as the private wealth management (PWM) industry for some time to come. Chief among the causes of the GFC is the problem of excess debt. It might be no

exaggeration to say, that the major economies of the world are in danger of drowning in debt. A case in point would be the U.S. where the financial crisis is ongoing, and whose leadership seems unable or unwilling to address that nation's budgetary and monetary dilemmas. Likewise, the Eurozone has been hurting and continues to suffer the effects of its debt woes. In Asia, Japan has endured a longstanding problem of economic stagnation that is also rooted in its problem of excess debt.

It is therefore reasonable to conclude that change will necessarily occur as a direct result of the enormous level of debt hanging over the global economy. Furthermore, this change will most probably be propelled either by market forces linked to a severe lack of regulation, or by ambivalent regulation, thereby giving rise to difficult choices necessitating the correction of decades of profligacy among these nations. Either way change is on the horizon.

### 1.2 The Chinese economic experience during the GFC

In the context of China, there have been substantial changes since 2009. In addition, further changes are anticipated over the next 5 years. Indeed, many sources ranging from the Pew Research Center to the U.S. National Intelligence Council and others anticipate that China will assume the role of premier economic power within the coming decade.

However, the current situation gives reason to reconsider this prediction. The conventional view that exports, investment and consumption (including private and governmental) have always been regarded as the three carriages driving China's economic growth, has been challenged recently. New data from the Wall Street Journal, demonstrates that the physical investment has been dropping consistently. Meanwhile, the trade balance has been shrinking gradually since its peak in 2007, and has actually dragged down the growth over the past two years. Although the economic situation has failed to look optimistic, it is always supported by stable government. It is clear that good political ambience always benefits all kinds of economic reform. According to Prasad (WSJ), while Europe, Japan and the U.S. are encountering political and economic dilemmas, China is moving towards solving its own economic problems discreetly, especially, it is expected and predicted that the new leadership, to some extent, will forge the tenor of reform in the economy.

It is reasonable to conclude (from the foregoing analysis) that faced with the new position onshore and offshore, policy makers inside China clearly recognize the need to instigate reforms without hesitation. Currently, investors are likely also to respond favorably. The attitudes change of policy makers and investors are surely inevitable and this could very well change in the PWM industry between today and the future.

Furthermore, with the increased life expectancy in China, it is very probable people will be living longer and the birth rate will be dropping. This might lead to a demographic time bomb. Therefore, some types of insurance such as life insurance and longevity insurance might be expected to play a more important role in the future China. However, underinsurance and low insurance penetration are a

common issue that developing countries are encountering. In order to resolve the dilemma of an aging population, the government could possibly depend on a fresh and feasible policy on retirement related to the PWM industry.

### **1.3 The impact of the GFC on the China PWM**

Due to the adverse impact and aftermath of the Global Financial Crisis ("The GFC"), the entire PWM Industry has been suffering from a serious credit and trust risk from their clients since more and more clients consider this moment the worst time to make any investment. PWM net worth grew by 14% of \$73 trillion in 2012, due to a too low figure in 2011. Inter, alia, the High-tech and Healthcare are rated the highest in creating more value for investors. While the HNW families are mainly distributed across the coastal belt of eastern China, we have the news that Beijing, Guangzhou and Shanghai had actually suffered a lower than national average HNW growth rate in 2012. Again, many HNW families have to tighten their belts to different extents than before due to the aftermath of the GFC.

From the perspective of investment sector in China, housing asset witnessed a very large drop in its assets, 3% for its investors. The most seriously-hit areas in China include Zhejiang and Inner Mongolia.

Before addressing the topic of PWM in China private wealth management industry in five years, it is necessary to introduce some background knowledge of the conventional "Pains" in China's PWM.

First of all, the trust and payment issue. There was barely any concept of PWM in China before 2010 (openly recognized), let alone any reference to better development of PWM topics.

What people were doing Choice in China in relation to PWM was mainly housing investments, or investments in

other fixed tangible assets like mines. Due to relatively poor and late access to financial services and products, people tended to believe what they could see instead of committing to any too complicated financial products or anything unpredictable like stocks, for instance. How can people be expected to trust and accept PWM as a reliable investment means when their mentality is still generally back there.

