

Further Opening-up of the Financial Services Industry

HSBC

Executive Summary

China's long-standing objective has been to create what President Xi calls "a moderately prosperous society", and from there "a great modernised socialist country". Reform and opening up has been the critical enabler of that vision, and fundamental both to China's rapid economic transformation and its integration within the global financial system.

But while opening up has been integral to China's past success, it's arguably even more important to its future. As China enters the next stage of its growth, further reform is necessary to help the economy generate its own demand without the need for significant stimulus. This means boosting the role of the real economy, moving industries up the value chain and improving the environment for foreign investment. Further reform and opening up of the financial sector goes hand-in-hand with this.

Recent examples show the benefits reform can bring. The incremental opening up of the onshore bond and equity markets has started to increase foreign participation, and paved the way for China's inclusion in global indices like the MSCI. Recent announcements about reform of state-owned enterprises, funding support for the private sector and steps to create a more level playing field within China are also all significant.

While China is the world's second largest economy, in contrast, there is still some way to go in the further opening up of its financial sector. In recent years, China's overall business environment has improved significantly. High-level policy for opening-up the financial industry is largely in place; however implementation is now the key.

Drawing on various sources of feedback, including white papers from the European and American Chambers of Commerce in China, the common issues could be summarised as below from the perspective of market entry and market participation of foreign investment:

- a) Even after the lifting of restrictions on market entry for foreign investment, promulgation of detailed rules and implementation plans does usually require time, and the approval process relating to some business licenses can be time consuming given the complexity.
- b) Implementation of the opening-up policies of the financial services industry is still dominated by the "positive list" approach.
- c) Financial regulatory framework should be more flexible; and the barriers for foreign investment participation should be reduced.
- d) Coordination amongst different regulatory authorities in implementing policies needs to be strengthened.

Based on our observations of implicit and explicit institutional barriers to market access and market participation for foreign financial institutions, as well as operational obstacles and difficulties facing foreign financial institutions and their

customers, the following four initiatives are proposed to the Chinese regulators and government authorities for consideration. These recommendations may be operational in nature, but would greatly aid in the actual implementation of policies.

1. Simplify the approval process and various formalities in existing policies and measures; reduce barriers for foreign capital to enter China's financial market; encourage foreign companies and foreign investors to further participate in the China securities market; and expand the types of entities and forms of foreign participation in China FX market.

a) Simplify the procedures for foreign investors to participate in the China Interbank Bond Market (CIBM).

- Allow bond settlement agents to provide intra-day or overnight overdraft funding arrangements.
- Remove the requirement on the bond settlement agency agreement.
- Further relax the regulatory requirements on multi-currency remittance by overseas institutional investors in CIBM.

b) Broaden the types of participants and methods of participation of foreign institutions in the FX market.

It is suggested that allowing foreign institutions to participate in the domestic FX market in various ways, for instance, not only allowing foreign institutions to

trade on the China Foreign Exchange Trading System (CFETS), but also simplifying the regulatory reporting process.

c) Allow and encourage foreign banks to provide financial services to third-party payment institutions and cross-border e-commerce companies.

It is suggested that China's regulator consider opening cross-border settlements and other related financial services for third-party payments to foreign banks to better support e-commerce players' overseas expansion by leveraging the global networks of foreign banks and driving the overall development of the third party payment market.

In addition, China's regulators can provide more flexible guidance and consider the overall operational and risk control capabilities of foreign banks, as well as the capitalisation of parent banks to allow qualified foreign banks to provide Payment Institution Account service to cross-border PSP and e-commerce companies.

2. Improve the infrastructure of the domestic financial market and promote the development of China's credit derivatives market.

It is suggested accelerating the process of establishing the close-out netting mechanism and the closed-out netting mechanism in order to improve the legal infrastructure of the derivatives market and to improve development of the credit derivatives market.

Without close-out netting, China counterparties will incur higher funding and transaction costs since non-netting jurisdiction counterparties may have to

calculate the exposures on a gross basis rather than net basis or limit trading volumes in cross-border business.

3. Continue to expand the RMB cross-border investment channels and promote RMB internationalisation (RMBI) and capital account convertibility.

It is suggested expanding individual RMB investment channels and launching the Qualified Domestic Individual Investor Programme (commonly known as QDII2) to allow domestic individual investors to invest in securities, bonds, etc., in overseas capital markets. QDII2 would enable domestic investors to expand investment scope and improve the effectiveness of asset allocation and asset liquidity.

