Continued Acceleration of the Reform of China's Capital Markets Still Needed

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Abstract China's *capital and financial markets*, among the largest in the world, play a key role not only in the raising and efficient allocation and management of capital, but also in attracting *foreign capital* and *institutional investment* expertise and knowledge. Markets including *equities*, *fixed income* and *foreign exchange* are growing, and regulation has also improved, improving the environment for investment in China.

Keywords Capital and financial markets · Foreign capital · Institutional investment · Equities · Fixed income · Foreign exchange

With over 140 members comprising a diverse range of leading financial institutions, including banks, asset managers, accounting, tax and law firms, trading platforms and market makers, clearing and settlement entities, credit rating agencies, index providers, and other market infrastructure service providers, ASIFMA is pleased to share with this audience the areas where our members see opportunities to make China's capital markets even more efficient and even more attractive to domestic and foreign institutional investors. Set out in this paper are proposed improvements to China's capital markets that our members would urge China to consider in making the most of China's future.

China's capital and financial markets, among the largest in the world, play a key role not only in the raising and efficient allocation and management of capital for both state-owned and private enterprises in Mainland China but also in attracting much desired foreign capital and institutional investment expertise and knowledge to the Mainland. Although there has been an acceleration of financial market reform in the last couple of years despite tensions with the United States and the COVID-19 pandemic in 2020, there is still more to be done in the equities, fixed income, foreign exchange, and derivatives markets. As China's domestic economy deepens and matures, it is also experiencing a slowdown compared with the frantic pace of growth of the last two decades and a build-up of debt, which is being exacerbated by needed fiscal expenditure in response to the pandemic. As growth slows, efficient, stable, and well-designed capital markets become more critical than ever to China's

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national objectives of sustainable growth. They support the transition from an export-driven to a consumption-driven innovative domestic economy, which is the main driver of the “dual circulation” policy articulated in the 14th Five-Year Plan.

There have been significant reforms in recent years that are too numerous to detail here in their entirety. One such reform was the establishment of the Financial Stability and Development Committee in June 2017 for further collaboration and alignment among the various regulatory bodies. Another was the liberalization of interest rates in 2019 by introducing a new benchmark lending rate for banks. However, some of the key reforms have been related to the further opening of Chinese financial markets to foreign institutional investors (FIIs) and foreign-owned financial institutions, which has brought in additional capital and expertise to accelerate the development of the domestic markets. These have included additional enhancements of Stock Connect (quadrupling the daily quota and increasing CNH supply via an HKMA swap line with PBOC), and QFI (unifying the QFII/RQFII schemes and removal of quotas and lock-up periods) market access channels, which will be detailed later in this paper and which make it much easier for FIIs to invest in a capital controlled economy. This resulted in the incorporation of Chinese securities into the various global equity indices such as MSCI and FTSE and the equivalent bond indices such as Bloomberg Barclays and JPMorgan. This brings substantial foreign investment, as any asset managers tracking those indices globally will now have Chinese investments by default.

Also, the cumulative reforms of 2017 and 2018 have allowed securities investments companies, fund management companies, and futures companies to increase their holdings in joint ventures with Chinese partners to 51% and then 100%. This has resulted in a flurry of activity of foreign-owned financial institutions establishing or reshaping their onshore entities. Finally, there has also been a series of significant technical reforms, such as reduced trading suspensions and improved closing auction in equities and the gradual consideration of the enforceability of close-out netting in the derivatives space.

In the past, China has relied heavily on a highly successful approach involving limited experiments and pilot programs as test cases for reform, only expanding them after careful and deep assessment. In recent years, this cautious approach has been emboldened by more significant reforms to encourage faster development in capital and financial markets. We believe that the focus on the Greater Bay Area, between Guangdong province, Hong Kong, and Macau, will provide considerable opportunity for further innovation and serve as an incubator for deeper financial market reform that, if successful, could ultimately be expanded throughout the Mainland.

