asifma
Growing Asia's Markets

China's Capital Markets

Continuing to Navigate the Road Ahead

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Disclaimer

ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Executive Summary

2018 marks the 40th anniversary of Deng Xiaoping's reform and opening-up. Over the last 40 years, China has witnessed progressive liberalisation of its capital markets and its contribution to the world economy, with China now being the world's second largest economy. Since ASIFMA published its paper China's Capital Markets – Navigating the Road Ahead in March 2017, China's capital markets have continued to develop and open up at an unprecedented pace. Over the last 12 months, we have seen the announcement of the lifting of ownership caps for securities firms, funds and futures, the launch of Bond Connect, the further development of Stock Connect, onshore FX hedging in China's Interbank Bond Market (CIBM), and the opening of local bond ratings to global agencies. This update to our original report provides a revised list of recommendations to address the developments now needed to continue to develop and open up China's capital markets.

We were encouraged by directives from the 19th National Congress of the Communist Party of China (NCCPC) to further open up China's capital markets to boost reform and development, especially those geared to better serve the real economy, increase the proportion of direct financing and cultivate the healthy development of multi-layered capital markets. This was confirmed by Minister Liu He during his speech at Davos 2018 where he spoke about the imminent announcement of new market access measures and greater protection for intellectual property.

The industry most welcomes the announcement made shortly after the Party Congress by State Council to increase and ultimately eliminate foreign ownership limitations for securities firms, futures firms and fund management companies. Indeed, this is a timely and important step towards the continued opening and reform of China's economy. Ownership caps in these sectors will be relaxed to 51% and, after three years, eliminated completely. The industry encourages expedited implementation of the announcement and the removal of other indirect impediments and hidden barriers that could still prevent a level playing field for foreign firms operating in the PRC. To that end, we welcome the CSRC consultation on the Administrative Measures for Foreign-invested Securities Companies, which was issued on 9 March 2018. It has also been rumored that the 20% monthly cap on repatriation by Qualified Foreign Institutional Investor (QFIIs), which ASIFMA has been advocating, will be lifted and we request that it will be shortly.

We also welcome the announcement of the Financial Stability and Development Commission (FSDC) to better lead and coordinate financial market reforms across all segments of the industry. There is much opportunity for financial markets not only to help deleverage and to reduce risks in China but also to better support the real economy and to improve its financial strength as well as to improve the livelihood of society in general.

Another major announcement was the launch of Bond Connect, which shows that China is accelerating the liberalisation of its capital markets. Bond Connect is a new mutual market access scheme that allows investors from Mainland China and overseas to trade in China and Hong Kong's bond markets through connection between the related Mainland and Hong Kong financial infrastructure institutions. Northbound trading commenced on 3 July 2017, allowing overseas investors from Hong Kong and other regions to invest under the Bond Connect through mutual access arrangements in respect of trading, custody and settlement. Southbound trading under the Bond Connect will be explored at a later stage. We believe that the addition of further trading platforms, tax clarification for foreign investors and real-time Delivery Versus Payment for China government bonds are needed for Bond Connect to fully develop. In the meantime, the market awaits the inclusion of CIBM bonds in global fixed income indices. We believe this will be a welcome development as it will create a stable class of foreign investment in the CIBM; naturally many of the recommendations we made in regard to the development of CIBM will need to take place. In February 2018, the Bloomberg-Barclays index decided not to include CNY bonds and the timing of future inclusion will depend on the progress of resolving the above key technical hurdles.

A significant step taken in 2017 to further open up the capital markets was allowing foreign institutional investors in the CIBM to have access to onshore FX risk hedging arrangements. The lack of onshore hedging capabilities was previously an impediment for foreign investors who had to resort to more expensive offshore FX hedging solutions. It still remains unclear whether QFIIs and Renminbi (RMB) Qualified Foreign Institutional Investor (RQFIIs) that invest in the CIBM also have access to onshore FX hedging products, which ASIFMA has been advocating.

Another welcome announcement in the bond market is that China has opened its doors to foreign credit rating agencies to rate bonds in the CIBM. However, there has been limited uptake and there has been little progress made so far in getting the international rating agencies to set up WFOEs.

On the equities side, MSCI's decision to include 222 Chinese A-shares in its Emerging Markets Index in 2018 was a milestone in capital market development. Inclusion will take place in two steps, with the addition of Chinese A-share stocks in May and August of 2018. A-shares will represent 0.73% of the weight of the MSCI Emerging Markets Index at a 5% partial inclusion factor (PIF). As of June 2017, USD1.6 trillion Assets under Management are benchmarked against this MSCI's emerging markets indices and China's inclusion is expected to lead to a growing influx of funds into the Chinese market from international investors. Although we applaud MSCI's inclusion of Chinese A shares in its emerging markets indices this year, we note still significant upside from the current 5% PIF and we look forward to partnering with China to help improve access for foreign institutional investors in order to pave the way and bring PIF to 100%.

