INCREASING INTERNATIONALISATION OF CHINA'S CAPITAL MARKETS

A CDF ENGAGEMENT PAPER

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Executive Summary

Recent "reform and opening up" initiatives in the financial sector have brought demonstrable benefits. Incremental opening up of the onshore bond and equity markets has resulted in a significant increase in foreign investment inflows and global index inclusion, lowering the cost of capital and increasing funding diversity for Chinese enterprises. Relaxations to foreign ownership restrictions of financial firms have resulted in numerous new entrants, bringing with them their experience in market development and risk management.

Despite impressive progress to date, significant opportunities for further achievements on reform remain. While caveating that an overly hasty opening can carry risks – as evidenced by the experience of other Asian markets in the 1990s – our interactions with our significant global client base, including companies, financial investors and individuals, show there is clear appetite to do more business in China, and in China's capital markets.

There are three broad categories of international participants in China's capital markets, being investors, issuers and intermediaries. This paper looks through the lens of each to highlight instances where real and current commercial opportunities exist to accelerate international participation in China's markets, but certain constraints are acting to limit the realization of those opportunities.

International investor participation in China's capital markets is an area with strong momentum, which we expect to continue over the foreseeable future. This is driven by the attractive investment opportunities available in China and enhanced ease of investor access as a result of market access reforms. Nevertheless, there are certain challenges that constrain international investors, the resolution of which could further accelerate entry of international investors into China's markets, and encourage existing investors to increase their participation.

These challenges broadly fall under three categories of reform. The first is increasing the availability of financial products and hedging tools for international investors, an area where some advancement has been made but timing and implementation details are still pending. The second is greater alignment between domestic markets and international markets in certain key areas, including close-out netting in the derivatives market and increased market infrastructure linkages, such as the recent "Yulan Bond" structure. The third is adoption of

measures to facilitate greater international investment, such as increases in the foreign ownership limits of Chinese listed equities and relaxations to remittance requirements for repatriations of investors' funds.

In contrast to significant international investor activity, the entrance of international issuers in China's capital markets has been significantly slower. Despite the significant presence of multinational companies in China, creating a strong commercial rationale for such firms to issue securities locally, various legal or regulatory constraints within established frameworks have acted to limit the extent of local issuance.

With respect to debt securities, there is natural demand for Panda bond issuance by international firms, as Panda bonds would help firms match their debt profile to the Renminbi cashflows their business operations generate. However, specific accounting requirements for Panda bonds introduce additional cost and burdens for certain issuers, making the transaction less attractive economically. Relaxation of these requirements could see significantly greater Panda issuance.

As it relates to equity securities, international firms currently have two options. One is the local listing of their Chinese subsidiary, and while such activity to date has been limited we foresee significant interest in local subsidiary listings for certain firms. While not applicable for all firms, a local listing can be strategically compelling in certain situations, as it provides Chinese operations a greater degree of autonomy and significant growth funding to pursue local opportunities in the dynamic Chinese market.

The second option for international firms is a listing of the parent entity via a China depository receipt listing under schemes like the Shanghai-London Stock Connect. There are strategic reasons for international firms to consider this option, but to date no firm has yet proceeded with a CDR listing. We understand the primary constraints on potential issuers relate to the additional legal and corporate governance requirements a UK listed company would assume under a Chinese listing, which could potentially act to constrain strategic flexibility and impose additional operational burdens in certain circumstances. Should the depository receipt framework evolve in a way that relied more heavily on the issuer's home market regulation to protect Chinese investors, that could reduce the additional impositions of a Chinese listing for potential issuers, and increase their appetite for such a transaction.

Lastly, the activity of international financial intermediaries within China's capital markets is an important supporting layer to encourage greater internationalization on both the investor and issuer side. International firms, like HSBC and others, can play a significant role in encouraging international entrants. This is not only by virtue of their global client bases, but also the differentiated services they provide these clients in comparison to domestic peers, including English-language research, corporate access, informational events and service innovations that are particularly relevant for international participants.

