The 'Singapore Solution' to China's Stock Woes

[Business Asia]

By Paul Gillis

Alibaba has finally announced its plan to list its shares in New York, after months of speculation about the location. This is a blow to Hong Kong, which had courted the Chinese tech company but was unwilling to change its rules to allow founder Jack Ma to keep control of the company after the listing. But this is also a blow to Chinese investors, who will yet again be denied an opportunity to invest in one of their country's most successful firms.

The problem is that so many Chinese companies are forced to list overseas because it is still so difficult to win permission to issue shares on the mainland. That makes the deals a lose-lose for investors everywhere. Chinese citizens can't buy offshore shares because of the mainland's capital controls. Meanwhile, foreign investors technically don't buy the company, either. To circumvent foreign-ownership restrictions, Chinese firms use the so-called variable-interest entity (VIE) structure. With the VIE structure, offshore shell companies have contractual claims to the revenues from, but no actual ownership of, the Chinese firms.

Fortunately, a solution is finally coming into sight, from an unexpected quarter: Singapore. The China Securities Regulatory Commission (CSRC) in November reached an agreement with Singaporean authorities to allow Chinese companies to list directly in the Lion City without first setting up an offshore holding company. If this becomes a template for other jurisdictions—and a seed of further reforms in China—investors everywhere stand to benefit.

The Singapore Solution addresses several serious flaws with the VIE overseas-listing model. First and foremost, it clarifies regulatory authority over the listed companies by specifying that the CSRC will retain jurisdiction. A major problem with overseas listed Chinese companies is that because they are neither wholly Chinese nor wholly foreign, regulators have struggled to determine whose laws the firms must follow and who will enforce them.

The offshore holding companies are not subject to Chinese regulation, and Beijing has been slow to cooperate with foreign regulators investigating Chinese companies that it considers domestic. Because the Singapore Solution makes it a requirement under Chinese law that companies comply with the laws of the jurisdiction where they list, this method also resolves the thorny sovereignty issues that arise when foreign regulators try to enforce foreign laws against Chinese companies on Chinese soil.

Another flaw with the VIE model is that the domestic Chinese company and the overseas-listed entity are technically not the same enterprise, and are only tenuously connected. This makes it impossible to do a traditional secondary listing onshore, leaving domestic investors permanently cut off from the opportunity to buy the shares.

> Allowing companies to list directly overseas is good for regulators and investors.

By allowing the Chinese enterprise to list abroad without a VIE, the Singapore Solution opens the door to secondary listings on China's stock exchanges. This would finally allow local investors to benefit from the growth of domestic companies. Indeed, this could open the door to the eventual "return" of such firms to China if, as the domestic financial markets grow, it becomes possible to use the proceeds of local share issues to buy out foreign investors.

The challenge now is for authorities in China and the main overseas listing venues for Chinese companies in Hong Kong and the U.S. to find ways to apply the basic Singapore model to their own markets. This will not necessarily be easy, but it is certainly achievable.

China could start by allowing Chinese companies to list directly overseas after gaining approval from CSRC. The vetting process could take account of Beijing's traditional concerns about overseas listing of companies possessing state secrets or with disreputable management.

The heart of the Singapore Solution is to make the CSRC the primary gatekeeper and regulator of overseas listed Chinese companies, charged with the responsibility to ensure that these companies comply with Chinese and foreign laws. The CSRC might ask foreign authorities such as the U.S. Securities and Exchange Commission and Public Company Accounting Oversight Board to help them meet their responsibilities, including sending inspectors to work with the CSRC to regulate these companies. Chinese regulators will likely reserve the right to punish miscreants, and the SEC and PCAOB should be happy to let them do so if the result is that American standards are met.

