Clarity, simplicity, practicality: China investments enter a new era

RMB Investors Forum Whitepaper

Here for good

Foreword

I am pleased to share the research and insights from the RMB Investors Forum 2018, our annual survey and discussion programme on China investment.

Several years ago, we recognised that there was a need to engage with market experts on the real investment issues surrounding China through research, debate and analysis. In response, we set up the RMB Investors Forum to provide a comprehensive understanding of how investors are reacting to the unique opportunity of investing into China.

Now in its third year, the programme includes a survey of investors, regulators and custodians in Asia, Europe and North America; we gauge their views on the issues impacting investors wanting to access China's onshore markets.

This year's survey gathered responses from 189 investment professionals and the results were used as the basis for a series of roundtable discussions in major financial centres. This year our discussions took us to Hong Kong, Singapore, Taiwan, South Korea, the United States and the United Kingdom, where investment professionals shared their insights with us, many of which have been used to support and develop the findings in this whitepaper.

Over the past three years, the RMB Investors Forum has tracked how China has become a bigger priority in portfolios as investors' understanding and comfort levels increased. It has also provided an important gauge of shifting investor preferences towards how they access China and their expectations for future market developments.

Key findings

Each year our survey provides new insights on how investors feel about China. This year's key findings include:

- Investor confidence is at its most bullish since we launched the survey with 88 per cent of respondents now investing in China, up from 69 per cent in 2017
- Positive investor sentiment is no longer concentrated only in the traditional RMB hubs of Hong Kong and Singapore. North America and Japan are among markets that are adopting a more bullish attitude towards China
- Investor priorities are shifting from the design of investment mechanisms to more practical considerations such as access to funding and account opening
- Thanks to their simplicity, Stock Connect and Bond Connect have become core investment channels, with 48 per cent of respondents planning to use Stock Connect for future investment, and 23 per cent expecting to use Bond Connect
- Index inclusion is impacting investor behaviour with 44 per cent of respondents investing before rebalancing
- Index providers are also helping to advance market development by setting the conditions and timelines for inclusion that encourage regulators to act
- Hong Kong faces greater competition from offshore financial centres such as London and Frankfurt, which want to connect to China's markets directly

I would like to take this opportunity to thank the investment professionals who took part in the survey and shared their insights with us. Standard Chartered looks forward to working with you and to continuing to deliver solutions that support and advance access to China's markets.

Margaret Harwood-Jones
Global Head, Securities Services, Transaction Banking, Standard Chartered

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Introduction

Following a number of challenging years for inbound China flows, investor sentiment is now at its most bullish since Standard Chartered launched the RMB Investors Forum Survey.

"The headline finding is that sentiment towards China has never been better and never have more people invested in China than today," said Margaret Harwood-Jones, Global Head, Securities Services, Transaction Banking at Standard Chartered.

The 2018 survey shows that China access is moving into a new era, one where concern over regulation gives way to more practical considerations.

This shift has been driven by the two issues that have dominated China investment this year — new access schemes and index inclusion.

The launch of the Bond Connect programme in July 2017 and continued enhancements to the Stock Connect programme have provided investors with two channels that provide a clear operational framework and swift application approvals. By reducing concerns over safety and transparency, the mechanisms are attracting fresh interest.

In addition, the inclusion of A-shares into the MSCI Emerging Markets Index and the proposed entry of onshore bonds into the Bloomberg Barclays Global Aggregate Index are spurring market enhancements, as regulators and markets take action to meet the inclusion criteria.

That said, there are still plenty of issues that China's regulators need to address, from clarification on the treatment of tax, to the harmonisation of investment channels.

But for the majority of market participants, the decision about whether to invest in China is no longer a question of if, but how.

Optimism drives China investment globalisation

Sentiment over the last few years could be described as cautious optimism. While the investment case for China is well known, the last few years have witnessed periods of volatility and a degree of regulatory uncertainty.

These periods, most notably in August 2015, continued to cast a shadow over investor sentiment into China: fueled by fears over potential capital controls and market change.

However, 2018 has seen that caution transform into robust confidence, with investor sentiment now at its most bullish since Standard Chartered launched the first RMB Investors Forum survey. This year, investors have stepped up their activity with 88 per cent of respondents investing in China (2017: 69 per cent) and 76 per cent noting plans to grow their China investments (2017: 69 per cent).

China investment has globalised

One of the key findings from this year's survey is that investor sentiment on China is no longer concentrated in the traditional RMB hubs of Hong Kong and Singapore: with newer centres leading the charge on accelerating investments into China.

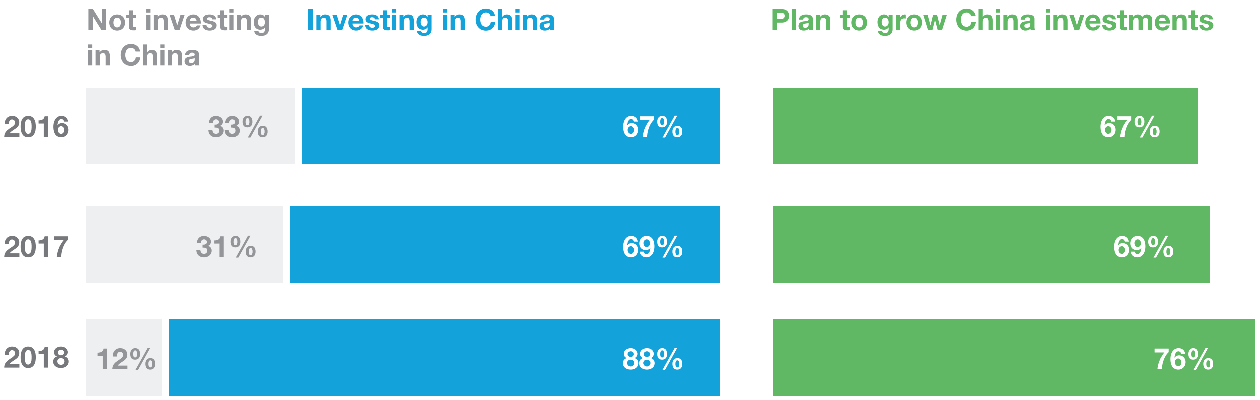
Understandably, Hong Kong scores highly when it comes to the proportion of investors who have investments in China (96 per cent) and for those who are expected to increase that in 2018 (81 per cent). However, North America has emerged as one of the most positive regions with 78 per cent of respondents investing in China and 87 per cent looking to increase their participation. Singapore also scores highly (with 91 per cent currently investing and 100 per cent expecting to increase). Equally, Japan is demonstrating a bullish view on China for the first time since our survey began: reflecting a growing desire to bring Chinese assets into Japanese pension schemes, among others.

"Our statistics show that investment flows from Japan are increasing quite rapidly," said a participant at the Hong Kong roundtable.

Investor certainty increases investment flows

Last year, there were three issues that investors considered the biggest obstacles to investing in China: a lack of clarity around operating rules, FX risk, and regulatory uncertainty in their home market. Yet in a further sign of how much investor sentiment has shifted in 2018, these three issues have largely disappeared from the list of concerns. This is because the new investment mechanisms — especially the Connects — have brought a greater degree of certainty to investors. As a result, they have been the leading contributor to new investment flows into China.