Another factor is payment justification. Very rarely can you find HNW in China recognizing the need to pay for a financial service. To the HNWs in China, the conventional view is that financial advice on investments is simply something on one's lips, that is, merely spoken, and therefore should be gratis. Consequently, conventional wisdom holds the idea that there is no need and it's not fair to pay someone for such "advice".

Additionally the one-child policy in China has a particularly profound impact on peoples' mindset, it is particularly important in China. Since China's one child policy was implemented, 99% of Chinese people have had only a single child. These children have grown up to be concerned only with themselves; they are therefore unaware of the concept of sharing with others. Furthermore, these single children have not adopted a solid work ethic. They mostly want to harvest without much effort. If the child is born with a English idiom says 'silver spoon', things become even worse. This is why in headlines of China we almost see car incidents causing poor people casualties in China's daily feature stories of the offspring of HNWs, who are responsible for many of the motor accident casualties involving less fortunate Chinese citizens. Mostly, suspects are either children of HNWs or senior officials. When this has become a daily issue, many HNWs have started to worry about their next generation's growth and success, and even the sustain-

ability of their wealth. This is so important in China just because this was actually originated from its history, unique history of One Child policy, and also a lame social education. This aspect cannot be underestimated as its origin is China's One Child Policy – a policy unique to China's history and part of its social fabric.

Thirdly, PWM is just starting up in China, and there are simply so many areas for improvement in relation to this novel fiduciary option. Most of HNWs in China mainly looks at the tax benefits PWM can bring to them. Some bankers have even made use of so-called PWM activities and created Ponze Scheme crimes, with the intention of illegally amassing money.

Finally, the government started giving away some public properties for free or at extremely low cost, for instance, RMB 1, to private enterprises who got rich through "MBO". Consequently, a considerable number of clever opportunists created successful start-ups overnight.

China's government policy worked. But this has come at a price. Due to the illegal ways of becoming rich, these entrepreneurs cannot transfer their assets out of China overseas without concern. The reason is that the Chinese government prohibits this. None of these same entrepreneurs have escaped scrutiny of their property assets once it became apparent that the intended to transfer their converted liquid assets abroad.

These four barriers seriously hamper China's PWM development. However, looking back at the policy adjustment abilities of its government, this author views positively that changes can be made in a timely manner to ameliorate the situation.

## **2. Attitudes of policy makers and investors have changed in China**

### **2.1 Chinese government will gradually relax current restrictions in the financial sector as the economy continues to expand and investors become mature, which will result in an overwhelming change in the Chinese PWM industry within the next 5 years.**

China has a number of unique characteristics with respect to the regulation and oversight of the PWM industry as a whole. Additionally, some of the current shifts in policy could further be expected to improve the PWM industry regulatory differences within a five year time frame. These include: emphasizing the interest of the investors ahead of others and creating more protection for the retail investors by enabling them to avoid investing in risky products. Finally, having more transparent fees, otherwise, charges should be closely controlled and even prohibited.

In addition, further reports from sources, such as the Wall Street Journal (Feb.'13), indicate that the Chinese government has proposed a number of reforms, such as, the removal of restrictions on labor mobility, greater spending on social programs to reduce household savings; the boosting of domestic consumption, the liberalization of interest rates, the easing of restrictions on capital inflows and outflows, and finally encouraging business innovation. This author is of the view that these actions would boost the growth of financial markets.

On the one hand, over recent years, the government has produced many new laws and regulations to improve its financial regulating system. On the other hand, the Chinese authorities are also continuing the reforms in the financial sector since China joined the WTO in 2001. These reforms are aimed at fostering China's

financial industries to become more comprehensive and healthy, and also help China gradually open the highly regulated domestic financial markets to the world, including the PWM industry. It is proposed that the relaxation on restrictions would benefit the PWM industry in two respects:

Currently, Chinese investors do not have many investment products from which to choose on mainland China. The stock market and housing market are the two traditional investment areas that Chinese select. Since 2009 when the government tightened the monetary policy and placed new restrictions on bank loans, trust products have become popular among investors, as they now can invest in the real estate developments and local infrastructure developments via trust vehicles and make a relatively high (at least higher than deposits in banks) and stable fast money (usually can be reclaimed within 2 years and banks will be expected to bail out the trust products if they turn out to be toxic at expiration). In addition, private equity products have become very popular among the clients of private banks and even among retail investors (though retail investors were not legally allowed to invest in such PE products until recently. The authorities have produced new regulations that allow mutual funds and insurance companies' subsidiary asset management divisions to manage PE funds) from 2009 to around mid-2012, but soon these became less sought again as the stock market has continued to drop since then.