It bears repeating that a broad reform agendum that encourages the development of deeper, more liquid capital markets with greater choice of investment products is critical to sustaining China’s growth as traditional drivers weaken, whether in terms of external trade or domestic infrastructure investment. At the end of the day, what is paramount is domestic capital market reform primarily for the benefit of the Chinese economy and its citizens and consumers. This includes enhancing corporate governance, minimizing market misconduct, transitioning from over-reliance on retail participation to more professional or institutional investors, and proper supervision of financial market participants, including technology firms.

While we expect China to continue to pursue a reform agenda for capital and financial markets as part of its 14th Five-Year Plan, geo-political tensions with the USA are not likely to subside under the new Biden administration and have recently started to spill over from trade into financial services. While we do not expect further escalation of measures targeting financial services from either side, we do expect further digital or technology decoupling between the two countries. This would significantly impact the use of data and technology across borders, which will make it more challenging for global firms to operate within China.

1 Equities

The equity market is the most developed of the capital markets in China. Nevertheless, solving the many practical barriers to the development of both listing and trading is essential if China is to balance liquid, transparent markets with less volatility in its equity market. This is in the interest of all investors (domestic and foreign) and for China's economy. Utilizing advances in technology, in which China is already a leader, to make its markets more efficient, along with proper supervision, further integration, and alignment with global markets, is paramount to growing China's role as a world leader.

A good example of this is the Shanghai Stock Exchange's launch of a registration-based STAR Board listings regime for innovative technology companies, coupled with more market-friendly trading rules including stock borrowing and lending. The Shenzhen Stock Exchange followed suit by revamping its own renovated Chinext listings regime in line with Shanghai's. Both are good examples of reforms taken to support more efficient capital raising for the most dynamic companies in China, fueling the growth generators of the economy. The registration-based listing regime should be further extended to the broader market on both exchanges to replace the long regulatory approval process for new listings, which slows down companies' ability to raise capital and would hamper the economy.

China equities now account for 40% of MSCI's Emerging Markets index series, 5% from A shares, and the other 35% from Chinese securities listed on other exchanges (HK, US). On the A share front, the current 5% represents a 20% MSCI Inclusion Factor (accounting for only 20% of China's overall market capitalization); as China continues with market reforms to facilitate easier access for global investors, there is potential for the A share component to increase five-fold to 100%.

To facilitate greater QFII/RQFII participation in China's equity markets through Stock Connect, QFII, and index inclusion increases, it would be helpful to align with global standards in areas including the following:

1.1 QFII/RQFII

- Allow delivery versus payment on T + 1 or T + 2 in the QFI channel so FIIs can better integrate their settlement processes globally. Asset safety is a key concern of global investors.
- Allow FIIs the ability to sell through multiple brokers to ensure the best execution, as well as the use of DMA / Program Trading in the QFII channel.
- Expand the block trading window, which would encourage larger and longer-term investments by FIIs in Chinese companies.

1.2 Stock Connect

- Allow for trading between the Mainland and Hong Kong on holidays so FIIs are not disadvantaged
- Expand SBL to not just Exchange participants (i.e. brokers) in Hong Kong, but affiliates of Exchange participants or asset managers/owners who have securities to lend
- Apply the short-swing profit rule at the fund level and not fund manager level, which is a particularly big problem for passive fund managers that merely track an index and do not make investment decisions or for large asset managers that manage multiple funds and client mandates.

The industry welcomes recent reforms to the QFII channel on the trading side, which includes (1) foreign investor access to securities lending; as well as (2) foreign investor access to listed derivatives as hedging instruments. Both of the above allow market participants to better manage their risk and will help the market improve in terms of liquidity and price discovery. The expanded portfolio of instruments has also attracted the interest of active fund managers to explore growing their investments in China.

Secondary market investment flows had become heavily skewed towards the Stock Connect channel in 2018–19 but have since rebalanced toward QFI thanks to the above-mentioned reforms. These are still at an early stage, and the industry will need to work with exchanges and regulators on enhancing the framework, including relaxing hedging quotas and providing greater tax clarity. FII inflows had been initially dominated more by passive fund managers, but per earlier mentioned, the QFII reforms are now attracting active fund managers to invest more in China.