1.1 Changes to investments in China over the next 12 months

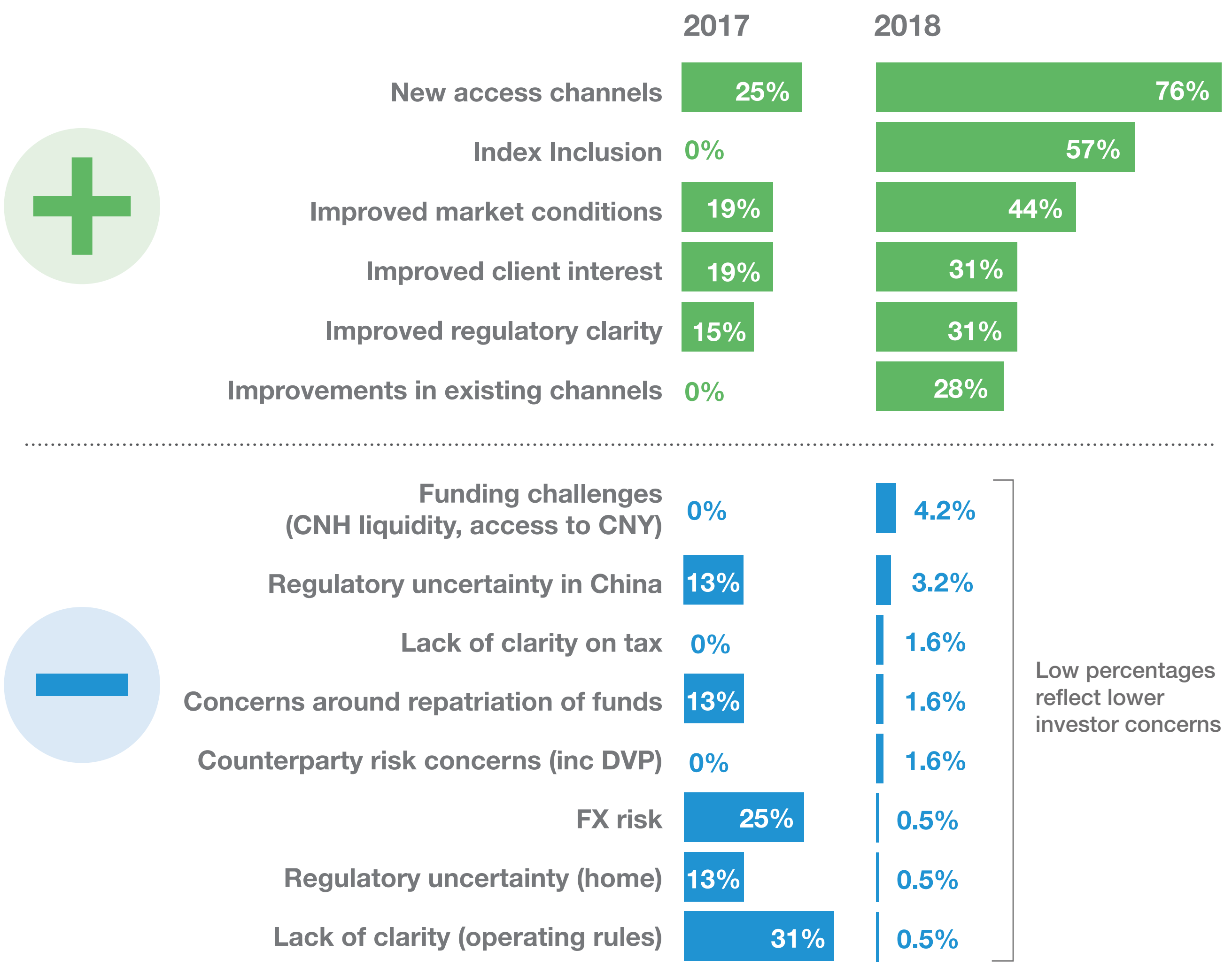


Positive response to new access channels

These developments have driven a new bullishness. Since 2017, there have been a number of key developments around China access, including the launch of Bond Connect, the introduction of delivery versus payment on Stock Connect, and the inclusion of mainland stocks into the MSCI Emerging Markets Index.

Just over three-quarters (76 per cent) of respondents cited new access channels as having the biggest influence on the decision to increase China investments, up from just 25 per cent in 2017. Index inclusion is the next largest driver (57 per cent). While 'improved market conditions' was only the third most important influence on investment decisions, China's macroeconomic backdrop over the past 12 months has certainly been conducive to investing, thanks to stability in the renminbi and in capital markets.

1.2 Reasons why investors do or do not invest in China



Taiwan takes a long-term view

However, for all the positive developments, there are still pockets of caution. According to the survey, 33 per cent of Taiwan respondents are not sure whether they plan to increase their investments. This partly stems from the memory of the turbulence of the last few years, said a participant at the Taiwan roundtable.

"I think the reason investors are not convinced is because two years ago there was the surprise renminbi depreciation. Another issue is that offshore renminbi funding is not there. The lack of transparency means that every time the renminbi depreciates, the funding tightens. You can buy a Chinese government or policy bank bond with a five or ten-year maturity, but if you roll over your funding, you will face more uncertainties."

But it's also important to note that Taiwanese investors have been investing in China for longer and with bigger allocations than most other markets, says Dennis Chao, Head of Fixed Income and FX at Hontai Life. As a result, they have already built their China exposure, unlike markets that are just starting to look at mainland assets.

"If you just compare Taiwan to other investor bases, we already invest into China and we know the Chinese markets," he said.

Europe stays on the sidelines

European investors are also showing a greater reluctance to increase their exposure (24 per cent). In part this stems from the lack of clarity over regulatory and operational issues.

"We are 150 per cent committed and have a very strong commitment from our senior management, and realise China is the place to go to. But where we hit roadblocks is on the operational and compliance side of things," said a participant at the Hong Kong roundtable.

One of the challenges for European investors is that expansion of China access mechanism coincided with introduction of UCITS V, which introduced a new risk management framework and culture throughout the investment management industry. And this conservatism is also reflected in the lack of priority they placed on China in their investment strategies, with 43 per cent categorising the market as a niche investment, presumably indicating that European investors still don't feel that they have sufficient clarity on China to adequately manage their risks.