However, due to China's strict regulations, many new products are still not available in China. Worse still, even those already available products are immature and less developed, such as hedge funds, real estate products, structured products, lifecycle planning, according to BCG and CCB's report. But as the government continues to reduce these regula-

tory constraints, it is believed that there will be the development and promotion of many more new products in the near future. Therefore, PWM firms need to be prepared to provide their clients an increased variety of new products when regulations are eventually relaxed.

Restrictions on capital flow in and out of China have been relaxed over time. Along with the introduction of QDII and QFII, it is easier now for Chinese investors to invest offshore and for foreign investors to gain direct exposure to China, though the constraints are still very pronounced. One example of such progressive relaxation is the Chinese authorities recently reached agreement with the Taiwanese authorities to allow both sides to invest in the stock markets of the others' territories. Also, the quota for QDII and QFII has been increasing. All these reforms help capital flow in and out of China, which not only gives Chinese investors more investment choices offshore, but also obliges domestic banks and PWM firms to develop new methods to maintain their leading position within China. Furthermore, these measures serve to arrest their lagging behind international competitors.

Tax optimization products will become popular in the future, since the government might take actions to fill the loopholes which currently exist regarding tax issues. One example is enforcing more tax on the wealthy, such as estate/death tax, real estate tax and capital gains tax are very real options in future. More tax consideration in investing in index funds indirectly instead of in stock directly to induce retail investors is another possibility. Firstly, more products could be allowed in the market, such as, derivatives and hedge funds. Secondly, creating marketable mechanisms to hedge the longevity risk instead of being paid by the government, such as introducing compulsory savings and innovative financial products

(life-cycle funds or reverse mortgages). Thirdly, allowing investors and companies to invest outside China to minimize the risk by providing opportunities for diversification. Finally, providing additional regulation to enhance the security and quality of financial services, for example, by setting up more industry communities, and including, supervising the PWM firms and advisors so as to build an evaluation system to credit the quality of the PWM industry.

**2.2 Chinese investors' will gradually mature, shifting from chasing "fast money", "absolute return", "beating the market and others" to thinking from the perspectives of "life-cycle" and "portfolio approach". In other words, investors will become more mature and rational. PWM firms, therefore, should notice the trend and be ready to help in leading their clients to a more mature approach in thinking and decision-making.**

Changes in attitude might be measured and the tendency predicted in the coming five years via analysis of the improvement in the quantity and quality of the investors in China. Firstly, as for quantity, according to a report issued by Bain Capital Investment (Bain) in collaboration with China Merchant Bank (CMB) which studied the private wealth management industry within China, during the period of 2009 – 2011, it has yet to be seen what tangible changes will actually take place. However, a number of conclusions may be drawn. Firstly, during the period 2009 and 2011, China's overall individual investable assets rose 19%, so it is estimated the stable growth rate is about 9.5% per year, and by 2018, this data will rise by 9 times to about 86%. Secondly, by the end of 2010, the number of HNWI's with assets of 10 million RMB was roughly 500,000. The report anticipates the number cited above will

grow to approximately 600,000 individuals by the end of 2011. Though it is not easy to be accurate, the increasing tendency of the wealthy number might be guessed at. Thirdly, as for the quality of investors, they will likely be more sophisticated and rational. These investors have become quite savvy in their approach to running private wealth management. This has provided an opportunity for HNWI's to optimize their asset allocation and reap the benefits of greater liquidity as well as revenue enhancement.