It is also suggested establishing more cross-border financial service platforms, such as “Insurance Connect”, “South-bound Bond Connect”, “ETF Connect”, “Primary Equity Connect” and so on.

4. Further opening-up of the financial services industry does not necessarily jeopardize supervision and risk prevention.

China can leverage international experience and regulatory practices in countering risks for financial industry. In particular, China can refer to the structural reforms made by countries in Europe and the US following the global financial crisis. These countries have formed a unified, coordinated and efficient financial regulatory system by strengthening cross-department coordinator mechanisms for financial industry and enhancing the cross-market, cross-industry, and cross-regional regulatory supervision.

It is therefore suggested that China could consider establishing a number of cross-departmental working groups under the Financial Stability and Development Committee (FSDC) to provide strong support to the Committee, which should be comprised of senior officials from the relevant authorities. These working groups could study and evaluate the risks presented by new cross-market, cross-industry and cross-region policies; and could assess the impact of changes in the international financial market to China's financial policies. More importantly, by strengthening coordination, the initiatives deployed by FSDC could be implemented quicker and more effectively in various government departments.

Context: The case for continued reform and opening-up

China's long-standing objective has been to create what President Xi calls "a moderately prosperous society", and from there "a great modernised socialist country". Reform and opening up has been the critical enabler of that vision, and fundamental both to China's rapid economic transformation and its integration within the global financial system.

But while opening up has been integral to China's past success, it's arguably even more important to its future. The paradox of reform is that it becomes more important as a country develops and moves up the value chain, yet also harder to achieve. As China enters the next stage of its growth, further reform is necessary to help the economy generate its own demand without the need for significant stimulus.

This means boosting the role of the real economy, moving industries up the value chain and improving the environment for foreign investment. In the medium-term this will make growth more sustainable and inclusive.

Further reform and opening up of the financial sector goes hand-in-hand with this. By increasing levels of foreign investment, China can further develop the direct financing market, and provide the economy with the level and diversity of funding it needs. It can better serve and support the needs of its growing middle class, and provide its industries with both the expertise and the capital they need to move up the value chain and internationalise.

Recent examples show the benefits reform can bring. The incremental opening up of the onshore bond and equity markets has started to increase foreign participation, and paved the way for China's inclusion in global indices like the MSCI. Recent announcements about reform of state-owned enterprises, funding support for the private sector and steps to create a more level playing field within China are also all significant.

With the global economy expected slowing this year and into 2020, cautiously increasing the pace and depth of financial sector reform can form part of China's response to changing external conditions. This paper sets out our recommendations, and also suggests ways in which existing processes can be improved and made more efficient.

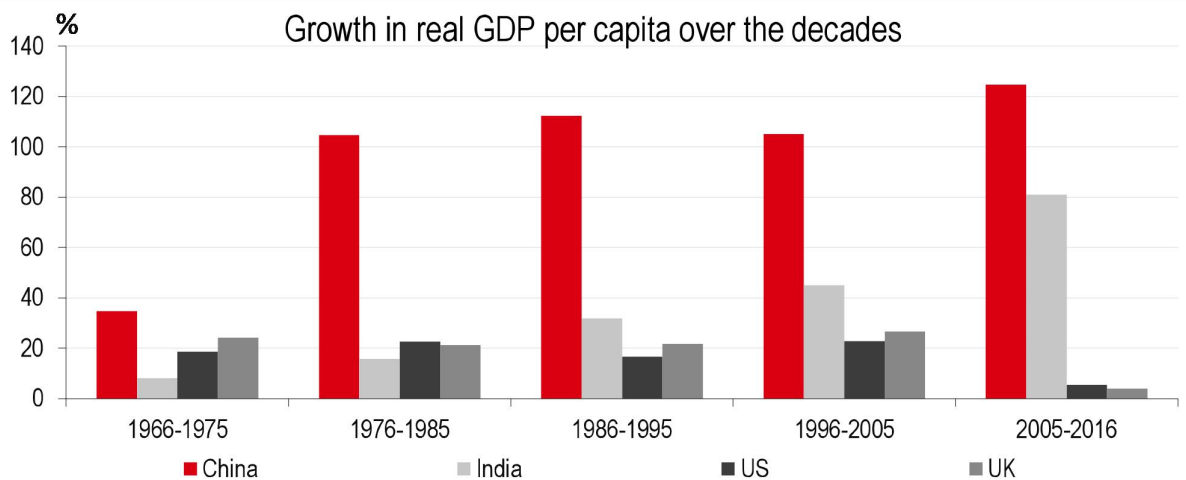
I. The merits to opening-up the financial services sector and integrating internationally: the global experience

Forecasts from the World Bank and IMF project that global economic growth may slow down during 2019 and 2020. In the context of anticipated macro-economic headwinds, the financial services industry globally will face increasing pressure of structural adjustments.