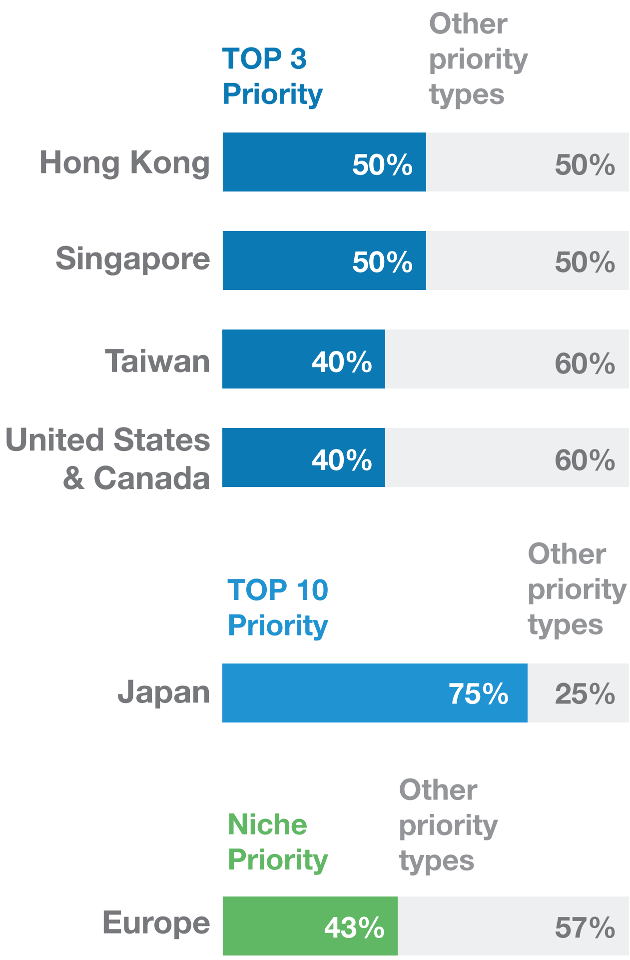
"As a European bank — so under European regulation — we need things to be clear and straightforward, otherwise compliance will stop me and ask me questions that I am not in a position to answer. And because I cannot answer now, I have to hold off from investing until everything is clear," explained a participant at one of the roundtables.

In contrast, nearly all the other markets and regions now say that China is a top-three priority. This includes Taiwanese investors, which shows that while there is some reluctance to invest, they recognise the market is one they need to monitor. Investors in Japan are also starting to take a keener interest in China, with it becoming a top-ten priority.

China is a priority for regulators

When it comes to investor type, it's clear that China is a strategy that continues to be driven by institutional investors with 47 per cent considering it a top-three

1.3 The importance of the China market to current investment strategy



priority. This is to be expected given that investors such as central banks and sovereign wealth funds have access to a wider variety of tools to hedge and manage their risk onshore than other investor types. In addition, the renminbi's entry into the International Monetary Fund's Special Drawing Rights (SDR) basket in October 2016 also created an increased natural demand for China assets from central banks.

Given the accelerated roll-out of access schemes, it is perhaps not a surprise that 54 per cent of regulators considered China one of their most important markets.

And while European regulators are likely to retain a conservative approach to China investment schemes in the short term, one participant from the Hong Kong roundtable is optimistic about the future.

"The regulators are learning: it's a slow but sure progress. And with more experience comes more confidence and that's what we are seeing," he said.

Standard Chartered also maintains a regular dialogue with regulatory authorities in Europe, for example working closely with them to ensure that Bond Connect was recognised as an investment mechanism under the UCITS V and Alternative Investment Fund Managers Directive (AIFMD) regimes, as well as continuing to work for greater clarity around issues such as the need for true delivery versus payment across all investment channels.

In contrast to regulators, global custodians are less focused on China than their clients, with 11 per cent not seeing China as a priority compared to 3 per cent of investors.

Equity and bond investors align

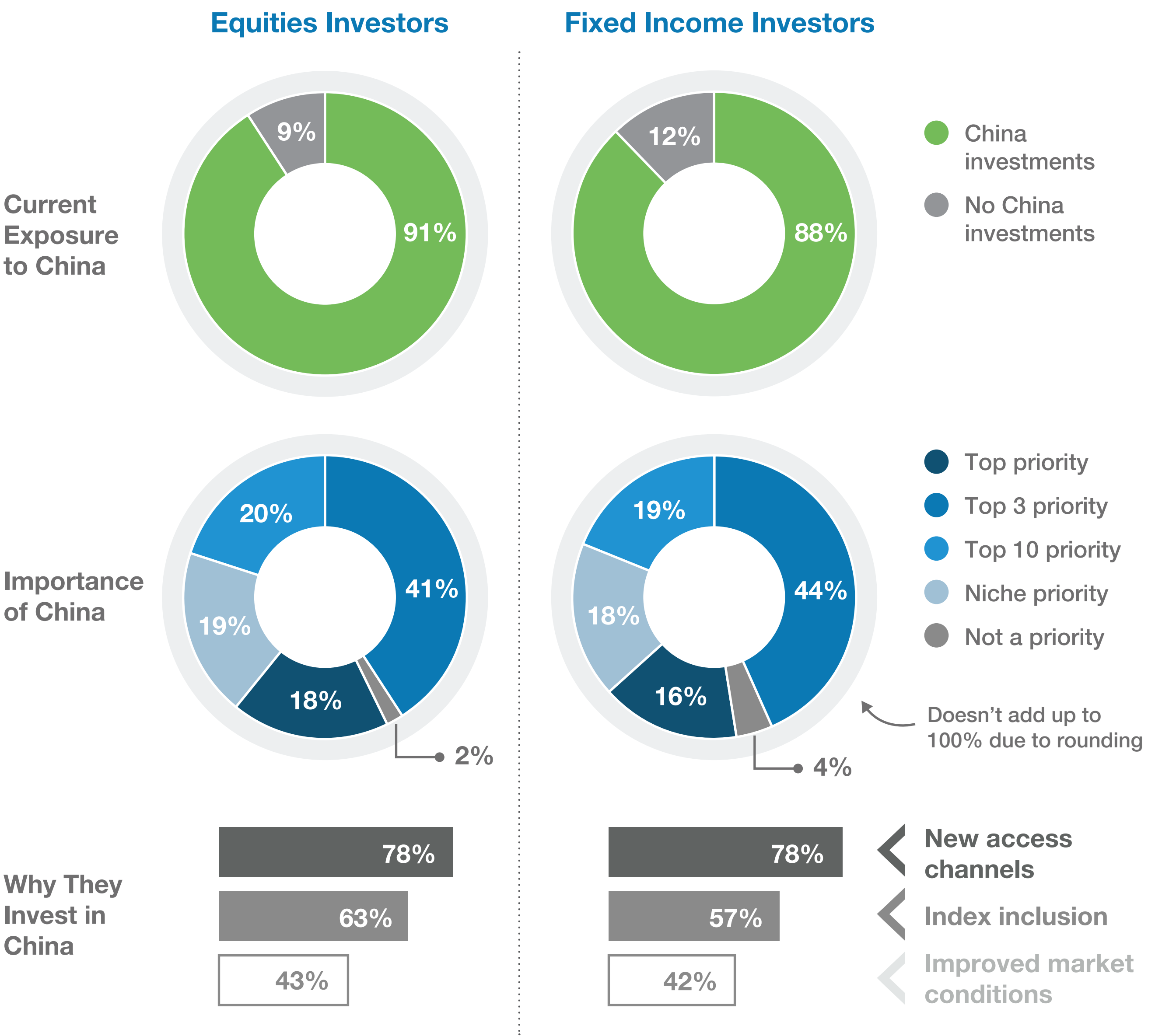
Interestingly, one area where there is no distinction between investors is in the perspective of equity and fixed income investors. This is noteworthy given that equity investors have had access to China's market for a longer time and the fact that equity and bond in-

vestors use distinct schemes that offer various levels of access, hedging and settlement.