The smooth implementation of Hong Kong-China Stock Connect and the build-up of institutional investor flows using this channel played no small part in MSCI's decision to include A-shares and we commend China's self-confidence to provide multiple channels of access to its markets for different categories of foreign investors at different stages of their engagement with China. ASIFMA is currently working closely with the investment community to launch Northbound ID in Q3 for greater market transparency, as well as with regulators on both sides regarding concerns about the insufficiency of the Northbound Daily Quota as well as with CNH liquidity. As we represent the global financial services industry, we can attest to its strong interest to invest in China and welcome any opportunity to help serve as a bridge to promote the right set of reforms at the right time to strengthen China's capital markets connection with the rest of the world but in a controlled manner.

Finally and not lastly for equities, we are encouraged by the significant reduction in the number of trading self-suspensions in the market this past year owing to improved regulatory oversight as well as improvements in corporate governance. This was the first on our list of equities recommendations when we launched our white paper last year.

China has also taken a leadership position in green finance and notable green bonds issuance. Climate Bonds Initiative figures show that total green bond issuance from China reached USD37.1 billion (RMB248.6 billion) in 2017, 4.5% up on the previous record-breaking year, making China the second largest green bond market in the world.

China has also emerged as a leading FinTech centre with four of the top five FinTech 100 now located in China.

While China has come a long way in 40 years – and made many significant developments in 2017 alone – further and accelerated reform is needed to support China's transition from a phase of rapid growth to a new stage of high-quality development. Access for foreign firms is still limited. This transition will not be possible without the support of the financial sector and the capital markets. We have outlined below our recommendations for the further development of China's capital markets. Per our report in 2017, these recommendations are not listed in any order of importance, nor do we prescribe a sequence for their implementation. The reality is that governing a country the size of China is extremely complex and the key message is to do what is achievable rather than adhere rigidly to a particular order of action. Over-emphasis on the order of implementation could risk bogging down reforms in regulatory inertia or disagreement on nonessentials. Moreover, most capital market reforms are highly inter-connected. We believe that the vast majority of reforms recommended in this paper need to occur if China's capital and financial markets are to reach their full potential.

Recommendations

1. Equities

- Promote increased participation by institutional investors, who can help to stabilise the market and improve capital market efficiency.
  - Offer QFII/RQFII investors the option to buy and sell through more than a single broker for each exchange so as to better ensure best execution
  - Extend block trading hours from the current limited window of 3:00pm to 3:30pm post trading to allow block trading during the entire trading day and to better align with international practice
  - Relax the Third Party Connection rule to allow Direct Market Access for institutional clients to trade directly via broker trading systems
  - Facilitate omnibus trading at the fund manager level to improve efficiencies and to provide fair and equitable pricing to their underlying funds
  - Develop an efficient Stock Borrow Loan environment to enhance overall equity market efficiency, enable efficient short selling to better manage risks, and allow participation of insurance companies and pension funds to help increase their yield on long term equity holdings
  - Continue reforms to discourage trading suspensions (except under exceptional conditions set out in transparently applied rules) to safeguard market liquidity – the industry appreciates progress already made
  - Terminate the current practice of 'window guidance' and instead provide clear rules and guidance re restrictions on selling activities
  - Allow off market trading to facilitate best execution, including alternatives to exchanges such as MTFs and ATSs
  - Widen allowable price moves for equities and consider reintroducing circuit breakers
  - Move to a settlement cycle where cash and stock settle simultaneously e.g., DVP, to protect investors (e.g. to T+2) as well as to remove the prefunding requirement to align with global practice
  - Allow for day trading
  - Less restrictions on the trading of futures contracts
- Permit foreign securities joint ventures to complement underwriting capabilities with securities brokerage licensing immediately, removing the current 3-year profitability prerequisite.
- Reform the pricing of IPOs by allowing market forces to determine prices; simplify the offline/online subscription process for IPOs.
- Adopt transparent rules for delisting sub-standard companies.
- Calculate short swing profit rule regarding holdings on an individual client/fund basis rather than at the fund manager level.