Other reforms might be more difficult. Beijing needs to allow a greater number of companies to accept foreign investment. The Third Plenum reforms last year promised liberalization in the rules on foreign investment in e-commerce and education, two of the most popular sectors that use the VIE structure. Premier Li Keqiang reiterated the commitment in his remarks to the National People's Congress on March 5. Allowing foreign investment in e-commerce and education would remove the need for the VIE structure for companies in those industries.

The Singapore Solution will require some attitude adjustment from regulators all around. But the alternative—booting Chinese companies off foreign exchanges while denying them the opportunity to list at home—is no alternative at all. After a troublesome several years concerning these listings, regulators should seize on the most promising model to date for how to move forward.

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Stress Tests Won't Prevent the Next Financial Crisis

By Rosa M. Abrantes-Metz

On March 26, the Federal Reserve will release the results of the "stress tests" it conducted on the nation's 30 largest banks. The findings will purportedly reveal how well a bank can withstand a financial crisis, but the Fed's decision to implement more complex stress tests doesn't address what caused the financial crisis of 2008.

Banks are required to fund some fraction of their lending or securities purchases with equity capital, which can absorb losses. The riskier the asset, the more capital funding required under the Basel accords. The Fed then requires tests on how well a bank's asset or investment portfolios hold up under different catastrophic scenarios.

But the financial crisis of 2008 wasn't characterized by asset losses. Instead, it was a run, or a collapse of short-term funding. Banks borrowed short to lend long, sometimes leveraged 30 to 1 on their short-term assets. When short-term funding suddenly dried up, banks were immediately and collectively in a crisis.

Which is why it's short-term overnight funding that needs regulation. Institutions should not be allowed to issue uncovered contracts—those not backed by an offsetting position to reduce risk—that are prone to runs. Banks could collateralize short-term assets with cash reserves or Treasurys and draw upon these in the event of a run. This would be a simpler, more focused and less resource intensive way to contain systemic risk.

But regulators have instead made a Rube-Goldberg attempt to control bank assets and behavior. Starting with Basel I in 1988, different assets were assigned different risk weights. These weights do not change over time through the business cycle, but risks do. Basel II, published in 2004, allowed risk weights of assets to change over time. Banks model the expected default and recovery risk of the assets, and they hold capital according to multiples of those expected losses.

But this introduces a vicious cycle. When the bank's models say times are good, funds can flow freely to seemingly low-risk assets. When times are modeled as bad, those funds can shut off abruptly, just when they are most needed. Banks have an incentive to play down risks and not raise capital requirements properly in advance of a downturn in the cycle.

Regulators responded by introducing "stress tests." These were meant to assess whether banks would be adequately capitalized against certain negative, but plausible, macroeconomic scenarios such as unemployment reaching 13% or a 21% drop in housing prices. Banks that appear undercapitalized are required to raise more capital. The first U.S. stress test in 2009—the Supervisory Capital Assessment Program—renewed confidence in the banking system. Of the 19 institutions evaluated, 10 had to raise additional capital.

Getty Images

European stress tests by the Committee of European Banking Supervisors were less persuasive. According to 2009 tests, 83 out of 90 banks were adequately capitalized. Those findings proved questionable when the European financial crisis began later in 2009. Serious stress testing and public-confidence building may be opposing objectives.

That's because stress tests have been oversold. First, the choice of financial scenario determines the outcome. If regulators choose "falling house prices," that will hit banks with large mortgage portfolios. If they emphasize "sharply rising unemployment," that will hit banks with large credit-card portfolios.

The stress scenario is never—by definition—the expected scenario. It's a risk scenario. There are many equally unexpected scenarios, but only one is picked.

Perhaps regulators have a reason: Housing prices fell by 30% from 2007-11, and overseers worry they may fall more. But why go through the trouble to model all of these complex relationships statistically? Why don't regulators simply require banks with large mortgage portfolios to raise more capital? Why not increase the risk weight on mortgages? This might actually target risk.