Some 91 per cent of equity investors have a current exposure to China versus 88 per cent of bond investors. These parallels are apparent for nearly all metrics including citing new access channels as the top reason why they invest (78 per cent vs 78 per cent) and considering China a top-three priority (41 per cent vs 44 per cent).

The shift in sentiment evident from this year's survey demonstrates that many of the arguments about whether to access China have largely been settled in investors' minds. The questions investors are now grappling with are when to invest and which access channel makes the most sense.

1.4 Equities investors vs fixed income investors



Simplicity steers the Connects to dominance

In our 2016 and 2017 surveys, clarity on rules was by far the most compelling concern among global investors when considering new investment channels into China. Today however, while clarity remains one of the priority issues, with 45 per cent of investors saying it is the most important investment factor, it is only one of three evenly ranked concerns. Funding flexibility (44 per cent) and speed and simplicity of application and/or account opening (41 per cent) are now equally key, highlighting a shift in investor priorities from more 'design'-based issues towards more practical considerations around operations and practicality.

After an increasing amount of time using the existing channels, experienced investors are now focusing more on practicality as they push for the optimal solution. Rounding out the top five are cost (34 per cent) and legal regime (32 per cent).

Need to hedge creates funding concerns

The main reason that funding flexibility has become a greater priority is the strong need to hedge by institutional investors. In light of growing regulation, leading insurers and pension funds need access to a complete range of CNY-denominated hedging instruments in order to adequately manage their currency risks. This remains a concern given that each access channel into China provides different access to these hedging tools: creating variation that can at times be confusing.

In addition, one of the concerns ahead of MSCI index inclusion was the availability of enough offshore renminbi (CNH) liquidity to fund the expected rise in Stock Connect transactions at the time of rebalancing. Fortunately, thanks to extensive engagement with and support from regulators in China and Hong Kong, the most recent rebalancing of MSCI's Emerging Markets Index caused minimal stress on the CNH.

Meanwhile, the need for speed and simplicity regarding the application process provides further support for the Connect mechanisms which give investors access within a matter of days compared with the months-long application process that has characterised the Qualified Foreign Institutional Investor (QFII) and Renminbi QFII (RQFII) schemes.

Speed is an issue that particularly comes to the fore in the context of index inclusion. As the months leading up to MSCI rebalancing demonstrated, index inclusion created a surge of demand for new accounts and the ability to process those quickly was vital if investors were to get access in time.

Clarity, practicality or speed?

While there is a clear agreement about the top five factors of clarity, funding flexibility, speed, cost and legal regime, when viewed from the perspective of different market groups, variations come into view.

Clarity is the primary concern in Singapore with 73 per cent of investors from the country citing it as an important factor, while speed dominates in Europe (55 per cent), North America (61 per cent) and Taiwan (61 per cent). Meanwhile for Japanese investors, legal regime and costs are joint-first priorities at 63 per cent.

Importantly, the inability of any of the channels to address the top five factors identified by global investors, is what encourages market participants to maintain the older channels alongside the newer ones. For example, for all its advantages, Bond Connect does not allow investors to hedge their exposures using onshore renminbi (CNY), but that is something that is available on CIBM Direct.

[1] Reuters, China to aid cross-border yuan flows ahead of MSCI inclusion, 18 May 2018, https://www.reuters.com/article/china-pboc-flows/refile-update-1-china-to-aid-cross-border-yuan-flows-ahead-of-msci-inclusion-idUSL3N1SP3IK

2.1 Important factors for choice of China investment channel

	2016	2017	2018
Clarity on rules	29%	16%	45%
Funding flexibility (CNH & CNY; hedging)			44%
Speed & simplicity of applying / Account opening		14%	41%
Cost	16%	14%	34%
Legal regime (HK vs China)			32%
Best execution / Choice of brokers			28%
Asset class coverage	13%	15%	20%
Eligibility requirement	13%		19%
Available quota	9%	13%	15%

2.2 Access schemes vs investors' top five important factors

KEY: Yes / Partially / No

	QFII	RQFII	Stock Connect	CIBM Direct	Bond Connect
Clarity on rules	Yes	Yes	Yes	Yes	Partially
Funding flexibility	No	Partially	Partially	Partially	Yes
Speed & simplicity	No	No	Yes	No	Yes
Cost	Yes	Yes	Yes	Yes	Partially
Legal regime in Hong Kong or China	No	No	Yes	No	Yes

Investors maintain multiple access mechanisms

For example, some 19 per cent of investors cited offshore bonds as a core investment channel, while QFII fulfils that role for just over 12 per cent. Perhaps more importantly, offshore bonds, QFII and even access products such as participatory-notes (P-notes) have carved out positions as access mechanisms with established, if niche usage.

"If it's an RMB investment we use the Connects; if it's a USD/HKD investment then we use QFII, that's how we decide. It also depends how we want to use the proceeds," explained Leo Shen, Deputy CEO at Rongtong Global Investment.

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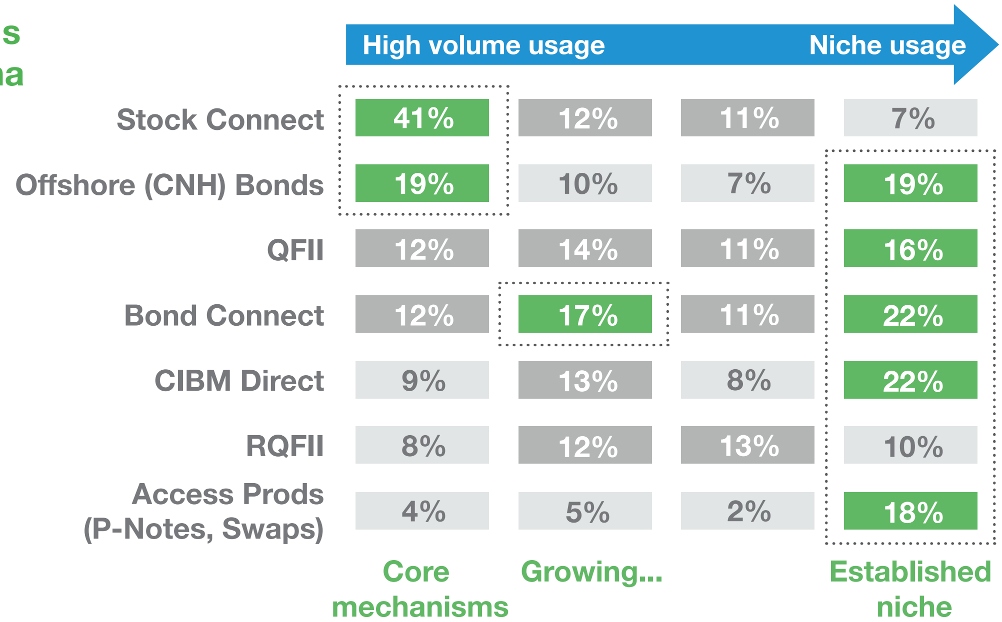
2.3 Current channels used to access China investments