With respect to the PWM industry, China is lagging behind most Western countries. However, the class of high-net-worth individuals (HNWI's) is working diligently to acquire the necessary skills and knowledge to address their desired investment strategy goals. Therefore, increasing investor knowledge continues to drive change. HNWI's have gained valuable skills, knowledge and insights during the period following the GFC. According to the report, indications are that many of China's high-net-worth individuals (HNWI's) began to modify their investment strategies in the wake of the 2008 financial crisis. These investors have become quite savvy in new approaches such as re-sampling of asset allocation and portfolio construction. The spread sheet analysis has provided an opportunity for HNWI's to streamline consumption.

Besides this, it will be interesting to see what follow-up areas become evident with respect to this area of anticipated change. Firstly, the wealthiest segment of Chinese population is located primarily in the provinces of Guangdong, Shanghai, Beijing, Zhejiang and Jiangsu. With the development of other main cities, the wealthy is unlikely to be so centralized. Secondly, higher and more professional requirements of advisors are probably going to feature rather than a focus on low fees, for instance, when constructing a well-diversified portfolio. Future inves-

tors are very likely to consider more the tax impact, the process, methodology and documentation. Additionally, after 2008 GFC, investors have paid more attention to "absolute return" alternative assets and incorporated them into the portfolio to avoid the next GFC. Finally, other changes might be more focused on insurance investments, especially endowment and annuities due to the one child policy; additionally, more consideration might be given to the damaging, negative effects of taxes over the last five years, and using philanthropic preference to benefit from taxation deduction immediately might also be an option to consider.

Obviously, the PWM firms who play a main role in this industry are not only supervised by regulators, but also provide services for investors. On the basis of new attitudes mentioned above, it is highly probable that these firms will change their products and services in order not only to survive, but also thrive in the market.

### **3. Analysis of where China PWM industry will be different in five years**

The PWM industry may include diverse aspects, from its skills to its clients, or life-cycle asset allocation to behavioral finance. However, considering China's status-quo of economic growth and its national conditions, and its "growing pains", of course, investment advisors should be focused on, in the first instance, the principle that the client is God.

#### **3.1. China Clients currently**

Factual statistics form the basis of the view, mentioned above that China's PWM clients mostly come from HNWs. Boston Consulting Group carried out research and surveys in China, which might be relevant in this light.

Although it's relatively less prudent to use statistics of such surveys in China than in the West, it's still worth trying to use as a reference barometer. The categories include: entrepreneurs, professional managers, others, housewives, other specialists, professional investors and freelancers. From these categories, one thing was apparent, namely that entrepreneurs are the major source of HNWs in China, and this could go on for some time considering the current economic growth momentum in China, and its national campaign of the fortunate few early beneficiaries helping the less fortunate majority. This will be discussed in the coming few paragraphs.

### 3.2. World Clients currently

It is worth noting that the world average has a noteworthy difference from China's proportional distribution regarding the ratios of different levels of HNWs. Although the world average categories are not made according to careers, there should be surprising similarities in the distribution of proportion between the pyramid and the career categorization as indicated in diagram following:

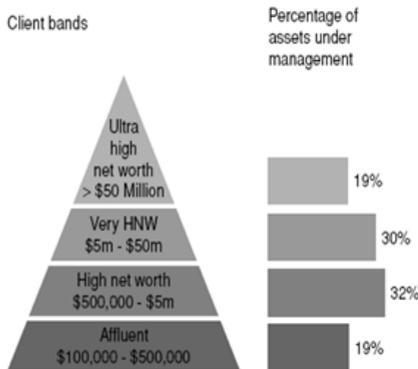


Figure 1 The wealth management Pyramid

Source: page 55, *Global Private Banking and Wealth Management* by David Maud

When compared, we can see that the two diagrams have similarities. Some might want to say that the UHNWs might have sportsmen like Michael Jordan. What is discussed here is the generic samples instead of exceptional samples. So generically, it is considered the same career has a general average similar income. So the similarities in the two diagrams should be recognized.

Upon that conclusion, it may all be realized that the UHNW of China have taken up 56%, a sharp contrast against the 14% of world average UHNW, covering a big portion of the wealth spectrum. Here you might speculate as to why China is just seeing its PWM start up, and furthermore why entrepreneurs would take up such a big portion of the wealth of the nation?