On one hand, the uncertainty stemming from trade tensions continues to persist, and geo-political risks are rising. A few emerging economies are already in recession and much of the developed world has slowed down. The Fed's tightening of monetary policy has caused capital outflows in emerging markets and turmoil in international financial markets.

On the other hand, the shift of global economic growth from the west to the east is still carrying on, and the overall trend of globalisation – while interrupted – remains unabated. The balance of power between developed economies, chiefly represented by the US, and emerging economies, represented by China, is changing (Chart 1).

Chart 1: The economic centre of gravity is shifting east



Source: World Bank, HSBC estimates

i. Despite the structural changes and challenges facing the world economy, global financial conditions are still relatively accommodative. On balance, there are stronger merits to opening-up the financial services sector and integrating internationally.

Global banking industry’s total assets grew in 2018 and asset quality improved, with the exception of a few Latin American countries. As the monetary policy stance of

some major economies has changed from one of easing to neutral, this provides support for earnings of the banking industry with higher net interest margins.

As for the global financial regulatory environment, the trend of imposing stricter supervision has continued since 2008, and a series of important regulatory policies and measures, including Basel III, have been introduced and fine-tuned. The pressure of regulatory supervision placed on financial institutions, especially large and systemically important financial institutions, is still rising.

In the context of financial sector opening-up, the industry usually views this via two dimensions: the opening-up of financial services sector, and the opening-up of capital accounts.

After the global financial crisis in 2008, there has been a lot of debate regarding the opening-up of capital accounts, and certain policy makers have become more cautious in this area. By contrast, the opening up of financial services sector have gained traction and achieved much faster growth in recent years, given it can attract foreign financial institutions to invest in the domestic market, increase competition within the industry while introducing new management skills and capabilities; which in turn help to drive domestic economic growth and improve the efficiency of investment and financing.

When balancing between risks and benefits on the whole, there are stronger merits to opening-up the financial services sector and integrating internationally.

ii. The past experience of opening-up the financial service industry in developed and emerging markets demonstrates that the level of openness is correlated with increased efficiency of the financial services sector.

In the UK and the US, where capital markets are developed and opened, companies tend to seek direct financing through capital markets; In contrast, China's financial system is dominated by indirect financing through banks, which is similar to the financial systems in Germany and Japan. The experience and progress of Germany and Japan in opening-up the shareholding restrictions of foreign investors in the domestic financial industry can be of good reference.

Both Germany and Japan lifted its restrictions on foreign shareholdings in banking, securities and insurance, which in turn attracted foreign players to enter their respective local financial sectors. As such, the entrance of foreign banks had generally improved the profitability and stability of the countries' banking industries.

From 2001 to 2016, the capital adequacy ratio of the banking industries of Germany and Japan increased steadily, and the proportion of non-performing loans continued to decline. At the same time, foreign banks did not replace local banks' dominant positions in their domestic markets. By the end of 2016, foreign owned bank assets in Germany and Japan accounted for 29.6% and 3.8% respectively, and local banks remained market leaders by a significant margin at their domestic markets.

Emerging markets such as Brazil, Russia, India and South Africa have all accelerated their financial industry reforms in recent years. These efforts have improved accessibility of financial services and investor protection in those countries; and in some ways have been ahead of China.

II. As a highly competitive industry, China's financial industry has significant room to improve efficiency, as well as effectiveness in deploying financial resources to serve the real economy.

While China is the world's second largest economy, in contrast, there is still some way to go in the further opening up of its financial sector.

i. In recent years, China's overall business environment has improved significantly. High-level policy for opening-up the financial industry is largely in place; however implementation is now the key.

China's overall business environment has significantly improved over the years as a result of targeted reforms. According to the "2019 Business Environment Report" by the World Bank, China's overall business environment ranking rose from 78th among the world's 190 economies in 2016 to 46th in 2017. Efficiency has significantly improved in terms of starting-up of business, streamlining of tax compliance procedures/ tax reductions, access to electric power infrastructure, protection of investors and facilitation of trade. However, certain aspects such as the ability for businesses to obtain credit still lags behind in terms of global ranking.