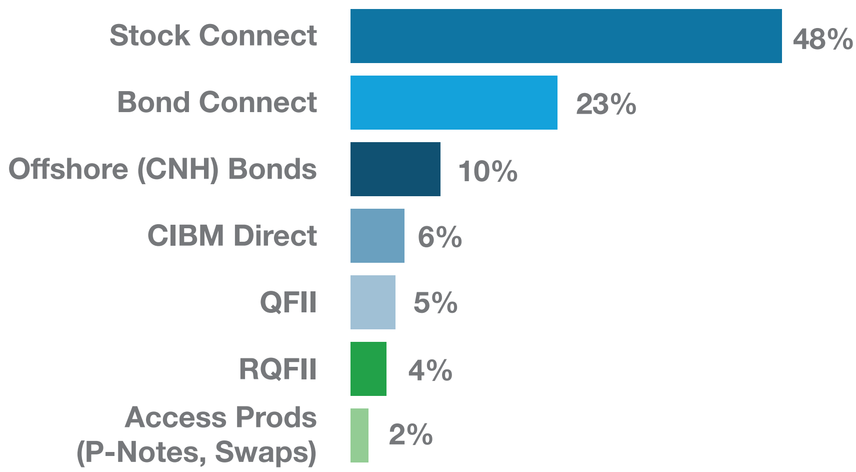


Connects become a core investment channel

But what is clear from the survey responses on both present and future use is that the Connects have become a core mechanism. Forty-one per cent of respondents are using Stock Connect as their core access channel and 48 per cent expect to use it for future investments — more than any other access mechanism. And Bond Connect looks set to copy the success of its older stablemate. One year in, and the survey shows Bond Connect has overtaken CIBM Direct as a core mechanism (12 per cent versus 9 per cent). Most telling about the scheme's future potential is its position as the second most-picked channel for future investments, at 23 per cent.

"When CIBM Direct launched, we didn't get many enquiries from private banks, but when Bond Connect started we got lots of questions. I think the reason for this is the success of Stock Connect. With Stock Connect, the entry is easy and it also allows intermediaries and the nominee structure," said a participant at the Singapore roundtable.

2.4 Expected future channels to access China investments



Bond Connect a blueprint for success

A closer look at the trading figures for Bond Connect demonstrates that when investors have access to a mechanism that meets their requirements for clarity, simplicity and practicality, it attracts a high level of flows. Bond Connect welcomed its 300th registered user in early May, with investors drawn from nearly 30 jurisdictions including Hong Kong (66 per cent), Taiwan (9.5 per cent), Singapore (5.6 per cent), the United States (4.9 per cent) and the United Kingdom (3.6 per cent), among others.[2]

The average daily trading volume reached around RMB3 billion, with total trading worth more than RMB60 billion at the time of writing. The figures, combined with the survey results on future channels for investment, support Standard Chartered's view that foreign investors will own some 4 per cent of outstanding onshore bonds by 2020, more than double the current 1.8 per cent. Certainly, for one fund manager, the introduction of Bond Connect was the catalyst that finally encouraged it to enter China's fixed income market, according to a participant at the Hong Kong roundtable.

Senan Yuen, Fidelity International

"For us liquidity is key, so Bond Connect is the best solution. When it was not there, we had zero interest," he said, while cautioning that the scheme does not yet meet all of the fund manager's investments needs.

"Having said that, the investment opportunities with Bond Connect are still somewhat limited because of the tax situation. That means arbitrage trades just don't work, so our exposure has been short-term sovereign paper and take a bit of carry. Our investor base prefers that rather than being exposed to uncertainty."

Connects still a work in progress

As the fund manager pointed out, the Connects are in some ways still under development — whilst other channels are secure in their niche. This is especially true for Bond Connect, where delivery versus payment is not available (unlike with CIBM Direct). In addition, Stock Connect does not yet offer the ability of block trading or trading on a Hong Kong public holiday, though it is hoped that all these issues will be resolved later this year.

"QFII still offers a couple of advantages over the Connect programme," said Senan Yuen, Head of Change Delivery, Asia at Fidelity International. "For example, when it's a holiday in Hong Kong, you can't trade in China, whereas with QFII you can still trade. For that

[2] Bond Connect, Welcome the 300th registered overseas investor of Bond Connect, 8 May 2018, http://www.chinabondconnect.com/documents/Bond_Connect_Registration_News_Release_180508(E).pdf

reason, some investors would continue to use QFII alongside the Connect programme."

Furthermore, because registration takes place through Hong Kong and offshore entities, the Connects also do not meet some participants' desire to be visibly investing in China — an important consideration for institutions that have broader strategic aims. For example, fund managers that have ambitions to sell funds and services onshore through a wholly foreign-owned enterprise (WFOE) may want to show their commitment to the market by using channels such as CIBM Direct or QFII, which require them to register with onshore regulators and brokerages. Likewise, central banks have preferred CIBM Direct as it offers more direct access to CNY and to a wider range of investment and hedging tools.

QFII, CIBM Direct still part of investors' toolkit

In addition, concerns over issues like CNH liquidity and quota limits mean investors are opting to spread their execution risk across multiple mechanisms. For example, 49 per cent of passive investors are using Stock Connect as a core mechanism, the biggest percentage of any investor group, but they also retain access to RQFII as a back-up. Meanwhile, at 30 per cent, Stock Connect is the most-used channel for actively managed funds, but 26 per cent of this investor group also use CIBM Direct as a niche channel. However QFII is the core mechanism for product creators (46 per cent) while Stock Connect is considered a more niche tool.

And while cost only comes fourth in the list of investor concerns across all respondents, Standard Chartered's discussions with investors highlighted the significant financial burden of maintaining multiple access mechanisms (for more see Scheme harmonisation section below). Specifically for Bond Connect, trading fees are seen as one of the biggest obstacles to using the scheme.

"We have several investments in China's onshore bond market including through QFII, CIBM Direct and Bond Connect. Bond Connect has several good elements but the most important thing is the cost is too expensive; we see it as more expensive than CIBM Direct," said Louis Mao, Fund Manager at Yuanta Funds.

The key conclusion here is that, although many access mechanisms are reaching advanced stages of maturity, investors do not yet feel comfortable concentrating all of their flows into a single channel. Instead they operate at least two parallel routes: either to take advantage of specific features or to simply spread their risks.

Index inclusion: the catalyst for market development

Without doubt, this year the major market event for China investing was the inclusion of A-shares into the MSCI Emerging Markets Index. On June 1, 226 large-cap Chinese stocks were partially included with a weight of 2.5 per cent and accounting for 0.8 per cent of the index.[3]

Despite concerns around market readiness, China's first inclusion into leading global index products was a significant success. In the months leading up to the inclusion, some investors had expressed concern about the market's ability to trade normally. However, over the rebalancing period, HKEX's securities markets operated without any disruptions. Meanwhile, the utilisation rate of RMB liquidity in Hong Kong was approximately 8 per cent.

