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Building a Closer Cooperative Relationship between Industry and Finance

CHEN Weidong

Close cooperation between financial institutions and companies is an important factor in China's high-quality economic development. In the past few decades, several global financial crises have reflected the absence of an effective and healthy cooperative relationship between financial institutions and companies.

Gains and losses of industry–finance integration from the perspective of existing practices

There are many cases of cooperation between industry and finance both in China and worldwide. Many international corporations participate in financial investment, particularly in the automotive industry. For example, the German Volkswagen Group established Volkswagen Financial Services, a business division whose core businesses include financing, leasing, banking, and insurance services for dealers and customers. Ford, which is based in the United States, established the Ford Motor Credit Company in 1923. This company provides automobile financial services to automobile consumers and dealers, with business in more than 30 countries worldwide. Japan's Toyota Group established a subsidiary, Toyota Financial Services, in 1988. This subsidiary leveraged the group's high credit rating to raise low-cost funds and provide customers with automobile loans, leasing, and credit cards.

United Parcel Service (UPS), a century-old US-based company, is the world's largest logistics express company. In May 2001, it acquired the US-based First International Bancorp, Inc. and transformed it into its financial arm, UPS Capital, to provide customers with related financial services, such as trade financing using inventory and international receivables as collateral. Owing to its advantages in logistics and information flow, UPS can better evaluate companies' operating conditions and maintain control of collateral during the financing process, which greatly reduces default risk.

These industrial companies essentially center on their main businesses and depend on the customer resources of their main businesses to develop financial businesses. The integration of financial businesses into

CHEN Weidong is Director of Research Institute, Bank of China

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the companies' main business helps to promote sales of the companies' main products and create new value-added services for customers. The main businesses of industrial companies and their financial businesses indeed create synergy effects.

In contrast, an industrial company deviating from its main business and extensively engaging in financial services may result in a completely different situation. Specifically, the process by which General Electric Company (GE), the most famous manufacturing giant in the US, has engaged in financial business is enlightening.

Founded in 1892, GE has always been a leading giant in global manufacturing, with the scope of its business including medicine, aviation, and new energy during its development. Amid the financial deregulation of the 1980s, however, GE began to expand into the financial field. Its financial subsidiary, GE Capital, achieved sound development and gained a good reputation in the industry, a continuously expanding scale of business, and a rising proportion of GE's operating performance. By 2008, GE Capital's assets reached USD538 billion, with the financial segment contributing more than 35% to the group's operating revenue and net profit. However, the subprime mortgage crisis in the US greatly impacted GE Capital, and its commercial real estate, consumer credit, and mortgage lending businesses in Britain all experienced huge losses. The financial sector's plight lowered GE's credit rating and market value. In 2013, GE Capital was confirmed as a systemically important financial institution by U.S. financial regulators and, hence, faced more stringent regulatory requirements, including higher capital adequacy and liquidity ratios, which increased its operating costs. Since 2013, GE has successively divested its financial business. In 2019, the financial segment only comprised 9.2% of the group's revenue.

In addition to the above-mentioned problems, a more important reason for this divesture is GE's strategic choices and positioning. GE's executives realized that the value concept of the financial segment varied hugely from that of GE's main business. GE's main business focuses more on long-term and stable development to become the world's best infrastructure and technology company, whereas its financial arm focuses on improvements to short-term profits. Prior to the outbreak of the 2008 subprime mortgage crisis, GE used proceeds from the financial arm's expansion to make up for the reduced profits caused by a continuous decline in industrial production. Thus, the financial arm provided financial services to GE's multiple industrial subsidiaries and created more room for development in

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related businesses. When GE closely focused on its short-term-focused, risk-sensitive financial business, however, it reduced investment and development in its high-tech businesses, greatly impacting its innovation capabilities and core competitiveness.

The status of China's industry–finance integration

Since the end of the 1980s, large state-owned enterprises (SOEs) in China have begun to enter the financial industry. After 2000, China's financial system reform led to the emergence and rapid growth of new financial sectors. All kinds of companies are increasingly interested in entering the financial industry, and the integration of industry and finance is becoming a trend as many Chinese companies aim to grow larger and stronger. Hence, this type of integration is in a stage of rapid development. Companies are setting up financial arms, and corporations are extensively investing in financial institutions, such as banks, insurance, trusts, securities, and asset management companies. Corporations, including SOEs and private enterprises, may hold various financial licenses, and thus, financial businesses are becoming an important source of their revenue.