Second, scenario-based stress tests are not comparable across regions. Should we run an identical unemployment scenario through the U.S. and Spanish models? Would the same scenario represent the same degree of stress? Most would say no, which means we should run different scenarios for both. But then how can we compare the results? The scenarios are different. Are they equally likely? Or are they equally stressful? How do we define that? The test is subjective.

Third, stress tests aren't that stressful. Supervisors evaluate bank capital by the losses they expect given the stressful scenario. But it's rarely the losses we "expect" that cause the crisis. What about the losses the models don't expect?

Fourth, few people predict what risks will cause a crisis. Right after the U.S. housing crisis, European bank regulators failed to notice that sovereign debt might be a tad risky. And despite decades of research, no economic model has proved reliable in anticipating a significant downturn. Yet we are relying on these to control systemic risks.

Stress tests aren't entirely devoid of merit or utility. They force banks to think through events that might hurt all of their investments at the same time. But they do little to prevent or even mitigate those events.

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Pop group AKB48, whose recent CD—like many records in Japan—offers extras to lure fans to buy more than one copy.

Japanese Music Sales Fall Behind Global Beat

By Hannah Karp
And Miho Inada

Even with the recorded-music business stabilizing in many countries, global music revenue shrank last year. The biggest reason: Japan's music market, the world's second largest after the U.S., is in free fall.

Revenue from digital-music sales in Japan sank 23% last year, while physical music sales slid 13%. Overall, Japan's entire music market shrank nearly 17% to 312.1 billion yen ($3.07 billion), according to the International Federation of the Phonographic Industry.

By contrast, global recorded-music sales shrank 3.9% last year, the IFPI said Tuesday. And excluding Japan's results, global sales edged down just 0.1%.

Though digital sales account for only 20% of Japan's total music revenue—far less than in the U.S. or other major markets—the plunge highlights Japan's extreme vulnerability in a world where physical music sales are in steady decline.

If there is a bright spot in the results, it is the enormous growth potential that remains for subscription-streaming services, which are only just beginning to arrive in Japan. Proposed streaming services from companies including **Spotify** AB, **Google** Inc., **Microsoft** Corp., Japan's messaging service **Line** Corp., and others, have yet to launch, because they are still hammering out licensing agreements, a challenge in Japan's highly splintered recording industry.

The latest numbers highlight several quirks in the Japanese music business. Among them: Digital revenue declined mostly because of a sharp drop in demand for outmoded mobile products such as ringtones, which had accounted for more of the digital market than in the U.S., the U.K. or Europe. In Japan, music shoppers would buy ringtones to sample a song before buying the whole track or album, but that pattern has faded with the rise of smartphones, which allow fans to enjoy their music through **YouTube** and other websites.

In the U.S., digital downloads are the biggest way that music is sold. But the basic download market is in its relative infancy in Japan. Many Japanese music companies have been reluctant to expedite deals with new digital services, attempting to protect a music-pricing system that allows record labels, instead of retailers, to set retail prices for physical music products.

That helps make physical sales far more profitable than downloads or streaming. **Avex Group Holdings** Inc., for instance, one of Japan's biggest music companies, said it sells albums for a minimum of 3,000 yen, or about $30, and singles for a minimum 1,000 yen, or about $10, increasing those prices whenever possible by bundling in merchandise or opportunities to meet members of the label's pop groups.

Such bundling with merchandise and perks is another unusual hallmark of music sales in Japan. Some Japanese fans are willing to purchase several copies of the same album to get such freebies. Just 200,000 fans could easily snap up 1 million physical copies of a given album or single—a rarity outside Japan, said one record company executive.

Shigeru Kimura, 22, last month bought 15 copies of pop group AKB48's most recent CD single, giving him the opportunity to meet 15 of the band's dozens of members—one handshake for every copy he purchased. He said he spends about 50,000 yen a year on music, about 30% of it on CDs, with the rest purchased through digital download.