Inclusion delivers record Stock Connect volumes

There was a significant increase in Stock Connect trading volume on the index rebalancing day (i.e. 31 May 2018). The combined Northbound trading on the Shanghai and Shenzhen Connects reached a record turnover of RMB34.69 billion, up 57 per cent from a day earlier. This was the highest Northbound daily buy and sell turnover since the launch of the Shanghai-Hong Kong Stock Connect in 2014 . And as one of the top three custodian banks for Stock Connect, Standard Chartered Bank Hong Kong recorded a near 10 times increase in daily trading compared with the average between May and June 2018. The majority of these trades were settled on a Real-time Delivery versus Payment (RDP) basis using both RMB and USD as settlement currencies. Moreover, approximately 65 per cent of trades were settled in RDP over the rebalancing period on daily average basis, compared to less than 1 per cent in Q1 2018.

What the surge in RDP transaction volumes indicates is that the Special Segregated Account (SPSA) model with RDP and true best execution is the key priority for investors. The market is moving to standardised multi-broker model allowing real best execution, and investors are now widely adopting RDP settlement. For example, from March 2018 to May 2018, there was a 60 per cent increase in the number of SPSAs opened.[8]

[3] MSCI, https://www.msci.com/china

[4] The percentage is Stock Connect buy trades turnover amount divided by RMB deposit amount in Hong Kong.

[5] HKEX, HKEX markets operate smoothly on day of milestone index rebalancing, http://www.hkex.com.hk/News/News-Release/2018/1805314news?sc_lang=en
Bloomberg, China's stock market is about to burst on the global stage, 14 May 2018, https://www.bloomberg.com/news/articles/2018-05-13/china-s-msci-debut-is-about-to-put-new-stocks-in-your-pension

[6] HKEX, HKEX presents Stock Connect Awards to honour market participants, http://www.hkex.com.hk/News/News-Release/2018/180308news?sc_lang=en

[7] To meet the market demand for real-time settlement which would address the potential counterparty risk under the Delivery versus Payment (DvP) settlement model, the HKEX introduced Real-time DVP (RDP) money settlement model (in RMB, HKD and USD) for China-Hong Kong Stock Connect Northbound transactions on 20 November 2017. HKEX, KEX to introduce Real-time DVP for Northbound Stock Connect trading on 20 November, http://www.hkex.com.hk/news/news-release/2017/1711062news?sc_lang=en

[8] HKEX, HKEX markets operate smoothly on day of milestone index rebalancing, http://www.hkex.com.hk/News/News-Release/2018/1805314news?sc_lang=en
Bloomberg, China's stock market is about to burst on the global stage, 14 May 2018, https://www.bloomberg.com/news/articles/2018-05-13/china-s-msci-debut-is-about-to-put-new-stocks-in-your-pension

Investors concerned ahead of rebalancing

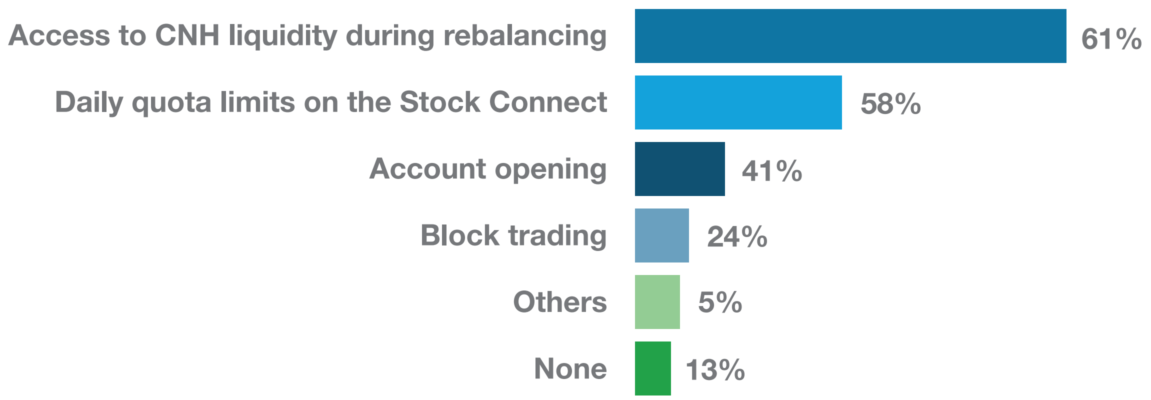
While index inclusion has proved a successful test of the Stock Connect infrastructure, investors voiced a number of concerns in the months leading up to rebalancing. Reflecting wider unease in the market at the time, some 61 per cent of equity investors in the survey said they were worried about whether the existing pool of offshore renminbi — which stood at about RMB525 billion when inclusion was given the green light [9] — would be sufficient to provide enough liquidity during rebalancing. Meanwhile, a further 58 per cent of equity investors had concerns about whether Stock Connect would be able to cope with the expected increased trading under the existing daily quota. This was particularly a concern for providers of passive investment products linked to the index who had no choice but to rebalance in June.

Regulators responded to both issues ahead of the deadline. In April, CSRC and Hong Kong's Securities and Futures Commission announced that from 1 May the daily quota for each of the Shanghai and Shenzhen Connects would quadruple – rising to RMB52 billion for northbound trading and RMB42 billion for southbound.[10] Then just over a month later, the PBOC announced measures to give Hong Kong and Macau-based clearing banks, and international investors greater access to onshore renminbi.[11]

Investors choose to invest before rebalancing

But while regulators did respond to the most pressing issues, the uncertainty appears to have had an impact on investor behaviour with the majority trying to avoid the period around rebalancing, according to the survey. In addition, the small size of the inclusion factor, at only 0.8 per cent of the index, meant investors were able to ignore the inclusion if they wanted to. Some 44 per cent of respondents said they planned to invest before inclusion, this was particularly the case among active asset managers with over two-fifths (41 per cent) saying they would act before inclusion. This strategy was evident in the trading flows on Stock Connect which hit a record high of over RMB40 billion in April.[12] Another 23 per cent planned to get into the market within six months of rebalancing.

3.1 Equities investors' concerns before inclusion of China A-shares in MSCI's Emerging Markets Index



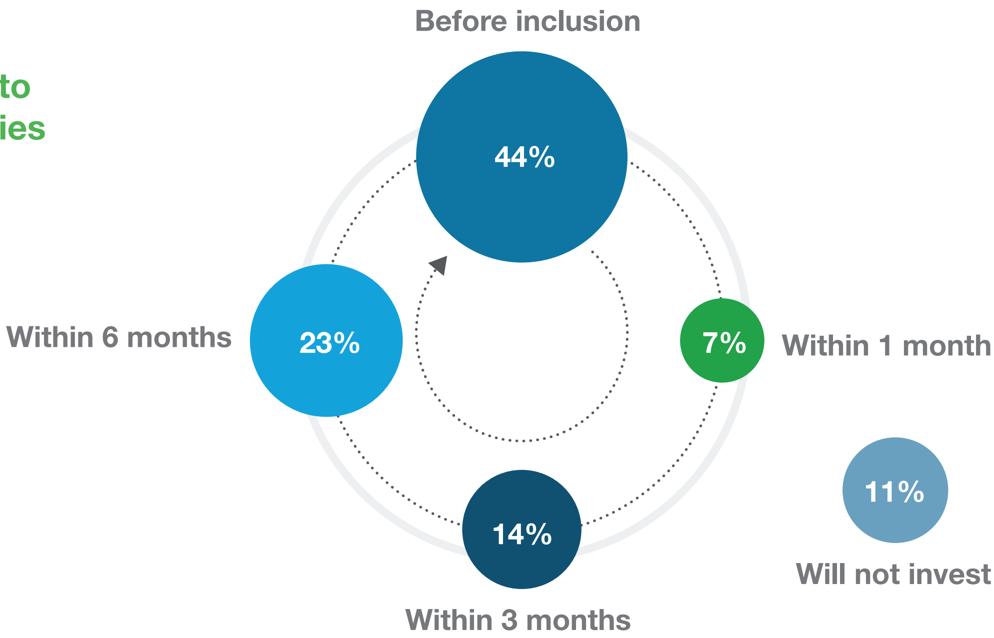
[9] HKMA, Monthly Statistical Bulletin, http://www.hkma.gov.hk/eng/market-data-and-statistics/monthly-statistical-bulletin/table.shtml