However, as new entrants to the market, these international intermediaries can face profitability challenges, compounded by market access and licensing restrictions that can act to limit their product portfolio and ability to meet client demands. Adoption of differentiated approaches to assessing international firms for licences, such as those adopted by NAFMII on bond underwriting, can be appropriate to reflect the unique situations of international firms, and allow them to contribute to continued market development. This also helps to support their business operations, profitability, and incentivizes them to continue educating international investors and issuers on the opportunities available in China's capital markets.

Capital Markets: The Backdrop to Reform

China's "reform and opening up" policy has been a critical enabler of China's remarkable progress and achievements in economic development, industry transformation and its increased global presence over recent decades. As China enters the next stage of its expansion, with increasing focus on higher quality growth and leadership in innovation, continued reform and opening up should complement the development of a dual circulation system and provide an ongoing tailwind to economic development.

The experience of all developed economies shows that reform and opening up of the financial sector go hand-in-hand with development of the real economy. Through increased international investment and participation, China can further develop its capital markets, providing the economy with greater volumes and diversity of funding. It can better serve and support the financial needs of its growing middle class, and provide industries with the expertise and capital they need to ascend further up the value chain.

Recent reforms to the financial sector have shown considerable benefits. The incremental opening up of the onshore bond and equity markets has resulted in a significant increase in foreign investment inflows and global index inclusion, lowering the cost of capital and increasing funding diversity for Chinese enterprises. Relaxations to foreign ownership restrictions of financial firms have resulted in leading international financial firms, including HSBC, increasing their investment in China, bringing with them their experience in international market development and risk management.

Achievements to date have undoubtedly been impressive, and policymakers will also of course have in mind the need to guard against an overly rapid opening up of the financial system given the experience of other Asian markets in the 1990s. However, significant opportunities for further progress on reform remain. Through our regular interaction with our significant global client base, from the largest multinational corporations to smaller businesses, along with financial investors of all sizes, there is clear appetite amongst our clients to do more business in China, and in China's capital markets.

This paper looks through the lens of three categories of international participants in China's capital markets – investors, issuers and intermediaries – and highlights instances where there are real and current commercial opportunities to accelerate international participation in China's markets, even if certain constraints may limit the realization of those opportunities.

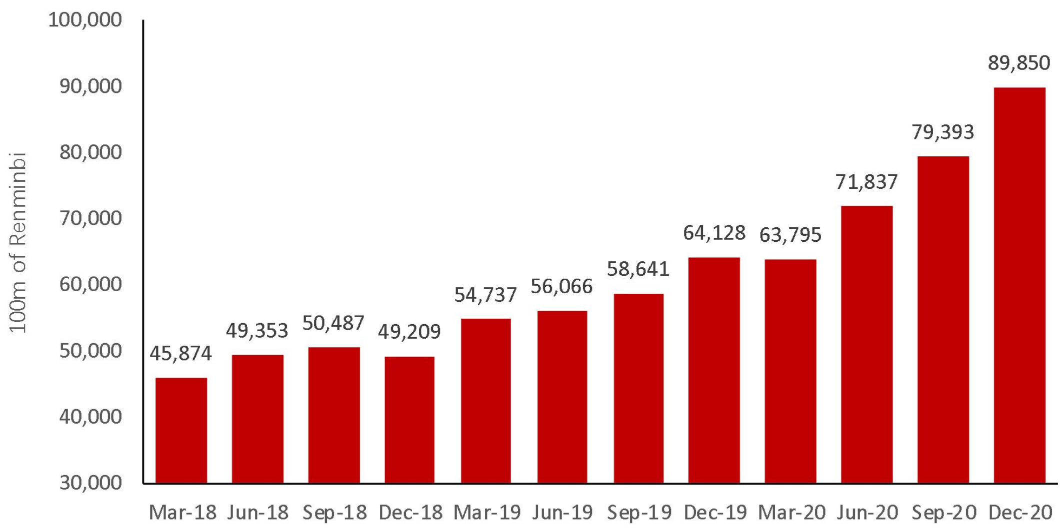
These are reasons why these constraints exist, and in highlighting these constraints we do not seek to blindly advocate for reform without consideration of all relevant factors. Rather, we seek to highlight the areas where – based on feedback from our clients – we see the greatest potential for commercial opportunities, to help inform your understanding as to prioritization in considering reform opportunities.