2. Fixed Income

- Broaden the range of financial instruments that can be used to satisfy bank liquidity requirements, and reduce the absolute level required.
- Adopt best practices based on global standards in information disclosure, for the prospectus/issuing document at the time of the new issue and on a continuing basis.
- Strengthen the financial, legal and business due diligence process in the primary markets.
- Streamline the bookbuilding process to provide flexibility in price determination similar to the process used in international offerings.
- Create a liquid classic repo framework for the repo market.
- Suggest CCDC to pay the coupon on repo bonds (pledge type) in CFETS directly to the lenders of the bond and clarify tax treatment on bond lending in CFETS with CIBM bonds as underlying.
- Allow banks, which are the major holders of bonds, to participate in the bond futures market.
- Issue guidelines for offshore investors and other market participants on the Chinese domestic CDS market.
- Formalise the central clearing of CDS and the designation of CCPs to mitigate counterparty risk.
- Harmonise the different securitisation regimes to create a bigger, deeper and more liquid securitisation market.
- Allow all foreign investors (including QFIIs) in China's bond market to hedge onshore their FX and interest rate risks.
- Clarify the tax treatment and withholding mechanism for foreign investors investing in China's bond market including:
    - Expand the Value Added Tax (VAT) exemption currently applicable to domestic financial institutions to foreign institutions due to the limited definition of financial institution under the current VAT regulation, including VAT exemption on financial bond interest and repo interest. The restriction on the exemption on domestic financial institution will create discrimination between foreign and domestic financial institutions.
    - VAT and withholding tax on the CIBM bond interest, if any, should be withheld by clearing housing on a centralized basis with tax treaty status of the foreign bond holder being considered.
- Continue and finalise the work done between EIB and PBOC on the taxonomy in the green bond catalogue.

3. FX

- Continue to encourage greater competition in electronic execution by allowing other platforms, similar to R5, to collaborate or to compete with CFETS thereby improving efficiency and driving down the costs of execution.
- Continue to identify opportunities to introduce new products to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.

- Clarify whether FX hedge transactions in the interbank FX market is exempt from VAT, in line with VAT exemption in the local currency market.

4. Laws and Regulation

- Increase regulatory transparency and consistency by a more open market consultation process, providing sufficient notifications of new rules and allowing public comments.
- Improve transparency and reliability of auditing and accounting standards to increase confidence by international investors in China's corporate governance.
- Improve the corporate resolution and bankruptcy process to allow investors to predict the impact of defaults by, among other things, ensuring the enforceability of all investor's direct security interest, if any, in a fair, transparent and clear manner in a restructuring or bankruptcy.
- Implement a resolution and recovery regime for financial institutions that is consistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.
- Incorporate clearly and unambiguously the enforceability of close-out netting in statute, reflecting internationally accepted practices.
- Amend the Securities Law to support the exchange of variation margin used in the international markets and reflecting internationally agreed standards.
- Clarify in the Securities Law the rights of beneficial owners and the responsibilities of nominee holders.
- Clarify the applicability of financial institutions' asset management regulations to private fund managers, particularly PFM WFOEs.

5. Market Infrastructure

- Create statutory provisions for settlement finality on transactions with CCPs and transactions across financial infrastructures in the Bankruptcy Law reflecting international standards enumerated in the CPMI-IOSCO Principles for financial market infrastructures.
- Allow the clearing member to create a security interest over cash in the margin account which is recognised by China's Property Law or Securities Law.
- Prioritise the application of SHCH to be recognised as an equivalent CCP under EMIR and as an exempt DCO by the CFTC.
- Provide foreign investors the option to use omnibus accounts to allow them to benefit from cost savings and efficiencies they currently enjoy from other developed markets. This would allow a simplification in their operating model and improve time-to-market for new products by avoiding the need to open segregated accounts in the entire chain.
- Ensure that the domestic market infrastructure is compatible with international standards, including the PFMI, in order to expand the use of the RMB as an international currency.
- Settlement of the RMB on a PvP basis in central bank money accounts with multilateral netting would support the continued, stable expansion in the global use of the RMB for trade, investment and as a reserve currency, and meet internationally agreed standards.
- Allow third party custodians to hold initial margin on behalf of the posting counterparty.

6. Market Access

- Implement the announced increase and elimination of foreign ownership cap for securities, trusts, asset management, and credit ratings entities.
- Harmonise the requirements of similar access programmes with a view towards future consolidation and/or alignment to improve efficiencies.
- Provide a level playing field by allowing international banks and financial institutions to acquire underwriting licenses on a fair and transparent basis.
- Remove all repatriation limits (e.g. QFII) and quotas (e.g. daily quota under Stock Connect) across all access programmes.
- Allow QFII/RQFII to be able to invest in private funds in China.
- Amend the rules on Stock Connect to allow affiliates of Exchange Participants, such as asset managers and custodians, to engage in stock borrowing and lending, and to permit block trades under Stock Connect.
- Improve the transparency and efficiency of the Northbound fund approval process under the MRF.
- Increase the range of issuers (besides just the sovereigns and quasi-sovereigns) for panda bonds, allow international credit rating agencies to rate panda bonds and allow flexibility in accounting rules in line with global standards (particularly for US GAAP).
- Further enhance the Bond Connect scheme, including streamlining the registration process, implementation of DVP settlement, introduction of block trading capability, accelerating the approval of more trading platforms, lowering the costs of onboarding and trading, and expanding the range of approved dealers to regulated offshore parties.
- Allow foreign investments into an onshore trust holding for securitised assets.
- Adopt a flexible interpretation of the Cybersecurity Law at the implementation level for the financial industry.
- Promote investor education programs that teach key principles of investment such as an understanding of risk, the role of diversification, and the importance of building a portfolio with an appropriate investment horizon.

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