Most major world economies have removed restrictions on foreign ownership in banking, securities and insurance sectors. Even though there may still be a shareholding ratio requirement in some countries, the treatments of domestic and foreign investments are largely the same.

China is one of the few countries that still treats foreign financial institutions differently in terms of shareholding ratio and business scope. A series of policies issued from early 2018 has taken the next major milestone step in

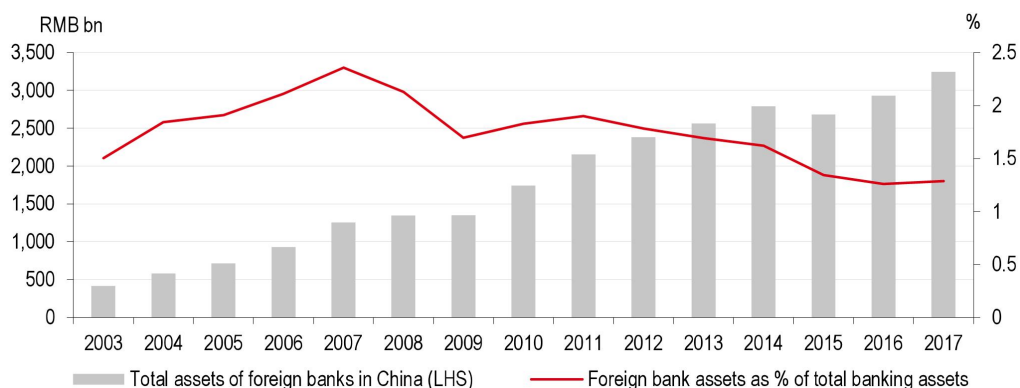
genuinely opening-up China's financial services industry. With further relaxation of restrictions on foreign shareholding in commercial banks, asset managers, brokerages and insurance companies, barriers to market entry have been significantly removed in principle. However, the effectiveness of these policies lie in its successful implementation.

According to the Financial Repression Index compiled by the Organisation for Economic Co-operation and Development (OECD) – which is a measure of losses incurred by savers and asset holders due to distortions imposed by official regulations and intervention in the financial system – China's index ranking is still high when compared with other countries. Key factors attributed to such ranking include the lack of depth of financial markets, limitations to private sector investment channels as well as the absence of interest rate marketisation.

In addition, state-owned shareholding in the financial industry is still deemed to be higher than international peers. According to China's Ministry of Finance, as of end-2017, more than 80% of the banking industry shareholding was owned by the state, and there continues to be market entry barriers for foreign investments.

At the end of 2017, total assets of China's banking industry was RMB 252 trillion, of which foreign bank assets accounted for only 1.32%. This was lower than the average market share of 2% between 2007-2011 (Chart 2). The market share of foreign investments in total assets and premium income of the insurance industry was 6.71% and 5.85% respectively - both having remained at a low level.

Chart 2. Market share of foreign-invested banks in China has gradually declined in the past few years



Source: CBIRC, HSBC estimates

As for China's bond market - which is the third-largest in the world - foreign institutions accounted for only 2.3% of debt holdings in the China interbank market at the end of 2018. Furthermore, in the China A share market (also the third-largest in scale globally), foreign capital accounts for about 6% of total market value, suggesting significant room for growth.

Perhaps more importantly, the scale of China's financial industry is huge but the efficiency of serving the real economy is not yet optimal. One reflection is the difficulties faced by the private sector in accessing financial resources – although it is noted that credit easing measures for the private sector have been recently announced.

In this context, it is very understandable that the top priorities for China is to deepen financial reform – so that the financial sector can meet the long term needs of China's economic transformation, to open up and diversify the country's financial services industry, and to improve the efficiency of the financial sector. As encapsulated by President Xi Jinping at the Boao Forum in early 2018 when he

announced the expansion of the opening-up financial services industry policy, the implementation of the opening-up policy should be "the sooner the better".

ii. The focus of market entry and participation of foreign investment still lies in the transparency of policy formulation and the coordination of policy implementation. There is still room for improvement in the policies' regulatory implementation.

Referring to the relevant white papers of the European and American Chambers of Commerce in China, the common issues could be summarized as illustrated in the table (Table 1) from the perspective of market entry and market participation of foreign investment.