International Investors: Accelerating Investment Inflows

International investor interest in mainland China's capital markets has grown strongly in recent years. Owing to reforms implemented to improve international investor access, which paved the way for recent global index inclusion, the attitude of international investors towards China's capital markets has shifted from China being a market only for the intrepid international investor to being a mainstream market which investors cannot afford to ignore.

According to PBoC data, overseas holdings of yuan-denominated assets increased 40% year on year in 2020 to reach CNY8.98trn by December. Foreign holdings of A-Shares represented 3.6% of the total A-share market cap and 8.9% of the free-float adjusted market cap, making foreign investors the second largest institutional investor group behind domestic mutual funds. Foreign holdings of Chinese bonds reached CNY3.47trn in January 2021, having risen 58% over the course of 2020.

Domestic RMB Financial Assets Held by Overseas Entities



Source: PBoC

Internationalisation of the investor base is clearly an area with strong momentum, and we expect continued interest over the next few years. The drivers of this interest include the scale, breadth and diversification offered by China's markets, the attractive yields available in China relative to other major markets, global index inclusion and enhanced ease of access as a result of market access reforms. A recent HSBC Qianhai Securities survey of 935 institutional investors and large corporates found 98% of them are actively engaged in the onshore market, and 62% of them plan to further increase their portfolio allocations to China over the next 12 months.

HSBC has a leading market position in facilitating this inbound investment, with 33% market share by number of overseas institutional investors served in CIBM, as well as 38% market share by number of investors under custody for the integrated QFII and RQFII schemes. Observations from our client base confirm that international investor interest is strong and rising but, nevertheless, certain challenges remain that constrain investors in accessing and participating in the market. Resolving these issues could help to accelerate further the entry of international investors into China's markets, and encourage existing investors to increase their participation.

These issues broadly fall under three categories of reform:

Increasing availability of financial products and hedging tools for international investors, for example:

- International investors currently have limited access to hedging products to manage risks related to their domestic investments, and documentation requirements for hedging transactions can prove operationally onerous. We expect hedging-related investor demand for a large range of derivatives, including bond futures, equity index futures, stock options, CNY interest rate options and commodity futures. Access to many of these products will be expanded under new CSRC rules, but the timing and implementation details are still pending. An accelerated rollout of these measures may help support continued investor inflows.

- International investors investing through the Stock Connect program are currently unable to participate in A-Share IPOs, being only able to acquire such shares in secondary market trading which offers more limited liquidity and typically higher valuations. Many of China's most attractive and technologically innovative companies are coming to market via IPO to seek funding, and allowing Stock Connect based investors to invest in A-Share IPOs would further enhance returns that international investors can derive in China's markets, thereby potentially attracting increased interest and inflows.

Greater alignment between domestic market infrastructure and international practices, for example:

- Introducing close-out netting for the derivatives market, which provides numerous efficiency benefits for the derivatives market, including
  - reducing credit lines and capital consumed by derivatives transactions, thus increasing headroom for market growth
  - providing for a greater availability of hedging solutions for international (and local) investors
  - mitigation of systemic credit risk by moving market participants onto centralized clearing houses (or margin exchanges for un-cleared derivatives)

  There has been noticeable progress already made towards the introduction of close-out netting, such as efforts by the PBoC and CBIRC engaging the Supreme Court on the option to issue a judicial interpretation on close-out netting. We encourage these efforts and believe close-out netting would further develop the derivatives market for both international and local investors.

- Increased linkages in market infrastructure between local depositories such as Shanghai Clearing House ("SCH") and international market infrastructure, e.g. Euroclear and Clearstream, would further support cross-border clearing and settlement, financing activities, collateral management and other operational processes. This is particularly relevant for inbound investment to China, where such linkages could potentially provide greater operational efficiency and support to international investors.