2 Fixed Income

China's fixed income market, which is now at USD 18 trillion and the second largest in the world behind the USA (USD 40trn), has seen an almost 50% increase over the past two years. China has become a world leader in the 'green bond' market as issuance has soared to about USD 190 billion as of the end of 2020 from less than USD 1.0 billion at the end of 2014. With 56% of the market instruments issued by government-related entities, the corporate bond market is much smaller than in major competing economies, mainly due to its high reliance on loans—proportionally 50% more than in the USA. Moreover, while the bond market is large, the liquidity in the secondary market is rather poor for its size. To better allocate capital to dynamic and healthy companies that will contribute to economic growth, China needs to continue to move away from the opacity of the loan market—where funding may be allocated based more on relationships or other factors such as a firm being a large local employer- and incentivize corporate issuances where investors can properly assess the credit risk of issuers. To achieve this, a number of steps need to be taken. The most important is establishing and allowing an independent credit rating system with an appropriate scale of differentiation between high- and low-quality corporates. This can hardly be possible today when 89% of the Chinese corporate and enterprise bonds are rated AAA and AA (compared with 7% of the US corporate market). When companies get into trouble, particularly state-owned enterprises, they should be allowed to default and not have the government intervene. Since 2018, there has been an increase in defaults, which is a sign of a maturing market and will lead to re-basing of credit risk.

To improve credit risk analysis, foreign rating agencies need to be recognized and allowed to rate all bonds and ensure a level playing field with their local competitors. The regulators should encourage further alignment of domestic ratings, together with information disclosure and due diligence processes, to international standards and best practices.

Improving the secondary market liquidity is another important factor for investors so that they can confidently and easily enter and exit the debt capital market without having to hold every instrument to maturity.

The derivatives market also needs to be further developed to allow market makers and investors to appropriately hedge their risks against interest rate, market, and credit risks, which ultimately benefits price discovery and lowers funding costs while optimizing resources allocation.

Bond futures are the most important listed derivative product, but lack liquidity. The big five domestic banks sit on the bulk of the underlying government bonds, but to date have not been accessing the futures market directly even though it has been legally permitted since early 2020.

To further develop liquidity and provide hedging instruments to a broadened participant base on a level playing field with their peers, direct access to more domestic institutions and international investors through QFI and China interbank bond market (CIBM) Direct channels must be permitted.

Interest rate swaps are relatively liquid, but floating reference rates are not aligned with corporate financing reference rates. There is limited recognition of ISDA documentation versus NAFMII documentation, which bifurcates the foreign and domestic derivatives markets and thereby undermines liquidity.

The other cornerstone in the fixed income markets is a well-functioning repo market where sellers can lend securities to buyers, who can, in turn, trade them in the market, providing liquidity to investors. Contrary to global standards, the securities are pledged in China and do not have their ownership transferred which prevents rehypothecation—hence reducing liquidity—and creates risks in case of counterparty default or bankruptcy. There is also no tri-party repo, an important feature needed to encourage bondholders like insurance companies, pension funds, etc. to finance or lend those securities, although we know the CCDC is working on a solution. With respect to foreigners, who are more familiar with repo, it would make sense to allow them to access this market via any channel and not just QFI, as it stands now, and to use the globally recognized GMRA master agreement rather than the local NAFMII documentation.

For both derivatives and repo to work well, close out netting needs to be officially recognized in China preferably through a legislative change at the State Council level; otherwise, these capital-intensive instruments will bear significantly increased costs.

Finally, as global fixed income markets are dominated by institutional investors, the size of their participation—both domestic and foreign—needs to increase dramatically. One big regulatory change would be to lower the statutory liquidity requirement on banks to hold government bonds so that insurers, pension funds, asset managers, etc. can be lured into the market. Regulators should also consider broadening the range of fixed income products for retail investors through bond ETFs or funds, which could partially unlock the large retail bank deposits (USD 32trn) as a potential source for future development.