Chinese companies may directly invest in or even control financial institutions, forming the distinctive feature of combinations of industries and financial institutions in China. Some companies have played important roles in the joint-stock system reform for financial institutions. For example, some corporations served as strategic investors in banks during this reform. Many companies have played important roles in the establishment and development of new types of financial institutions, such as insurance, trust, and asset management institutions. After becoming important shareholders of various financial institutions, many companies grew deeply involved in the decision-making and operation processes of these financial institutions. Industrial companies have boosted the reform and development of China's current financial industry and enhanced its strength. Of course, companies' intentions for investing in financial institutions have differed. Some companies viewed such investments as opportunities for corporate transformation, others chose to hold shares in financial institutions as a means of improving profits, and still others tried to control such institutions for policy arbitrage or illicit profits.

The industry–finance integration process in China has also revealed problems and risks. At a micro level, several risks are likely to occur. Strategic portfolio risk can occur when a company blindly expands its boundaries, resulting in an excessively wide business scope. In this case, financial business development

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can fail to enhance endogenous competitiveness. If a group lacks proper management and control capabilities for investing in non-main businesses, excessive investments in financial institutions may bring new operating risks and affect the competitiveness of the group's main businesses. Financial leverage risk arises because forming a complex equity relationship between industrial capital and financial companies is likely to cause rapidly inflated book assets and insufficient actual capital, which affects the entire group's financial security. For example, D'long Group used over ten financial institutions under its control to form a complex financing chain, which eventually led to unsustainable financial leverage. In recent years, Hainan Airlines Group's diversified business expansion and continuous deviation from its main business made it impossible to maintain its financial leverage. Finally, internal transaction risk refers to the huge losses that financial institutions may suffer in the event of opaque information about transactions between affiliated companies and financial institutions or frequent so-called capital operations after gaining control of financial institutions to conduct deliberate asset transfers. An example is Tomorrow Group's actions toward Baoshang Bank, which the former controlled.

At the macro level, industry–finance integration may have two main negative effects. First, companies may be able to circumvent macroeconomic control policy. In China, this policy often involves industry restrictions on financing by financial institutions. Many companies may circumvent these credit-granting restrictions by directly holding financial institutions or bypass regulatory policies through financing arrangements made by non-banking financial institutions. Some companies use the conduit businesses of trusts and fund companies to issue wealth management products for fundraising, thereby bypassing regulations and reducing the effectiveness of macroeconomic control policy. When real estate companies hold shares in banks, they can avoid the industry's credit regulations, and the strengthened links between the real estate market and the banking system aggravate the market's systemic vulnerability. Second, industry–finance integration has exacerbated social capital's flow from the real economy to the virtual economy to a certain extent. With China's slowdown in economic growth, the rates of return of many industrial companies' main businesses have trended downward. In contrast, since 2000, China's financial industry has experienced a golden period, and the scale of its assets and profits has grown rapidly. Thus, this industry is seemingly more profitable. Companies have been trying to achieve business transformations by investing in the

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financial industry, and their financial segments are surpassing their main business segments in terms of revenue. As a result, companies' traditional main businesses are suffering from insufficient investments and reduced competitiveness, which are negatively impacting development in the real economy.

Establishing a sound industry–finance relationship

International experience suggests that industrial companies' investments in financial businesses can only develop more effectively if these investments better serve their main businesses. The rising breadth and depth of the integration of industry and finance in China has both positive effects and the aforementioned problems. As the development environment for financial institutions and companies is changing, it is important to reconsider the development of future industry–finance relations.

First, from the perspective of profitability, financial institutions once had higher yields when the market environment was inadequately competitive. As the number of market participants has increased, intensifying market competition, the financial industry's margin has been trending downward. Considering the strong spillover effects of financial institutions, more regulatory restrictions should be adopted to convert a portion of the social costs of this trend into such institutions' internal operating costs. In particular, financial business development is strongly procyclical, and financial institutions' operating performances need to be assessed across cycles. These costs have been manifested through bankruptcies in many countries. For example, a considerable number of banking institutions in the US have gone bankrupt in recent decades. When China's economy maintained relatively high growth, financial institutions' relatively high profits became a key incentive that attracted substantial industrial and social capital. Considering the operating losses of cross-cycle development and further refinements to regulatory measures, regulatory arbitrage opportunities will decrease, implying that financial institutions' social margins will be merely average. Only by focusing on their main businesses and developing their expertise can companies gain a leading edge in the industry, which is a cornerstone for improving viability. An industry can obtain a better rate of return only with a leading edge. In China's high-quality economic development phase, institutional design should encourage various types of companies to focus on their main businesses and improve their core competitiveness.