  A recent case study, with the first successful issuance in January 2021, is the groundbreaking "Yulan Bond" structure. Under the Yulan structure, Euroclear acts as the common depository for offshore international investors while SCH serves as common depository for the issuer. This technical co-operation could be further extended to potentially allow offshore investors only holding Euroclear accounts to directly participate in onshore markets, with transactions cleared through SCH.

- Similarly, providing international investors with an option to use the same legal documentation they use in other markets (e.g. utilizing their Global Custody Agreements for QFII/RQFII market entry, or Global Master Repurchase Agreement for repo trading in CIBM) would potentially provide greater operational efficiency and reduce set-up barriers in entering domestic markets for international investors.

Adopting measures to facilitate greater investment, for example:

- An increase in the foreign ownership limitation on investor holdings of Chinese equities such as A-Shares. International investor interest tends to concentrate in a smaller number of securities, so while overall market investment is well below the 30% threshold, at the individual security level the 30% limitation has proven a constraint. With increasing inflows, this constraint could be even more relevant going forward. An increase in this foreign ownership limit provides further capacity for continued international investment, helping to lower the cost of capital for Chinese firms and providing greater liquidity and potential sources of funding.

- A relaxation on the requirements for fund remittances would provide greater flexibility for international investors to repatriate funds, which would also encourage further investment into domestic markets. For example, many CIBM investors find the multi-currency ratio calculation method complicated, and can need to liquidate securities in order to fulfil the ratio requirements resulting in incurring additional operational, transaction and funding costs. Simplifying this process could improve investor flexibility and encourage further investment.

International Issuers: Increasing Participation

In contrast to the significant achievement to date in expanding international investor activity, the entrance of international issuers in China's capital markets has been significantly slower.

Despite the significant presence of multinational companies in China, many of which are active securities issuers in overseas markets, there are only a handful of examples of foreign companies issuing securities locally.

Based on our conversations with our client base, we see a strong commercial rationale for certain firms to issue securities locally, particularly for debt securities. However, there are various legal or regulatory constraints within established frameworks which have prevented these from being effectively realized.

In this section, we consider the most promising commercial opportunities across both debt and equity issuance, and outline the potential constraints to further transactional activity.

Debt Issuance: Panda bonds

Many multinationals have substantial investments and operations in China, representing a significant part of their revenue, profits and asset base. To manage the currency exposures that result from these operations, firms tend to look to match the currency of their liabilities to the currencies their business operations generate – creating a natural demand for firms to issue Renminbi-denominated debt.

However, to date there have been only a limited number of international firms (including HSBC) who have issued Panda bonds, which are onshore Renminbi-denominated bonds issued by an offshore incorporated entity. The primary reason for the lack of activity is due to Ministry of Finance regulations, which stipulate that Panda bond issuers should use China Generally Accepted Accounting Principles ("GAAP"), or a GAAP deemed equivalent to China GAAP, for publicly syndicated offerings.

Selected Corporate and Financial Panda Bond Issuers to Date

Corporate		Financial	
Air Liquide	Industrial gases	HSBC	Banking
BMW	Automobiles	CA	Banking
DAIMLER	Automobiles	Maybank	Banking
新鴻基地產 Sun Hung Kai Properties	Real estate	Standard Chartered	Banking
TRAFIGURA	Commodity trading	UOB	Banking
VEOLIA	Environmental services		
WHARF	Conglomerate		

Source: HSBC

Note: Names (excluding HSBC) displayed in alphabetical order. A number of supranationals, sovereigns and agencies have also issued Panda bonds, as well as numerous predominantly Chinese entities incorporated offshore.