Currently, limited FII participation (3.2%) is mainly focused on government bonds and is very small compared with other large bond markets. There has been growing interest around bond index inclusion following the FTSE Russell announcement. To encourage further FII participation, the various access channels can be further streamlined (see below under market access). There is also a need for an overall tax exemption reform or clarification (e.g. extension of the tax exemption for FIIs expiring in November 2021 from VAT and withholding tax on interest and widening of the scope of eligible debt securities to asset-backed notes, asset-backed securities, and certificates of deposits, FX capital gains on repatriation) to bring China in line with other markets. Finally, there is very limited use of RMB as an international currency (1.16%/1.88% according to SWIFT). USD remains the key currency for international trade and financing, including for BRI projects. Accelerating capital account and foreign exchange reforms would support the adoption of the currency for both financing and investment. This is a good segue into our next topic.

3 Foreign Exchange

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. The FX market is also the basis of the global payments system. The volume of transactions is, therefore, very high, and these transactions are often executed by market participants across geographical borders.

China first indicated its intention to internationalize the RMB and decouple its dependency on the USD in the early 2000s. This accelerated in the period after the financial crisis as China started to recognize the risks inherent to their reliance on the USD. As part of this effort, the PBOC announced in 2005 that it would adopt a managed floating exchange rate system in which the daily fix for the exchange rate was to be determined by referencing a basket of currencies, instead of only the USD, and allow the currency to float within strict bands.

In December 2015, CFETS unveiled the CFETS RMB Index to be used to assess exchange rate movements. This was an attempt to shift the market's focus from the RMB against the USD exchange rate to the RMB's performance against the basket of currencies used by its trading partners, reflecting the perspective that the exchange rate should capture the international trade flows of China. The original Index consisted of 13 currencies with weightings based mainly on a trade-weighted average, as such the USD had the largest weighting at 26.4%. In December 2016, 11 more currencies were added to the CFETS Index, resulting in a reduced weighting for the USD.

More recently, the CFETS announced that it would adjust weightings in its currency basket from January 1st, further reducing the USD weighting from 22.40% to 21.59%.

Year-on-year growth in the global trading of RMB has been the highest of any currency. Average daily volumes have increased from USD 119bn in 2013 to USD 285bn in 2019. Domestically, FX is the largest asset class, making FX swaps, at 48% of volume, the most widely traded product as market participants have become more sophisticated in trading FX instruments as tools to hedge risk and as a means of funding.

Despite the growth in the domestic FX market, it is still very small relative to GDP and its economic links with the rest of the world even when compared to other emerging market economies. It is expected that demand for more complex FX products will grow as banks look to offer more complex structured products to their clients and as investment managers seek alternative investment solutions in response to changes in regulation. The FX market should be encouraged to grow by enabling firms to structure yield-enhancing products and zero-cost hedging strategies using exotic options. The product offering could also extend to an exchange-traded market in FX futures and options that would provide end-users with alternative hedging tools as well as additional liquidity and transparency in the market.

Despite the growing domestic demand, the FX market—except for spot and FX swaps, which are highly liquid—is inefficient and costly, thus making it less attractive. A contributing factor is regulations restricting access to non-bank participants that trade both sides of the market. Hedging in the FX market is currently very directional, resulting in a build-up of risk by the banks, who act as liquidity providers. This incurs costs that need to be recovered through wider spreads, which dampens the demand from end-users. In order to further attract international capital and grow the domestic market through increased liquidity and transparency—as well as reducing the costs of trading—the restrictions over access to the market should be removed.

For participants transacting onshore, FX trades are governed by NAFMII master agreements. This practice restricts the ability of international market participants to trade with domestic commercial banks as they would normally use international master agreements to assist in the management of credit risk. The use of separate agreements between onshore and offshore trades creates basis risk because of the different treatment of collateral, settlement, and close-out netting. Consideration should be given to the introduction of international master agreements.

As China looks into removing its dependency on the USD, it will need to increase the use of the RMB as a settlement currency used to settle current account transactions. In 2018, the RMB was the eighth most active currency for domestic and international payments. In terms of international payments, the RMB ranked eighth in November 2018 with a share of 1.16%; in December 2020 neither its rank nor share had changed.

As noted, increased use of the RMB outside of China will result in increased familiarity among investors, which will result in much greater FII participation directly in China markets. China has set up USD 500 billion equivalent in CNY currency swap agreements with more than 30 countries. However, there need to be adequate offshore CNY deposits in order to ensure that there is adequate liquidity, and to do this China would need to run either a current or capital account deficit. Without a significant increase in RMB usage outside of China, projects such as the Belt and Road Initiative will continue to be funded in USD or local currency.