Table 1. Common issues confronting foreign financial companies in China: market entry and market participation

Focuses	AmCham China		EU Chamber	
	Key Challenges	Affected Business	Key Challenges	Affected Business
Limited financial market access	Difficulties in obtaining required licenses	Lead underwriter in CIBM	Limitations on shareholding ratio; Limitation on specific businesses	European banks and securities companies' business licence application
		Qualification of custody service		Acquiring of lead underwriter qualification
Institutional obstacles	Limited business scope and strict qualification assessment	Limitation of shareholding for foreign invested securities broker-dealers	Limitations on the expansion of foreign institutions	Review on macro prudential requirements
		JV's business scope expansion		Foreign debt indicators
		Financial qualification of JV partner		Address funding limitations in the interbank foreign exchange market
	Requirements to comply with Chinese	Accounting standards of Panda Bonds issuance	Lack of openness of following international practices	Accounting standards and financial statement of Panda Bonds

	standards or inability to participate in standards setting	Market access of international credit rating agency		issuance International credit rating of Panda Bonds issuers
Complicated administrative approval process	Complicated administrative approval process		Branch/sub-branch business development barrier	Establishment of new branches and sub-branch offices Downsize or exit some activities or unprofitable segments/locations
Inconsistent and unclear regulatory policies	Inconsistent regulatory interpretation and unclear rules	Clarification of articles in CAC Draft Measures and Cybersecurity Law Detailed qualification criteria for Northbound Trading application for Bond Connect between Mainland and Hong Kong	Limitation/requirements for foreign banks to move IT onshore; Regulations referring to IT security and controllability requiring foreign banks to purchase Chinese technology	Implementation of Cybersecurity Law

Source: European Chamber of Commerce, American Chamber of Commerce, HSBC analysis

- a) Even after the lifting of restrictions on market entry for foreign investment, promulgation of detailed rules and implementation plans does usually require time, and the approval process relating to some business licenses can be time consuming given the complexity.

There is still a lack of specific supporting rules or detailed implementation procedures, even in areas where there have been high-level policy liberalisation. In particular, cross-regulatory and cross-departmental approvals usually require the relevant authorities or regulators to have their respective administrative measures in place for approval.

From national laws to the administrative measures and departmental regulations, any full implementation of a policy would require a prerequisite, i.e. the alignment

of the legislative and administrative measures or guidance among the relevant government authorities and regulators. Otherwise, a scenario often seen is that “there is a closed door inside an open door”.

In reality, foreign institutions are excluded from the scope of eligible institutions. Some qualified foreign banks with large business bases, strong business performance and sound risk management are still excluded from applying for a new business or license due to its foreign ownership, even if they meet the qualification requirements (which may include measures such as net assets, capital adequacy ratio, compliance and risk control, corporate governance, etc.)

- b) Implementation of the opening-up policies of the financial services industry is still dominated by the “positive list” approach.

Compared to the positive list approach that would only lay out services and sectors covered by the market access rules, the negative list outlines all the sectors where national standards do not apply to foreign investors, hence providing more corporate freedom.

Using securities issuance as an example, under the current “pre-approval” approach, regulators not only conduct a thorough review of the issuer’s compliance performance and business qualification qualitatively, but also control the size of issuance and issuance price. Such a non-market driven approach will inevitably intensify the friction between market participants and regulators, and will weaken the functionality of the market. From a macro angle, a very strict market entry mechanism for securities issuance also inhibits the development of

derivatives markets and risk hedging products, impacting the role of financial markets in pricing, monetary policy transmission and risk management.

There is still room for improvement regarding overall policy implementation in China's financial sector. If a "negative list" approach for supervision of foreign investment market entry can be adopted – to be in line with other domestically owned financial institutions in the name of "national treatment", there is no doubt that it will play a key role in clarifying the boundary between financial markets and financial supervision, and will help promote the openness and transparency of policy implementation.

- c) Financial regulatory framework should be more flexible; and the barriers for foreign investment participation should be reduced.

Some large international financial institutions have implemented full-scale and strict control mechanisms given their presence and experience in overseas markets, including enhanced regulatory and compliance requirements in markets particularly affected by financial crises.

In contrast to domestic financial institutions, foreign financial institutions in China are generally much smaller in terms of assets. Yet in certain business and market segments, the simple application of "one rule fits all" for all market players does not create healthy and diversified competition.

Taking banking policy as an example, a large number of market entry rules emphasise the size of assets or capital of the applicant, preventing foreign banks from applying for new business or license just because foreign banks operate on a smaller business scale. At this time, the size and qualifications of foreign banks'

parent banks are excluded from qualification consideration. This has led to the decline in market share of foreign banks.