Avex—which reaps two-thirds of its revenue from its artist-management and video-streaming divisions—said its revenue from physical music increased slightly last year, while digital music revenue fell.

"Our margins are much higher on physical sales so that is what we try to focus on," said Avex spokesman Kaoru Yanagihara. "Our goal is to add more value to the CD."

Even so, sales of CDs at Tower Records Japan, the country's largest music chain, with 84 outlets, have been in decline. "People increasingly listen to music through free access sites like YouTube," said company spokesman Tatsuro Yagawa.

Tatsuyoshi Kimura, a 22-year-old college student, used to spend 3,000 to 4,000 yen a month on CDs. But he rarely spends money on music any more, he says. "There are many sites like YouTube where I can listen to music free," he said. "That was not possible five years ago."

Reiko Masamoto, 48 years old, a serious fan of a pop band called Exile, still spends money on the group's CDs—to support them and to get freebies like a photo book. But other than that, she has stopped buying CDs. "I check out trendy music on YouTube," she said. "If some of them hit my heart, I'd then rent out CDs or borrow them from my friends who share the music taste with me."

Apple Inc. launched its iTunes music store in Japan in 2005. But **Sony** Corp.'s Sony Music Entertainment Japan—which operates separately from Sony's global music unit based in New York, Sony Music Entertainment—made its catalog available to Japanese iTunes users only two years ago.

Sony Music Japan said the delay was due to the time it took to make a deal with Apple. The iTunes store's sales in Japan grew 20% last year, and for the first time it is generating more revenue for some big labels than Recochoku, a Japanese digital-music store.

Adding to digital services' challenge in Japan: The country's music industry isn't dominated by a few major labels, as it is in much of the world. In the U.S., major labels distribute more than 85% of the recorded music. Japan, by contrast, has 65-plus record labels, and major labels control only 36% of the market.

Big record labels typically have been more receptive than their independent rivals to music-streaming services, in part because their vast music catalogs are able to generate relatively large royalty payments, even if the average new album or song doesn't necessarily produce much in the way of royalties yet.

Streaming services generated more than $1 billion globally last year, with 28 million people paying for a music subscription, up from 20 million in 2012 and eight million in 2010, according to the IFPI.

Google, LG Team Up For Smartwatches

By Rolfe Winkler
And Alistair Barr

Google Inc. looks set to beat **Apple** Inc. to market in a new category of mobile devices—smartwatches.

LG Electronics Inc. and Google's Motorola unit on Tuesday said they would begin selling smartwatches in coming months that run on a new version of Google's Android operating system for wearable devices, Android Wear. LG worked closely with Google on the design of the watch, which LG will call the G Watch, and Motorola, the Moto 360.

The watch will link to Android smartphones and respond to voice commands by using Google Now, the company's personal-assistant software that can make recommendations, answer questions and predict information users will want.

Apple has been working on a smartwatch for more than a year, and Chief Executive Tim Cook has said that the company was looking to enter new product categories this year. An Apple spokeswoman declined to comment on Tuesday.

As with its Android smartphone software, Google will offer Android Wear free to device makers to encourage its use, a person familiar with Google's plans said. Google hopes that Android Wear ultimately will power many kinds of wearable devices, not just smartwatches.

By releasing its smartwatch and operating system for wearables ahead of Apple, Google would grab a lead in the young smartwatch category. Sales of Android smartphones, by contrast, didn't catch up to the iPhone until 2010, three years after Apple unveiled the device.

Market-research firm ABI Research projects that smartwatch shipments will climb to 90 million in 2019 from 7.5 million this year.

Google hopes that its smartwatch will be better than earlier offerings, notably **Samsung Electronics** Co.'s Galaxy Gear smartwatch, which was released last summer. The watch failed to catch on because of poor battery life and limited functions, problems that Samsung is seeking to address with the Gear 2 smartwatch unveiled last month.

Motorola/Reuters

The Moto 360 will link to Android phones and react to voice commands.