4 Regulation

As we have noted above, there has been a great deal of financial market reform in China and we also recognize that, for reform to work, technical cooperation across multiple agencies is required, which can be challenging. However, from a practical standpoint, the implementation of these measures has not been as smooth as one would like. Some of these regulatory changes, although welcome, have given market practitioners insufficient time to respond. Providing ample notification of new rules as well as allowing enough time for public comment and implementation will significantly improve the regulatory rule-making process. More advance coordination would help to ensure sufficient industry buy-in and minimize implementation risks, which benefits everyone. Abandoning the practice of implementing regulations immediately after a consultation closes would go a long way to building trust in the process as clearly the responses could not have been given adequate consideration within such a short time period.

Conversely, other policy changes, once introduced, have been implemented more slowly than some market practitioners would like. It was a year before regulatory authorities approved the first majority stake in a domestic financial firm by an international bank, and licenses for some international rating agencies, underwriting licenses for fixed income participants, clearing licenses for bank and bank card payment firms take a significant amount of time—sometimes years—before being approved and seem to be quite often linked to the state of the political relationship with that firm's country. Often, the update of tax legislation is even slower than other regulatory changes. For example, so far there are no tax regulations addressing the tax treatment of the new investments introduced by the new QFII regulation, which was released in September 2020. We believe that by opening foreign firm participation in the domestic market, China has an incredible opportunity to build on the experience of developed markets, avoid their past mistakes, and leapfrog their successes.

5 Operating in China

With 100% foreign ownership of Chinese private fund management companies ("PFMs") being permitted since 2016, of Chinese banks since August 2018, and of Chinese securities companies, fund management companies (FMCs), and futures companies from April 2020, we have seen at least 32 wholly foreign-owned PFMs established (mostly in Shanghai, one in Shenzhen, two in Tianjin and two in Zhuhai) and at least six applications for a wholly foreign-owned FMC submitted to the CSRC for approval as of the end of 2020. We have neither seen any applications for wholly foreign-owned banks nor majority foreign-owned banks in China, but at least eight CSRC approved majority foreign-owned securities companies have been approved in China as of the end of 2020. The option for foreign interests to establish a wholly or majority foreign-owned entity in the Mainland is clearly present, but as we have observed, one cannot rely on the fact that one structure was approved and followed the same precedent. This is a high-risk strategy in China. Greater clarity by regulators as to the types of acceptable structures would provide much greater certainty to firms looking to set up or expand their business in China, which would make things more efficient for all sides.

5.1 Simplification of the Complicated Regulatory Structure

A clear and simple regulatory structure in any country obviously has its benefits as it would reduce bureaucracy and facilitate the doing of business. It would also take a lot of determination and effort to achieve this in a country like China where there are many regulators with overlapping jurisdictions which means firms in the same sector may require different licenses depending on their legal structure. For example, banks, insurance companies, securities companies, and fund management companies are all able to conduct asset management services, but the CBIRC regulates banks and insurance companies, while the CSRC regulates securities companies and fund management companies.

While there is an attempt to standardize the asset management services provided by financial institutions and unify the regulatory standards for similar asset management products in the Guiding Opinions regulating Financial Institutions' Asset Management Business issued by the PBOC, CSRC, CBIRC, and SAFE on 27 April 2018, the Guiding Opinions have yet to be implemented and we do not know how effective they will be in achieving their stated goal as there are still different regulators and different regulations for similar types of services, which is confusing not only for market participants but also the investing public.