[10] HKEX, HKEX comments on Stock Connect daily quota expansion https://www.hkex.com.hk/News/News-Release/2018/180411news?sc_lang=en

[11] Reuters, China to aid cross-border yuan flows ahead of MSCI inclusion, 18 May 2018, https://www.reuters.com/article/china-pboc-flows/refile-update-1-china-to-aid-cross-border-yuan-flows-ahead-of-msci-inclusion-idUSL3N1SP3IK

[12] Bloomberg, China's stock market is about to burst on the global stage, 14 May 2018, https://www.bloomberg.com/news/articles/2018-05-13/china-s-msci-debut-is-about-to-put-new-stocks-in-your-pension

3.2 Investing into Chinese securities after index inclusion



Stage set for bond inclusion

But A-shares aren't the only China securities looking to be included in global indices: CIBM bonds are equally likely to see index inclusion during 2019. Two years ago, just under a third of respondents expected an announcement to be made this year - and they were rewarded when Bloomberg confirmed in March that it plans to add onshore government and policy bank bonds to the Bloomberg Barclays Global Aggregate Index in April 2019.[13]

Much like A-share inclusion in MSCI, there are a number of issues that investors want clarified ahead of any rebalancing. Bloomberg has also set criteria that China will need to meet for the inclusion to go ahead as planned (see box right).

"From an index perspective, implementation of delivery versus payment settlement; ability to allocate block trades across portfolios and clarification on tax collection policies were areas of enhancements. These enhancements will help increase investor confidence and improve market accessibility," explained Yasmin Ghale, Head of Southern APAC region for Portfolio and Index Sales at Bloomberg.

Bloomberg bond inclusion – key facts:

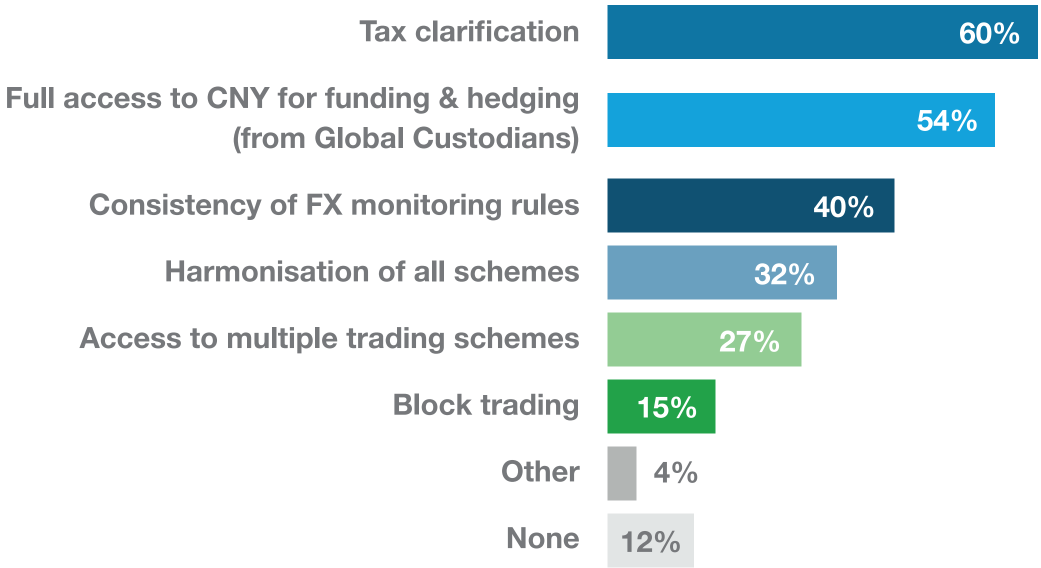
- Securities to be phased in over a 20-month period starting April 2019 (provided inclusion criteria are met, see below)
- Once completed, the renminbi will be the fourth largest currency component after the US dollar, euro and Japanese yen
- Based on data from 31 January 2018, the index would include 386 Chinese securities, representing 5.49 per cent of the index.

Criteria for inclusion:

- Implementation of delivery versus payment on the Bond Connect
- Ability to allocate block trades across portfolios
- Clarification on tax collection policies.

[13] Bloomberg, Bloomberg to add China to the Bloomberg Barclays Global Aggregate Indices, 23 March 2018, https://www.bloomberg.com/company/announcements/bloomberg-add-china-bloomberg-barclays-global-aggregate-indices/

3.3 Key concerns prior to index rebalancing



Back office struggles to be ready for inclusion

But what about the back office? In the rush of excitement that greets a new access channel or market development, the focus falls on front-office priorities such as CNH liquidity and investment quotas, while the back-office account opening is often overlooked. Specifically, in the run up to MSCI index inclusion, many new investors to Stock Connect left account opening until just a few months before the deadline, creating backlogs for custodians, sub-custodians and brokers. The industry is understood to have opened over 2000 Stock Connect accounts in the run up to the recent A-shares inclusion. Anecdotal evidence suggests that lessons have been learnt, with investors acting early to get in their applications for Bond Connect ahead of next year's proposed inclusion, but the industry still has work to do in making sure it is ready for rebalancing.

Inclusion drives market enhancement

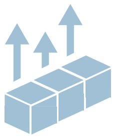
What becomes clear from both the MSCI and Bloomberg inclusions is that market development is being driven by the index providers, in addition to regulators. While China has a long-term policy of opening up its financial markets to overseas investors, much of the development of recent years has been accelerated by the conditions and timelines determined by index providers. And as the MSCI example shows, only when the conditions are met will access be granted, thereby placing the onus on Beijing to act. The hope is now that increased investment flows created by the entry of A-shares into a major equity index and the prospect of bond inclusions leads to a timely resolution of some of the outstanding issues on the Connects:

Real time delivery versus payment (DVP)

DVP came into force on the Shanghai and Shenzhen Stock Connects in November 2017, and there is an expectation that this will be available on Bond Connect at some point this year. At the time of writing, DVP was only available through the Shanghai Clearing House (SHCH), one of two custodians supporting Bond Connect. Once the China Central Depository and Clearing (CCDC) aligns its settlement model with SHCH then true DVP will be available. The decision by Bloomberg to make DVP one of its criteria for including onshore renminbi into its index in time for its April 2019 rebalancing is driven largely by UCITS regulators and investors, who see the need to minimise counterparty risk as a fundamental driver.