At present, referencing precedent transactions, the Ministry of Finance only recognizes HKSAR GAAP or EU IFRS as equivalent to China GAAP, with both jurisdictions signing mutual recognition arrangements. This means that potential issuers who utilize US GAAP, or other accounting standards, are unable to issue a Panda bond directly through a publicly syndicated offering. While alternate options exist – for example, issuers could prepare a summary of the differences to China GAAP of their chosen accounting standard, or proceed via a Private Placement – the additional cost and burden involved makes the transaction uneconomic for the potential issuer.

Should the accounting requirement for Panda issuance be relaxed, we anticipate a significant pipeline of Panda transactions as multinational companies look to issue onshore Renminbi debt to match their significant Chinese operations.

This could be further supported by changes to the bookbuilding process for bond issuance, which differs in market practice to international norms. In international markets, bond bookbuilding is typically conducted using a process with greater information shared, with investors provided with information on demand levels and issuers having full visibility as to demand composition. Onshore market practice differs, with the Bookrunner typically being the sole party with full visibility of the bidding process. This creates opportunity for the Bookrunner to maneuver and possibly provides favoured bidders with superior intelligence and outcomes. This can result in inferior pricing outcomes for issuers, along with giving issuers no influence over their investor base. A bookbuilding process with greater transparency of information would provide international issuers (as well as international investors) greater confidence in the issuance process, further encouraging potential issuers to come to market.

Furthermore, efforts to facilitate greater investment in Panda bonds will further improve the attractiveness of Panda bonds as a funding option for issuers. One technical aspect particularly relevant to Panda bonds is that Panda bonds issued into the interbank market are currently cleared via the Shanghai Clearing House ("SCH"). Certain international investors – particularly central banks and international agencies – only have existing accounts with China Central Depository & Clearing ("CCDC"). Account linkages between SCH and CCDC, similar to the "Yulan bond" structure noted above, could facilitate greater participation of these investors in Panda bond issuance, enhancing the attractiveness of Panda bonds to international issuers.

Equity Issuance: Stock Connects, e.g. Shanghai-London Stock Connect

In recent years, China has revised securities regulations and established new boards to allow foreign incorporated companies to list locally. To date, there has been limited IPO activity by international issuers on Chinese exchanges, with a recent exception being the listing of Yihai Kerry Arawana by Singapore's Wilmar International. We foresee increasing interest from multinational companies in listing their local subsidiaries, as part of a strategic decision to provide their Chinese operations with greater autonomy, flexibility and funding for growth to pursue opportunities in the large, dynamic and fast-evolving Chinese market.

Another relatively recent development is the establishment of the Chinese depository receipts ("CDR") program in conjunction with the Shanghai-London Stock Connect, whereby the parent company of an international firm can directly access China's equity markets, with an equivalent global depository receipt for Chinese firms listing in London.

To date, there have been four "Westbound" listings of global depository receipts on the London Stock Exchange by Chinese firms, but there has yet to be an LSE-listed firm to pursue an "Eastbound" listing on the Shanghai Stock Exchange.

"Westbound" Listings under Shanghai-London Stock Connect To Date

Source: LSE
Note: Amounts of capital raised includes exercise of over-allotment options.

There are strategic drivers for international firms with significant Chinese operations to consider such a listing, including the profile and branding benefits a Chinese listing can bring in China, the opportunity to allow China-based stakeholders to participate in the company's success, and to participate in opportunities created by the growing wealth and investment appetite in China.

Based on potential issuer engagement, we understand the primary constraints on issuer appetite for an Eastbound listing to date relate to the differences in the legal and corporate governance requirements between those a UK listed company is accustomed to in its home market, and those it would be subject to under a Shanghai listing.

On the strategic level, there are uncertainties as to how certain corporate finance initiatives that are customary in foreign markets but not currently practiced in China's local markets would be accommodated within the CDR framework. Examples of this include the use of non-China listed shares as consideration in a takeover offer, or the use of a scheme of arrangement as an acquisition structure. As a result of these uncertainties, issuers may have concerns about constraints a CDR listing could place on their company's strategic flexibility.