Therefore, the importance of consultation with market participants during the process of drafting and improving rules and regulations cannot be overstated. On the policy implementation side, if there are no material and fundamental conflicts in guiding principles between domestic and international practices, it is recommended that foreign financial institutions be permitted to follow international practices at operational level and to allow certain flexibility in conducting business in China, with an aim to promote the stable development of financial market diversification and promote the pace of opening-up.

- d) Coordination amongst different regulatory authorities in implementing policies needs to be strengthened.

In parts of the financial markets which have already opened-up, the launch and operation of some businesses need coordinated efforts among regulators and different government authorities, and among different departments within a same regulatory/ government body (e.g. joint pre-approval). The current independent approach taken by regulators or government authorities in formulating new policies or regulations may inevitably lead to situations where different regulatory/ government bodies may take different opinions or positions, causing confusion or even conflict on the same issues. Such situations may create uncertainty for foreign banks who are committed doing business in China.

In recent years, various local governments have introduced a “one-stop problem-solving” mechanism, which has significantly improved the overall

business environment. They are still mostly concentrated on the process of establishing business entities, including the business registration process. What is still required is an efficient and effective coordination mechanism for various administrative approvals to support business development in China.

The establishment of a high-level cross-ministerial level coordination mechanism will help foreign investors to effectively resolve obstacles and difficulties facing their entry into the Chinese market and in developing business, as well as help foreign investors respond to different regulatory policies in a timely manner.

It is also noted that during the Executive Meeting of the State Council on 20FEB19, Premier Li Keqiang requested that all government departments must solicit opinions from relevant enterprises and industry associations at the time of formulating laws, regulations and administrative documents, in an aim to make governmental decisions more practical and transparent. The central government's guidance is highly encouraging and further exchange of information between the government and commercial institutions in future is anticipated.

III. Policy recommendations

HSBC suggests that the challenges impeding the efficiency of the financial services sector discussed under Section II can be a starting point for the Chinese Government to develop initiatives which will result in the further opening-up of the financial services sector.

Based on our observations of implicit and explicit institutional barriers to market access and market participation for foreign financial institutions, as well as operational obstacles and difficulties facing foreign financial institutions and their customers, the following four initiatives are proposed to the Chinese regulators and government authorities for consideration. These recommendations may be operational in nature, but would greatly aid in the actual implementation of policies.

i. Simplify the approval process and various formalities in existing policies and measures; reduce barriers for foreign capital to enter China's financial market; encourage foreign companies and foreign investors to further participate in the China securities market; and expand the types of entities and forms of foreign participation in China FX market.

a) Simplify the procedures for foreign investors to participate in the China Interbank Bond Market (CIBM).

- Allow bond settlement agents to provide intra-day or overnight overdraft funding arrangements.

To better support funding efficiency of overseas investors, we suggest China's regulators allowing bond settlement agents to provide intra-day or overnight overdraft funding arrangements to overseas investors before the funding reaches their onshore account.

- Remove the requirement on the bond settlement agency agreement.

According to the existing requirement, overseas investors are required to sign the bond settlement agency agreement with a bond settlement agent before

entering into the market. However, the negotiation of such agreement is usually very time consuming and requires significant legal resources, therefore would slow down the whole process and demotivate investors from entering into CIBM. It is suggested that overseas investors can follow the practice of Bond Connect for entering into CIBM by selecting the suitable model for agreement execution among overseas investor, global custodian and local custodian according to market norm overseas.

- Further relax the regulatory requirements on multi-currency remittance by overseas institutional investors in CIBM.

Some overseas investors' find the multi-currency ratio calculation method adopted by Chinese regulator to be very complicated. Some overseas investors may not be able to conduct repatriation under certain circumstances due to the multi-currency ratio requirement, and have to sell the bond holding to adjust their repatriation amount to fulfill the ratio between the accumulative foreign currency repatriation and accumulative RMB repatriation, causing additional operation and funding cost for investors. Under this circumstance, the investor may be hesitant when planning their investment size.

- b) Broaden the types of participants and methods of participation of foreign institutions in the FX market.

Broadening the types of participants in the domestic FX market will help introduce different trading needs to the domestic FX market, and hence encourage a more diverse set of trading behaviors for the market. It is also suggested broadening the

types of foreign institutions permitted to participate in the domestic FX market, together while continuing to allow foreign institutions to participate in the domestic FX market in various ways, for instance, as well as allowing foreign institutions to trade on the China Foreign Exchange Trading System (CFETS). China's regulators could also allow domestic qualified market makers to conduct FX transactions directly with those foreign institutions and submit the transaction data subsequently through e-filing to the relevant regulators.

c) Allow and encourage foreign banks to provide financial services to third-party payment institutions and cross-border e-commerce companies.