As was pointed out in the 4th 'pain' of China, the policy pain is the crux of the problem. Although China has benefitted greatly from the consequences of its reform and opening-up policies over the past 3 decades, cronyism and corruption still bedevil this arena. The major beneficiaries still remain a very small number of closely-knit associates and corrupt officials, which makes it easy for the government to organize big events like the Olympics but difficult to cope with press freedom issues.

### 3.3. China PWM industry in five years

#### ★More sophisticated clients.

With more and more access to international-level financial services and players, Chinese investors are likely to become smarter and more and more discerning.

#### ★Inter-generational advice

For the third pain of China, let's have a look at how things get better now. In Hong Kong, more and more HNWs have started to hire advisors to educate their inheritors in market competency. This altered mind-

set is also spreading to the whole of mainland of China as well.

★ More colorful, simple and transparent products

Products such as equity, bonds, funds, trusts and community futures, real estate and insurance have historically been the traditional route for Chinese investors. To cater to the needs of the new class of HNWI, more new products must inevitably emerge in the coming 5 years. Products such as: publicly-offered funds and private equity, as well as innovative funds like hedge fund; in addition, life-cycle funds and reverse mortgages and other new insurance products to reduce longevity risk; standard products convenient to building financial supermarkets; treasury bond futures; option product trials and lastly, international products.

Overall, it may be predicted that there could be wider scope in the products chosen by future investors. More simple and transparent products could very well be designed to suit investors, as some complicated products may be overly-expensive and fail to meet the client's needs, such as some structured products, for instance. Diversification of products might make portfolio construction possible. However it is a fact that institutions involved in the lexicon of financial management widely understand the implementation of portfolio strategies and tactics instead of retail investors. This might cause more perfect performance of the institution rather than suiting retail investors. Gradually, the amount of the retail investor will decline to ultimately disappear, which will result in the specialization of the future financial market in China. According to the credible information from Essence Securities in China, this is the direction to develop PWM industry in a healthy and orderly direction.

★ More service

Firstly, with the increasing amount of products and institutional investors, tax-

ing schemes have become more complex. This, in turn, requires a greater array of services, such as financial planning, private banking, specialized accounting, tax insurance, legal advice and estate planning. Facing these complex issues, products and situations, it is indispensable for future investors to consult some professional PWM advisors. Correspondingly, practitioners might change their roles from just salesmen to consultants. Therefore the situation of the international and domestic economies and real context in which the investor sits, together with the investor's individual personality should be considered fully by PWM advisors. PWM firms relate to advising individuals about investment strategy, providing services to that end and investing through means of corporations and institutions that are an extension of an individual, such as family companies, trusts and charitable entities set up by wealthy individuals.

Secondly, today's market is geared to dealing with the wealthy, but that will very probably also change. Similarly, many investors are spreading their investment portfolios among several different private wealth management (PWM) firms. As a result, the Chinese private banking industry (CPBI) is rapidly moving into the growing HNW wealth management market. These wealth management competitors are now set to focus on the development of their respective brands. It is therefore imperative that they build a reliable brand image to enhance customer loyalty.

Thirdly, the population of HNWI's within China continues to grow at a rapid pace. It is predicted that real estate and private equity trusts appear to be leading the way in this expanded growth of individual wealth. A case in point is of a class of approximately 500 billionaires which has been created during this time period.

In addition to this level of growth, the number of elder Chinese citizens has increased as well. This segment of the population will require new strategies and new services to address their needs.

All of the aforementioned indicates a clear need for PWM firms to provide a broad array of creative new services.

★Quality of services

Clients in the future will surely become smarter and probably know about more complicated funds, for instance hedge fund. If a client knows that a hedge fund in Wall Street earned a return of 34%, he definitely will consider more complicated services from you.