It is not surprising that within the investment or asset management business, there would be different regulations for public and private funds, insurance and pension-focused products, investment management and advisory services, as well as inbound and outbound investments. However, what is particularly inefficient is the need to set up separate entities (e.g. fund management company (FMC) for retail funds, private fund management company (PFM) for private funds, QDLP for outbound investment funds) in China to be able to provide each of these services. Unlike other financial hubs (including Hong Kong), firms in the Mainland are not able to set up a single entity with different licenses that can carry on multiple lines of essentially the same business. This is highly inefficient, increasing operating costs and reducing profitability for firms operating in China, particularly firms (foreign or domestic-owned) that have plans to diversify and expand their business lines. For the sake of not only foreign-owned firms but also domestic firms and the investing public, China should move toward further simplifying its regulatory structure and allow single entities to conduct multiple lines of essentially the same business, particularly in the asset management business. Any potential conflicts of interest can be addressed by requiring Chinese walls to be established separating the various business lines, as is commonplace in other major jurisdictions, instead of requiring such business lines to be in separate operating entities.

Another challenge is the opacity of abiding by the regulations once you have the approvals and licenses to operate. The reality is that it is often difficult to interpret Chinese regulations (often deliberately), and they are often overlapping or duplicative, so implementation is challenging, and many rules are not designed with foreign-owned firms and operating models in mind (see next section). The Personal Information Protection Law and Cybersecurity Law are two very good examples of this reality. Requirements for extreme transparency to regulators on all of a firm's activities, such as regulatory reporting, often mean hundreds of required reports to be provided per month per entity. Finally, and as noted throughout, the massive volume of regulatory change that is coming down the pike all at once as China catches up with other global regulatory frameworks—at China speed and often with limited consultation—as noted above—means these approval schemes and regulatory rules even if understood make operating in China challenging.

5.2 *Cross-border Sharing of Information, Cybersecurity, and Operation of Global Practices*

Among the benefits that China recognizes in having more foreign-owned or controlled financial institutions operating in the Mainland is the opportunity to bring established and global best practices to China to raise the standard of domestic players so that they are able to compete more effectively on the global stage. However, when setting up wholly or majority foreign-owned entities in the Mainland, foreign institutions encounter several operational challenges, which, if addressed, would not only be helpful to foreign-owned financial institutions but also the development of China's capital markets.

For example, one of the biggest challenges for global financial institutions are Chinese regulations that restrict the sharing of information, knowledge, and technology between onshore entities and their offshore affiliates, which disproportionately affects international financial institutions operating in China and facilitating capital inflows to support the growth of the broader economy.

While the Chinese government's concern with data privacy and protection—especially personal data—for its citizens is legitimate and no different from that of other major jurisdictions—we believe that policymaking should be reasonable and proportionate. Personal information is pivotal to the financial industry and is already highly regulated, and concomitant protections on the collection and processing of such information are essential to the integrity of financial markets and, more broadly, the confidence of customers and businesses. While it is also important for governments to set cyber security standards, this should not be detrimental to financial service providers' abilities to provide legitimate services, conduct legitimate business in China and/or comply with international anti-money laundering regulations and KYC requirements. The current laws make the business climate in China unpredictable for both foreign and domestic-owned firms in terms of cross-border data flow and the use of technology in line with global best practices.

This translates to localizing more of a firm's people, processes, systems, and data than in many other markets in APAC and in EM globally, which often lend to using fragmented technology and divergence from efficient global operating models. This is a particular problem for global financial institutions that ordinarily deploy global systems of internal controls to ensure compliance with both local regulations and global requirements, including compliance with anti-money laundering and counter-financing of terrorism laws through global service centers. Localization does not improve data protection. On the contrary, burdensome localization requirements introduce technical complexities and additional administrative layering into corporate operations, both of which ultimately compromise cybersecurity and risk management. They also undermine the ability of firms to leverage the use of cloud technology globally, which offers best-in-class cybersecurity and technology.

As a consequence of China's unique approach to data and privacy, foreign-owned firms need to spend significant amounts of internal stakeholder management explaining why, for example, policies and operating models need to be localized for

China, or exemptions carved out, which makes operating in China extremely inefficient. Finally, the complexity of navigating the Chinese regulatory environment, combined with the required knowledge of operating in an international environment existing within foreign-owned firms, means a need for a strong local management team that can operate and make decisions to a firm's culture and principles and with the trust of management. The talent pool for such a unique skill set on the mainland is very small. This makes it challenging to find, train, and retrain staff when competitors are all trying to establish and expand their businesses.