In recent years, the cross-border e-commerce industry has grown quickly and companies holding third-party payment licenses (Payment Service Providers (PSPs)) are also stepping up efforts on cross-border payments. However, given the fact that cross-border e-commerce players and PSPs lack familiarity with overseas markets, and due to the accelerated growth of cross-border settlement volumes, there are still gaps in achieving efficient, flexible and convenient offshore fund settlement services while addressing FX and payment security needs.

Foreign banks have an inherent advantage in the field of cross-border payments by leveraging a wider overseas network than domestic banks to help e-commerce players expand in the international market more effectively. International banks have experience serving overseas customers and have established and comprehensive risk management frameworks, including Know Your Customer (KYC), Know Your Bank (KYB), full-scale due diligence and other control processes. The leading international banks have also invested significant resources and technology into risk control measures, such as blacklist management,

anti-fraud, anti-money laundering etc., and establish three levels of controls (pre, post and real-time controls) to build effective risk management mechanisms.

It is therefore suggested that China's regulators consider opening cross-border settlements and other related financial services for third-party payments to foreign banks to better support e-commerce players' overseas expansion by leveraging the global networks of foreign banks and driving the overall development of the third party payment market.

Currently, as per existing regulations, only qualified banks can provide Payment Institution Account services to PSPs for their cross-border settlement needs and qualification largely depends on the very rigid requirement of the size of capital. This requirement on capital does not reflect the overall prudential risk management capabilities of banks. In addition, due to this capital requirement being limited to the scale of the bank's business operations in China, most foreign banks (except a few leading foreign banks, such as HSBC) cannot meet the capital requirement. It is suggested that China's regulators could provide more flexible guidance and could consider the overall operational and risk control capabilities of foreign banks, as well as the capitalisation of parent banks to allow qualified foreign banks to provide Payment Institution Account service to cross-border PSP and e-commerce companies.

ii. Improve the infrastructure of the domestic financial market and promote the development of China's credit derivatives market.

Credit derivatives form an integral part of a mature financial market and play an important role in reducing systematic risk. With the introduction and

development of China's credit derivatives, the National Association of Financial Market Institution Investors (NAFMII) has formulated business rules and adjusted the supervision framework to support the development of the credit derivatives market. Under this framework, we suggest focusing on infrastructure construction (including system development) and creation of business processes for clearing mechanisms as well as the clearing approach; meanwhile, as long as permissible by the relevant regulatory requirements, we should pay attention to clearing mechanism innovation, broaden the scope of clearing and improve clearing efficiency.

It is suggested establishing the close-out netting mechanism to improve development of the credit derivatives market. Close-out netting is a fundamental principle in a derivative market and impacts all aspects of the derivative business as it can effectively and efficiently calculate credit risk / risk weighted assets on a net basis rather than on a gross basis. It is expected that close-out netting would materially reduce risk exposure of derivatives in the China market. Without close-out netting, China counterparties will incur higher funding and transaction costs since non-netting jurisdiction counterparties may have to calculate the exposures on a gross basis rather than net basis or limit trading volumes in cross-border business. Applying to the CIBM, foreign investors will have higher costs in managing risk in facing China counterparties and netting may affect the market size of CIBM invested by foreign investors in the long run. In addition, from a capital management perspective, the "standard method for measurement of counterparty credit risk exposure" will make a substantial difference in the calculation of risk exposure depending on whether there is a close-out netting mechanism or not.

A working group (the China close-out netting working group) was formed under a mandate from the UK and China governments to study close-out netting in China, with HSBC being a member. HSBC concurs with the “3-steps” approach proposed by Bank of China, and suggests that the working group accelerates the process of establishing the close-out netting mechanism in order to improve the legal infrastructure of the derivatives market.

iii. Continue to expand the RMB cross-border investment channels and promote RMB internationalisation (RMBI) and capital account convertibility.

