Beaumont Capital Markets

China – A Market with Unprecedented Opportunities for Foreign Asset Managers

I. Tremendous potential for future growth

As of December 2019, China[1] became the world's second largest stock market with a combined aggregate market capitalisation of RMB59.2 trillion, and the second largest bond market with a total notional value of outstanding bonds standing at RMB97.0 trillion.

Since 2018, China A-shares have been included in several major international indices, such as MSCI, FTSE Russell, and S&P Dow Jones indices. With the announcement by FTSE Russell in September 2020 to include Chinese bonds from October 2021, Chinese bonds are set to enter the three major global bond indices, namely Bloomberg Barclays Global Aggregate Index, J.P. Morgan Government Bond Index-Emerging Markets, and FTSE World Government Bond Index.

Index inclusion has in recent years brought billions of dollars of inflows into China and greater allocation of RMB-denominated assets by foreign investors. Despite this, however, foreign participation in China's onshore equity and bond markets was only around 3% - 4% as of the end of 2019, far less than comparable market peers.

To further accelerate foreign participation in Chinese financial markets, the Chinese government has announced a series of measures at the central and local levels to expand access to international investors, which, among others, advance the deadlines for removing foreign shareholding caps in several financial industries and encourage foreign investment in asset and wealth management industries.

The near term has shown great potential for the future growth of Chinese onshore equity and bond markets, given the under-ownership of Chinese securities, continuous opening-up measures, outperformance of China A-shares and the Chinese high-yield bonds in the low global interest rate environment.

II. Cross-border business opportunities for global asset managers

A. Access to Chinese securities markets

(i) R/QFII schemes

The Qualified Foreign Institutional Investor (QFII) scheme was introduced in 2002, which was followed by the 2011 launch of its sibling scheme, the RMB Qualified Foreign Institutional Investor (RQFII). Both QFII and RQFII schemes enable qualified foreign investors to access Chinese onshore securities markets within a quota granted by the State Administration of Foreign Exchange (SAFE). With PRC regulators' efforts over the years and with the intent to reinvigorate interest in the R/QFII scheme, the QFII and RQFII schemes went through a number of substantial developments and liberalization in 2020, and were officially merged as of 1 November 2020.

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Yin has extensive experience in representing international asset managers, financial institutions, central banks, sovereign wealth funds and trading platforms on various cross-border investment initiatives, such as R/QFII, R/QDII, QDLP/QDIE, Stock Connect, Bond Connect, Mutual Recognition of Funds, setting up WFOE PFM, WFOE FMC and foreign-controlled wealth management joint venture companies. She has also been deeply involved in advising on legislation and regulation of China's asset management and financial services sectors.

To further accelerate foreign participation in Chinese financial markets, the Chinese government has announced a series of measures at the central and local levels.

[1] For purposes of this article, "China" refers to Mainland China, excluding the Hong Kong Special Administrative Region, the Macao Special Administrative Region, and Taiwan.

In 2020, the R/QFII quota restrictions were abolished and R/QFIIs may now freely choose the amount of investment capital and the timing and currency in which investment capital will be remitted into China. The process for repatriation was also simplified to remove the need for a special audit report for routine repatriations. The R/QFII scheme, upon its merging, lowered the bar for eligibility by removing the track record and AUM requirements. Most notably, the investment scope was expanded to include, among others, private investment funds, commodity futures, financial futures, options, margin trading and securities lending, while some of these products made available for investment still await regulatory approval or market testing.

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(ii) Access to Chinese stock markets - Stock Connect

In addition to the R/QFII scheme, which enables foreign investors to trade onshore listed shares, Stock Connect was launched between Hong Kong and Shanghai in 2014 and between Hong Kong and Shenzhen in 2016, which enables foreign investors to invest in Chinese-listed shares via connections between stock market infrastructures. While foreign investors under the Stock Connect may only invest in listed shares that are constituents of certain indices or that have H-share counterparts listed in Hong Kong, R/QFIIs have a wider selection of investable shares, including all listed shares in China.

On 27 November 2020, Shanghai, Shenzhen, and Hong Kong stock exchanges jointly announced an expansion of the scope of eligible securities under the Stock Connect scheme to include shares listed on the Sci-Tech Innovation Board (STAR) for northbound trading, and pre-revenue biotechnology companies listed in Hong Kong for southbound trading. The expansion is expected to be implemented in early 2021 after the completion of market preparation.

(iii) Access to China's bond market

China's bond market comprises two major markets, the China Interbank Bond Market (CIBM) generally representing over 95% of the total market share and the exchange-traded bond market, which have distinct characteristics and apply different sets of rules. As of today, in addition to the R/QFII scheme, China has launched two additional cross-border investment schemes for foreign investors to trade onshore fixed-income products, i.e. the Bond Connect scheme, which allows foreign investors to engage in onshore cash bond trading in the CIBM under the northbound trading link, and the CIBM Direct Access scheme, which allows foreign investors to invest in cash bonds in the CIBM and engage in bond lending, bond forwards, interest rate swaps and forward rate agreements for hedging purposes. Among all the cross-border investment schemes for foreign investors, only R/QFIIs are allowed to trade in the exchange-traded bond market.