And in the case that the HNWs seek more providers of services, you probably even will get prosecuted if you got the investment 0 or worse returns. The following diagram shows how clients care about quality of service, diagram following:

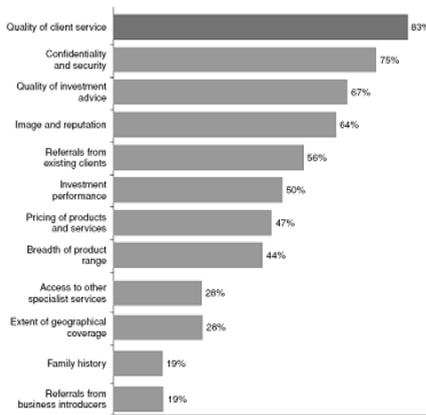


Figure 2 Ranking of preference according to level of important

Source: page 52, Global Private Banking and Wealth Management by David Maude

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★Regional differences

The current regions with the most HNWs are Beijing, Shanghai and Guang-

zhou. Among them, the investable assets in Beijing’s HNWs amounted to more than RMB 5.6 trillion associated with an average investable assets of more than RMB 30 million/person, which is the top of the nation.

This was again caused by the government favorable policies. But considering now the central government is tilting policies towards western part of China, we assume some regional HNWs will be created in middle or western part of China.

★More evenly distributed wealth

It has been documented that China’s wealth is very unevenly distributed, with around 56% in the hands of the UHNW. This can be adjusted slightly 2018, and hence better in the farther future. China’s policies now are more and more tilted towards the middle class, with tax, personal income, GDP growth, etc. The national government has actually long realized this tough issue and started to put forward positive ideas for dealing with it. One of the favorable policies for the middle class and lower class is the new pension fund system. People pay less and less to enjoy the public funds. The government also realized that its principle of “The few who got rich first should help the rest reach affluence in the end” should start working for its second phase now, which is to for the few who got rich because of government “special policies” to help the rest reach affluence.

★Less assets transfer abroad

Wall street Journal published an article on the “888” visa to be issued to HNWs to Chinese under the very hot topic of transfer of assets by HNWs abroad. The real reason behind the transfer of assets is less transparent legal system, children’s education, better living environment, etc. This might be difficult to change in a very short period of time, but it is hoped that the government would do something to make a change, especially on the education system reform on how to create a

more free, transparent and respectable academic environment to attract more students and professors to stay to focus on their work and study. Anyway, this is going to be a long term issue.

Where China is going in its PWM industry is a very complicated issue. It's not just discussion over its business model or simulation or techniques. There are simply too many aspects which need consideration and one of the most critical is the state policies, which it is predicted that China government is going to release gradually.

#### **4. Challenges and opportunities to PWM firms**

As stated above, the monumental debt problems facing the world's economies will be a primary challenge for PWM firms as they work to preserve and hopefully grow the wealth of China's investors. Meanwhile, the fact that there are more and more wealthy Chinese people indicates tremendous market and growth potential for the near term. It is always important to bear in mind this has occurred during what has been an otherwise tumultuous ride across the global economy.

As for the aging population, China does not have any equivalent to the social security type programs for the elderly recipients of the West. The looming debt problems facing the West will show that governments will in no way be in a position to provide more old age pensions in the future. China is not immune to this issue. The possibility of outliving one's resources is real. Though, on the positive side, China has enormous human capital to offset this concern, and additionally, while Chinese culture has historically revered the elderly, it will not always be a sustained mechanism. Depending on the market system to manage longevity risk would afford more opportunity for astute

PWM industry to find solutions to these concerns.

Although it is over 20 years since the Shanghai stock exchange opened, the PWM industry is in the development stage, rather like a toddler. On the one hand, there exist lots of problems requiring urgent solutions. On the other hand, increasing wealthy people will enlarge demand for the PWM industry rapidly. The PWM firms who can grasp the nettle might seize the chances.

#### **5. Conclusion**

In a country where the economy is moving forward, the political system is stable, the leadership is opening its mind, the wealthy are keeping private, it is almost certain that the eyes of the world can be attracted to this PWM heaven. A thriving and brilliant future for the private wealth management industry in mainland China is coming. How to outperform becomes the key task of the body involved in the PWM industry. Opportunity always offers itself to the person who is already well prepared. Hence, seizing and exploiting the gap between PWM industry in China between today and future is the key premise towards winning the situation and seizing the luck.

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