The focus on opening-up of financial services sector has helped to drive RMBI and the liberalization of China’s capital account. Although RMBI efforts have experienced challenges in the past few years, it is anticipated that RMBI will reaccelerate to become a priority in the near future. HSBC would like to make the following suggestions:

a) Expand individual RMB investment channels

According to the existing Qualified Domestic Institutional Investors (QDII) regulations, individual investors are not permitted to invest in overseas markets directly. Individual investors can only access overseas market indirectly via purchasing relevant wealth products through commercial banks and mutual funds and at the same time cannot choose the investment targets of wealth products designed and managed by commercial banks or mutual funds. Therefore QDII can only provide limited choices for local investors to access overseas markets. In order to expand overseas investment channels and the

volume of RMB invested in overseas markets, it is suggested that the Qualified Domestic Individual Investor Programme (commonly known as QDII2) be launched to allow domestic individual investors to invest in securities, bonds, etc., in overseas capital markets. QDII2 would enable domestic investors to expand investment scope and improve the effectiveness of asset allocation and asset liquidity.

b) Establish more cross-border financial service platforms

In the past few years, the Connect mechanism has been largely established, namely, Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Bond Connect. Based on market demand, the operation performance of interconnection, as well as cooperation between Mainland authorities and Hong Kong authorities, the next step should be to refine the mechanism, expand the scope of interconnection, deepen and enrich the financial products within the scope of interconnection, and gradually relax investment restrictions. In light of this, Hong Kong should continue be used as the "experimental field" and "firewall" of the RMBI initiative, and enhancements to the following investment platforms are suggested:

- “Insurance Connect”: suggest further opening-up through sales of Hong Kong insurance products to mainland China residents, and vice versa.
- “South-bound Bond Connect”: suggest expanding “South-bound” based on “North-bound” trading, i.e. allowing domestic investors to trade in Hong Kong bond markets through the interconnection mechanism.

- “ETF Connect”: suggest launching Exchange-Traded Funds (ETF) Connect, through which domestic investors could access overseas assets through ETF listed in Hong Kong; and through which Hong Kong investors could access ETFs listed in Shanghai and Shenzhen.
- “Primary Equity Connect”: suggest opening-up of the Primary Equity Connect, allowing Hong Kong investors to participate in Shanghai and Shenzhen IPOs. It would also allow domestic investors to participate in Hong Kong IPOs.

Meanwhile, both sides are making good progress on the implementation of the Shanghai-London Stock, allowing cross listing of Depository Receipts (DR) by Chinese and British listed companies. At the latest China-Germany Economic and Financial Dialogue in Dec 2018, Deutsche Boerse Group and the Shanghai Stock Exchange have conducted a feasibility study on depository receipt transactions by listed firms by each side.

With the strengthening of China’s economy, RMBI will be further accelerated and eventually will promote the further opening up of China’s financial industry.

iv. Further opening-up of the financial services industry does not necessarily jeopardize supervision and risk prevention.

It is critical for the Central Government to closely monitor international financial risks and coordinate with various departments to adjust domestic policies swiftly in response to market movements, especially at the critical stage of China domestic reforms and further opening-up.

China can leverage international experience and regulatory practices in countering risks for financial industry. In particular, China can refer to the structural reforms made by countries in Europe and the US following the global financial crisis. These countries have formed a unified, coordinated and efficient financial regulatory system by strengthening cross-department coordinator mechanisms for financial industry and enhancing the cross-market, cross-industry, and cross-regional regulatory supervision.

It is therefore suggested that China consider establishing a number of cross-departmental working groups under the Financial Stability and Development Committee (FSDC) to provide strong support to the Committee, which should be comprised of senior officials from the relevant authorities. These working groups could study and evaluate the risks presented by new cross-market, cross-industry and cross-region policies; and could assess the impact of changes in the international financial market to China's financial policies. More importantly, by strengthening coordination, the initiatives deployed by FSDC could be implemented quicker and more effectively in various government departments.

It is also suggested that China improve policy transparency, as well as the timeliness, effectiveness and the authority of policies and regulations to effectively guide market expectations. Therefore, senior officials (head or deputy head of FSDC) may hold both regular and ad hoc press conferences to communicate directly with market participants and investors to timely introduce the background and implementation details of new policies.

With increasing participation of international investors in the China financial markets, the transparency of policies is of particular importance for stabilizing market sentiment and for boosting market confidence.

Conclusion

Further liberalisation of the financial sector is crucial to helping China meet its long-standing aims. Creating a more supportive environment for foreign investors can improve the efficiency of China's financial sector, and provide its economy with the level of funding it needs. Doing so would be to the mutual benefit of both international investors, and the people and businesses of China.

HSBC will continue to build its business in step with China's reforms, leveraging its global network and international experience to support China's development and help its customers to tap into opportunities in China and around the world.