It is also important to recognize that the sharing of data across borders is not only good for bringing into China the best technology and practices for managing internal controls, and compliance for large companies, particularly global firms, but also for the overall development of China's own financial industry and its personnel. We suggest that some of the regulations that prohibit the cross-border sharing of information be relaxed or clarified to allow for information sharing across borders for legitimate reasons and with proper safeguards.

The cross-border sharing of research between onshore and offshore entities, particularly for global financial institutions, is especially important to the ultimate integration of China's capital markets with that of the world. Regulators in financial hubs such as New York, London, Hong Kong, and Singapore vie to attract investment professionals such as portfolio managers and research analysts to their jurisdictions, and it would be in China's interest to do the same. Clarifying that the management of offshore funds sold outside China by onshore managers would not create a permanent establishment issue for these offshore funds in China would further encourage the relocation of investment professionals to China, which is beneficial not only to the development of the investment management business within China but also for the valuable exposure for China-based investment personnel to the offshore fund management business.

5.3 Level Playing Field

China's removal of foreign ownership limits on most of its financial institutions over the past two years is most welcomed, but the application of certain policies and unwritten rules to only foreign-owned entities means that the playing field remains unlevel for foreign-owned entities in China in certain areas. For example, we understand that with the "One Control and One Participation" policy (i.e. a shareholder of an FMC is limited to having control over one FMC and minority interest in another FMC) the CSRC will not, in practice, allow a foreign shareholder to have an equity interest in more than one FMC. This is not beneficial or helpful as China has made a lot of progress in trying to level the playing field for foreign-owned firms over the past few years. The "One Control and One Participation" also applies to banks, but many foreign-owned banks have a banking business, a securities brokerage business and even an asset/wealth management business, all under the same group. If such a policy was to apply at the group level, it would disadvantage foreign-owned banks more than domestic-owned banks, so it may be helpful for China to clarify that this policy applies separately by institution type rather than at a group level.

6 Investing in China

Finally, China clearly wants to attract more foreign capital, as frequently noted, while FIIs clearly are interested in investing in China's capital markets.

6.1 Alignment of Access Channels

However, the multitude of investment access channels and their different requirements and investment scopes are very confusing to FIIs and make it difficult for them to easily invest in China's equities and debt markets.

After almost 20 years, China finally simplified its first investment access scheme for FIIs, the onshore QFI scheme, by merging it and the subsequent RQFII scheme into one QFI scheme last September. In the meantime, China also launched in 2010 an onshore access scheme for FIIs to invest in the CIBM, followed by an offshore Stock Connect scheme between the Shanghai and Hong Kong stock exchanges in 2014 and between the Shenzhen and Hong Kong stock exchanges in 2016, and an offshore Bond Connect scheme for FIIs to invest in the CIBM in 2017.

Due to the different investment scopes (with the onshore ones having a broader investment scope and permitting more activities) and operating requirements (such as capital controls when investing from onshore) of these schemes, FIIs often have to choose between one access channel over another or incur the time and monetary costs of investing through multiple access channels, which often require different infrastructure or system supports. Like the issue of financial institutions having to operate in China through many different entities, it is highly inefficient for FII investments in China to go through multiple access channels. Alignment of the access channels to the same markets, such as CIBM Direct and Bond Connect to the CIBM, would greatly reduce the complications involved, make investing in China easier for FIIs, who would like to be able to consolidate their positions in one scheme for ease of management and to reduce duplication, minimize operational risks, achieve cost efficiencies, and optimize returns for their end investors.

Further Reading For a more in-depth analysis of capital and financial markets in China, please see the following papers:

ASIFMA's "China's Capital Markets: The Pace of Change Accelerates", June 2019.

ASIFMA's "Accessing China's Capital Markets", January 2021. ICMA's "The Internationalisation of the China Corporate Bond Market", January 2021.

ISDA's "Developing Safe, Robust and Efficient Derivatives Markets in China", Upcoming 2021.

EuroCham's "Decoupling: Severed Ties and Patchwork Globalisation", January 2021 WEF's "Data Free Flow with Trust (DFFT): Paths towards Free and Trusted Data Flows", June 2020.

ASIFMA's "Technology-Neutral Principles for Virtual Data Storage", June 2019.

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