At the compliance level, Chinese laws would also impose certain burdens and obligations on the issuer, its directors and its shareholders that are additional to those an issuer would be subject to under UK law. Examples include the higher director liability standard under Chinese law, including a presumption of director liability, the higher certification standard for annual accounts under Chinese law, and the additional financial and other information disclosures an issuer would be required to make in relation to its Chinese listing. While these issues are more of a technical nature, in practice they can result in additional operational burdens or risks for an issuer, which in certain circumstances could potentially result in quite significant impacts for the firm.

Should the Shanghai-London CDR scheme, or other Stock Connect-style schemes, evolve in a way that allows issuers to rely more greatly on home market regulatory compliance to protect Chinese shareholders, that could reduce the degree to which issuers face additional constraints and risks under the CDR framework. This may increase the attractiveness of such issuance amongst the universe of potential international issuers, helping to internationalise the investment opportunities available to investors in China.

International Intermediaries: Playing a Key Role

In addition to directly encouraging greater internationalization on both sides of the capital market – investors and issuers – the activity of international financial intermediaries within China's capital markets is an important supporting foundation to encourage greater internationalization.

The relaxations on foreign ownership and improved market access for international financial firms have encouraged a number of new international entrants to the securities industry, and the financial industry more generally. HSBC was the first international firm to own a majority stake in a Chinese securities company, HSBC Qianhai Securities, and a number of our international peers have followed suit.

In addition to bringing experience in international market development and risk management, international firms also play a significant role in encouraging greater activity amongst international investors and potentially international issuers.

International firms are uniquely positioned to play this role, by virtue of their large existing global client bases and established brand names, and are the typical channels via which international investors and international media organisations will discover and research new investment opportunities.

As an example, some of HSBC's activities in supporting China capital market development include:

- Research publications on the Chinese economy, Chinese market opportunities and stock-specific research, with a particular focus on dual-language material, reducing information asymmetry for international investors.

- Facilitating corporate access for international investors to listed Chinese companies, through bilateral engagement, roadshows, conferences and other events – with an example being our signature China-specific HSBC China Conference.

- Participating in market innovation, such as facilitating the first securities lending transactions under QFII, the first batch of Japan-China ETF Connect participants, and the first batch of GDR registrations under the Shanghai-London Stock Connect program.

HSBC Chairman Mark E Tucker addresses HSBC's 6th Annual China Conference in Shenzhen, May 2019. The event was attended by over 400 investors and 160 corporates, with 45 speakers and 17 analyst-led tours. The conference was held digitally in 2020 due to COVID-19.

Other peer international firms pursue similar approaches. However, the ability of international firms to play this role relies upon the commercial success of their operations in China. The securities industry in China remains extremely competitive, and international firms face certain key structural disadvantages.

As new entrants, they lack the scale of established domestic competitors, which creates profitability challenges. This is compounded by market access and licensing restrictions, which may limit their product portfolio and ability to meet client demands.

One example is that certain licenses consider the scale of a firm's existing local operations. This can effectively exclude international firms from consideration by virtue of their smaller scale domestically, regardless of the size and maturity of their global operations. Alternate assessment criteria for international firms which considered their global scale would help level the playing field.

In certain areas, regulators have indeed adopted innovative practices to encourage international firms. For example, NAFMII granted the Type B (Foreign Bank) lead underwriting license to international firms, including HSBC, recognizing that foreign firms would face significant difficulty in meeting local license requirements. Amongst other market liberalization measures, NAFMII has also recently granted Type A lead underwriting licenses to certain international firms. A continuation and extension of this support would support the commercial operations of international firms, and incentivize them to continue educating international market participants on the opportunities available in China.

Conclusion

Great progress has been made in increasing international participation in China's capital markets, which is testament to a successful reform program and the strong commercial rationale for international participation. The overarching frameworks for international participation are in place. Further adjustments to support and accelerate international participation would be of mutual benefit to both international market participants and the people and businesses of China.

HSBC continues to see significant opportunities by participating in China's ongoing development, leveraging our global network and international experience to support China's development whilst helping our customers access opportunity in China and around the world.