To promote the unity of the two bond markets, in July 2020, the People's Bank of China (PBOC) and the China Securities Regulatory Commission (CSRC) jointly announced their approval of inter-connectivity between the CIBM and exchange-traded bond market infrastructure institutions, so that qualified investors in the CIBM and exchange-traded bond market may trade bonds in the other bond market. The regulators are still working together on the implementing details of the connect scheme and the specific launch date has yet to be announced.
In September 2020, PBOC, CSRC and SAFE further issued a consultation draft of an announcement which intends to allow foreign investors to access the exchange-traded bond market if they have already had access to CIBM, either under the CIBM Direct Access or Bond Connect scheme.

(iv) Access to Chinese futures markets

On 26 March 2018, China launched RMB-denominated crude oil futures on a domestic futures exchange and for the first time designated it as a futures product available for trading by foreign investors, which marked a milestone development for the opening up of Chinese futures market. Following crude oil, China has been accelerating the opening of its commodity futures market. As of today, China has launched and designated seven commodity futures products available for trading by foreign investors, namely, crude oil, iron ore, PTA, low sulfur fuel oil, TSR-20, copper and RBD palm olein.

Separately, R/QFIIs are allowed to trade onshore stock index futures for hedging purposes. For other futures products (including long-awaited treasury futures products), even though R/QFIIs have in principle been allowed to trade commodity futures and financial futures, the specific futures products permissible for trading and trading methods still await regulators' final green light.

(v) Access to Chinese foreign exchange derivatives markets

With the opening up of Chinese securities markets to foreign investors and the allocation of RMB-denominated assets, China has noticed the increasing demands of foreign asset managers to hedge their foreign exchange risk exposures and has taken several measures to better facilitate risk management.

On 14 February 2020, Chinese financial regulators permitted the use of internationally prevalent ISDA master agreements to document onshore foreign exchange derivative transactions, while previously foreign investors were required to enter into a Chinese counterpart master agreement prepared by the National Association of Financial Market Institutional Investors (NAFMII), which may be unfamiliar to foreign investors.

Separately, foreign investors, either under the R/QFII scheme or CIBM Direct Access scheme, have been given a wider selection of their counterparties to conduct foreign exchange derivatives transactions in 2020, which had been limited to their respective custodian/settlement agent. Further, foreign investors under the CIBM Direct Access scheme may obtain access to the China interbank foreign exchange market through a prime broker beginning 1 February 2020.

With the above measures, foreign asset managers have been given much easier access to onshore foreign exchange hedging instruments and at more competitive prices.

(vi) Wealth Management Connect

On 29 June 2020, the PBOC, Hong Kong Monetary Authority (HKMA), and Monetary Authority of Macao jointly announced the launch of a pilot scheme, the Wealth Management Connect. The northbound connect will enable Hong Kong and Macao residents in the Guangdong-Hong Kong SAR-Macao SAR Greater Bay Area (GBA) to open designated investment accounts with banks in Mainland China and invest in eligible wealth management products distributed by such banks.

The three authorities are currently working closely to formulate the implementation details with a view to rolling out the scheme as soon as practicable, but the specific timetable is yet to be announced.

(vii) More connect schemes to come

An HKMA official recently recognised the success of connect schemes between Mainland China and Hong Kong financial markets, namely Stock Connect and Bond Connect schemes, and stated that HKMA is attempting to launch more connect schemes for other asset classes, such as stock and bond derivative products, to meet the increasing demands of foreign asset managers to hedge risk exposures from holding RMB-denominated assets.

B. More outbound investment from PRC investors

Amid the two-way opening up of Chinese financial markets, Chinese regulators have also been striving to promote cross-border investment by domestic investors into offshore markets.

(i) QDII scheme

The Qualified Domestic Institutional Investor (QDII) scheme was launched in April 2006, which enables qualified Chinese financial institutions to invest in offshore markets. On 30 November 2020, SAFE announced that it would grant new QDII quotas to approved QDIIs, after which a total of USD 116.7 billion in investment quotas were granted to 169 QDIIs, including, fund management companies (FMCs) and wealth management companies (WMCs). This is the third time in 2020 that SAFE has granted new QDII quotas, which shows SAFE's intent to encourage the outbound cross-border investments.

(ii) QDLP schemes

Since 2012, Qualified Domestic Limited Partnership (QDLP) scheme as a pilot local program has been launched in Shanghai, followed by similar schemes launched in other major cities in China such as Beijing and Shenzhen. Such local programs are intended to permit foreign asset managers to set up onshore wholly foreign-owned enterprises (WFOEs) to act as the manager of onshore QDLP funds and to raise capital from domestic qualified investors and invest in offshore markets. The QDLP schemes are subject to investment quotas granted by SAFE.