The experience and lessons of development in Chinese and foreign

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companies demonstrate that these institutions gain core competitiveness from their R&D advantages and the development and application of new technologies. Financial business development is currently becoming more and more complex. For example, in the case of banking institutions, traditional deposits, loans, payments, and clearing businesses are being replaced by wealth management, direct financing, cash management, and other new methods, indicating a shift away from the era in which banks relied on the franchise value of licenses to obtain traditional interest spread and intermediary income. The increasing use of new technologies has even replaced banks' intermediary role. As China's financial industry becomes more open, it will face competition from global institutions, meaning that China's financial institutions must be more responsive to future market challenges. Similarly, industrial companies need to accelerate their technological innovation and process transformation to enhance their brand images in the domestic and international markets. Facing new competitive pressure, both financial institutions and industrial companies should focus on their main businesses and increase investments to address the challenges created by new technologies while continuing to achieve new technological breakthroughs more frequently. If companies cannot keep up, they will be driven from the market. The more open an industry is, the more difficult it is to sustain high-intensity investments in innovation and R&D.

The corporate governance mechanism is the core element that determines an organization's survival. Financial institutions and industrial companies differ in terms of industry characteristics, scale economy boundaries, business opportunities, and risk factors. Thus, they require different corporate governance systems and management methods. Executives must have relevant industry qualifications and experience to make good judgments about industry development. As market acumen needs vary across industries, different incentive and restraint mechanisms need to be adopted to maintain a balance of gains and risks in an institution's growth. Theoretically speaking, financial capital has a short circulation chain, whereas industrial capital typically has a long one. Thus, it is generally believed that holders of financial capital should focus on short-term profits, whereas holders of industrial capital need to rely on long-term investments for income, resulting in different value orientations of the operating management of the two types of institutions. Following shareholding and equity participation, mutual synergies are difficult to achieve without board-level crossovers or management-level integration

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of the two types of institutions, but deep participation or integration may cause unmatched decision-making suggestions owing to differences in the industries' value orientations. In extreme cases, illegal interest arbitrage may occur among rule violations that generate temporary gains, which cannot save a company but often play a role in corporate declines.

It is necessary to explore methods of in-depth cooperation. Industrial and financial capital are strongly interdependent. Situational developments and changes have increasingly demonstrated that the establishment of a closer cooperative relationship between the two may be more conducive to enhancing each one's core competitiveness and sound, lasting development. Within the corporate sector, the centralized management of global funds through centralized financial operations can better match the capital flow involved in companies with the material flow in production and sales, which helps to improve the efficiency of capital allocation and risk management and the control capabilities of each company. On this basis, companies and financial institutions should explore effective and close collaborations in the following aspects.

The first is to find the greatest common denominator of cooperation in the vision for industry development. Based on analyses of historical lessons and industrial development characteristics, companies should carefully evaluate the rationality and necessity of directly holding or investing in financial institutions in the new environment. Companies should ask whether doing so will enhance the core competitiveness of their main businesses or distract from their main purposes. They should also investigate how to enhance core competitiveness by strengthening stable and efficient cooperation with financial institutions. Companies and financial institutions need to deepen their understanding of each other's development and closely observe the opportunities and challenges in industrial development to make strategic trade-offs, create a cognitive foundation for professional cooperation, and find the greatest common denominator of cooperation.

The second is long-term cooperation. Companies and financial institutions should form lasting cooperative relationships. In China, the vast majority of both types of organizations have short operating histories and little experience in testing across different cycles. The lack of mutual integration and trust also drives difficult and expensive financing to a certain extent. This factor has required companies to rely on external guarantees to obtain financing or bear higher financing costs. For a creditworthy company, strong support from at least one financial institution

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that allows for quick fundraising when major opportunities or temporary difficulties occur, combined with a joint response to adversity, may make corporate development and growth easier.

The third is more targeted product design. A stable cooperative relationship helps financial institutions clearly understand the full cycles of corporate production and capital from production to product sales and from capital investment to capital withdrawal. Better financing, wealth management, and payment products can be designed according to a company's cash flow status, and pricing based on operating risk and product characteristics enables the efficient operation of corporate funds.

By utilizing the efficient services of financial institutions to better connect with external financial markets, companies can continuously operate with greater economic leverage to effectively reduce their financial costs. Moreover, they can focus more resources on developing and improving their main business products to enhance market competitiveness. In comparison, financial institutions with improved product design can enable financial service solutions to better meet corporate financial needs, maintaining client loyalty and satisfaction, and increasing market viability. Only when more participants in the market become more competitive can the transformation of China's economy shift towards high-quality development.

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