SAFE announced on 29 November 2020 that it will grant more quotas under the QDLP schemes to meet domestic investors' global asset allocation needs, and will also support the launch of QDLP schemes in Chongqing and Hainan.

(iii) Southbound Bond Connect

Given the success of the Northbound Bond Connect, PBOC and HKMA are currently studying the launch of the Southbound Bond Connect at an appropriate time to enable mainland investors to invest in Hong Kong bond markets, with the specific launch date unspecified.

(iv) Wealth Management Connect

Similar to the northbound connect under the Wealth Management Connect scheme, the southbound connect will enable mainland individual residents in the GBA to invest in eligible wealth management products offered by Hong Kong or Macao banks. The launch of the Wealth Management Connect marks another important milestone for the China's capital account liberalisation after the Stock Connect and Bond Connect schemes.

III. Setting up an onshore presence to conduct asset management business locally

In addition to cross-border investment, China has also put in place measures to attract foreign asset managers to set up onshore presences, conduct local-to-local asset management business, and bring in international talent and best practice.

In 2016, foreign asset managers were allowed to set up onshore WFOEs to register as private securities investment fund managers (PFMs), which may raise capital from domestic qualified investors and invest in domestic securities markets.

On 20 July 2019, the Financial Stability and Development Committee (FSDB) announced 11 key measures to further open up Chinese financial markets (the "11 Measures"), which also attach great importance to the asset/wealth management industry and the relevant specific policies include, among others:

(i) the deadline for removing the foreign shareholding cap for securities companies, FMCs, and futures companies was advanced by a year to 2020;

(ii) foreign financial institutions are encouraged to invest in the wealth management subsidiaries of Chinese commercial banks;

(iii) foreign asset management companies are allowed to establish foreign-controlled WMCs with the subsidiaries of Chinese banks or insurance companies;

(iv) foreign financial institutions are allowed to establish or invest in pension fund management companies; and

(v) the foreign shareholding cap is lifted for insurance asset management companies (i.e. 25%).

Pursuant to Article 4.7 of the Economic and Trade greement Between the Government of the People's Republic of China and the Government of the United States of America, signed on 15 January 2020, China committed to eliminating foreign equity caps in securities, fund management and futures services by no later than 1 April 2020.

To implement the China-U.S. trade agreement and the 11 Measures, the foreign shareholding cap for securities companies, FMCs and futures companies were officially lifted as of 1 April 2020.

As of today:

(i) in the PFM WFOE industry, 33 foreign players have successfully secured PFM licenses and are allowed to engage in private securities investment fund management businesses;

> The foreign shareholding caps for securities companies, fund management companies and futures companies have been officially lifted as of 1 April 2020.

(ii) in the FMC industry, BlackRock has successfully obtained CSRC approval to establish a wholly-owned FMC, and four other foreign players have filed applications with CSRC and are awaiting approval, namely Neuberger Berman, Fidelity, Van Eck and AllianceBernstein;

(iii) in the wealth management industry, Amundi and a subsidiary of the Bank of China (BOC) have received approval from the China Banking and Insurance Regulatory Commission (CBIRC) to set up a joint venture, Amundi BOC Wealth Management Company Limited, with Amundi and BOC holding 55% and 45% stakes, respectively, which commenced operations in September 2020. BlackRock, Temasek's subsidiary Fullerton, and a subsidiary of China Construction Bank (CCB) received CBIRC approval in August 2020 to proceed with preparatory work for setting up a wealth management joint venture, with BlackRock holding a 50.1% stake, CCB holding 40%, and Fullerton holding the remaining 9.9%;

(iv) in the pension fund management industry, as it is still at early stages of development, CCB Pension Management Co., Ltd., the joint venture between CCB and the National Council for Social Security Fund is the first and only pension management company in China. Those two shareholders have offered to transfer partial stakes to a foreign asset manager, but the specific transferee is yet to be determined.

With a view to attract foreign asset managers and cultivate more friendly and international business environments, Chinese regulators have issued a series of favourable policies at the central and local levels to support the establishment and development of Shanghai as a global asset management centre, and have explicitly provided that Shanghai is the top priority for piloting all financial policies in support of free and convenient investments. As of today, 29 out of 33 PFM WFOEs are located in Shanghai and around half of the top 50 global asset managers have set up an onshore presence in Shanghai and engaged in asset management business. We believe the prosperous Chinese asset management market will incentivise more global asset managers to expand their footprint into Shanghai, and Shanghai is more than willing to embrace their coming.

We have been advising many international asset managers and financial institutions on various China-related initiatives as first-movers in response to China's financial market liberalisation policies. We have also been deeply involved in the relevant legislation process while China's regulatory environment continues to evolve. The business developments opportunities in China are unprecedented and shall not be underestimated.