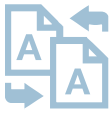
Tax

The issue of tax remains without solution for the Bond Connect. While Chinese authorities have provided a temporary waiver for the Stock Connect, it is understood that similar measures will not be applied to the Bond Connect. As a result, investors and infrastructure providers are still looking for clarification on how any potential taxes will be administered and operationalised on the Bond Connect.



Block trading

As yet, block trading is not available on either Stock or Bond Connect. The segregated nature of the A-shares and CIBM markets have made this an operational challenge to date. However, market expectations are for block trades to be allowed on Bond Connect later this year, while Bloomberg has made the ability to conduct block trades one of its conditions for index inclusion (see box above).



Holiday trading for A-shares

One of the factors holding back trading on Stock Connect is the fact that northbound investors are unable to trade on the days where Hong Kong is closed for a public holiday, but China remains open. The was certainly a frustration shared by the guests at the roundtable events and was one of the reasons why QFII is still used, as these restrictions do not apply. With this problem expected to be resolved by the end of the year, it will be interesting to see if investors continue to use QFII or if the remainder of those investment flows transfer to the Connects.

Much of the focus on index inclusion has been on the investment flows it will drive into China, but what is clear is that index providers are now playing a vital role in accelerating the opening up of China's financial markets, and the alignment of domestic trading rules with international standards. Index inclusion has also highlighted that the investment industry still has work to do in ensuring it gets the accounts and systems in place to meet the opportunity from rebalancing.

Industry faces up to the challenge of new channels

Whither Hong Kong?

Hong Kong has played a vital role in facilitating the process of the opening of China's financial markets. But other markets are now increasingly active in wanting to connect to China's markets directly.

The United Kingdom is a leading contender thanks to the expected launch of the London-Shanghai Stock Connect later this year between the two stock exchanges.[14] Advantages this is expected to offer over the Hong Kong-based Connects include allowing investors to use CNH bonds as pledged assets, and permitting settlement on a T+2 basis.

"Worryingly, I can imagine a world where the London-Shanghai Connect — which is quite good — would be preferred over the Hong Kong Connects because from a European perspective, they are so complicated," said a participant at the Hong Kong roundtable.

Meanwhile in Germany, China Europe International Exchange (CEINEX) — a joint venture between Shanghai Stock Exchange (SSE), Deutsche Börse Group (DBAG), and China Financial Futures Exchange (CFFEX) — is positioning itself as the first dedicated trading venue for China- and RMB-related investment products outside of mainland China.[15] Its products include D-shares – stocks listed in Germany by companies incorporated in mainland China.

Results from the survey certainly suggest that investors are relaxed about which market offers access, as long as that market is able to provide a robust and transparent legal framework. Legal regime was only the fifth most important factor that investors looked for in an access channel (see chart 2.1). And the vulnerability of

[14] Bloomberg, London-Shanghai stock link takes a step closer to reality, 21 May 2018, https://www.bloomberg.com/news/articles/2018 -05-21/london-shanghai-link-moves-closer-as-lse-pitches-program-details

[15] https://www.ceinex.com/about-us

Hong Kong is something investors in the city are keenly aware of. For now, Hong Kong looks set to remain the primary gateway for international investors, but this may not always be the case, warned a participant at the Hong Kong roundtable.

"One day when China opens up completely, where will that leave Hong Kong? This is something that needs to be considered. China is already servicing investors directly onshore. We have to accept Hong Kong may become a Dublin or Luxembourg – a processing centre to China," he said.

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Scheme harmonisation

It was clear from all the roundtable discussions that investors feel there are now too many different investment channels offering too many different levels of market access — and consequently that some rationalisation is needed. In part, this is driven by the need for simplification.

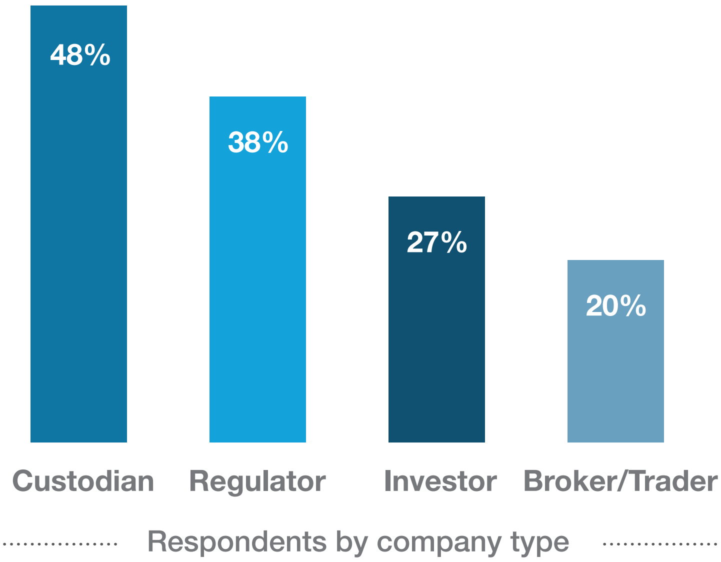
"You think you understand Stock Connect and suddenly London Connect comes out, and so then you have to take time to understand that," said a participant at the Hong Kong roundtable.

The cost of maintaining and monitoring multiple access mechanisms is becoming burdensome. In the short term this cost burden may benefit the Connects. For example, Standard Chartered understands that three major funds have opted to solely use the Connects for trading due to cost reasons. However, over a longer time period it could hurt China's ability to attract inflows.

Among fixed income investors, 32 per cent want some degree of scheme harmonisation before bonds are included in a major index, coming ahead of access to multiple trading systems and block trading. That figure rises to 38 per cent among regulators and is highest for custodians at 48 per cent. Unlike investors who can pick and choose which schemes they want to use, custodians need to provide access to the whole suite of channels.

"I don't think people are seeing the payback for all these investment schemes yet. First there was QFII and RQFII, then we built CIBM Direct and we were just starting to get some traction with clients on that when the announcement came out about Bond Connect. The question is where does it end and when does it start to add value?" said a participant at the Singapore roundtable.

4.1 Concerns prior to index rebalancing: harmonisation of all schemes



Conclusion

The RMB Investors Forum 2018 survey shows that investors are accessing China in greater volume than ever before - as robust optimism about the market outlook combines with the availability of access channels that meet the industry's requirements for speed, simplicity and clarity.

This year's survey also revealed that investment flows are now fully globalised, with the majority of markets showing a greater comfort with China investment. And while some investors are taking a more cautious approach to China risk, there is a recognition that it is a market that can no longer be ignored.

Thanks to their usability, Stock Connect and Bond Connect have been key drivers of new investment flows. The channels have quickly become the dominant method of accessing onshore China markets and are well positioned to extend that role. That said, the Connects still do not offer investors all the risk management tools they require, such as the ability to hedge and delivery versus payment. And these omissions continue to hamper take-up from jurisdictions with stricter regulatory oversight. For this reason, access mechanisms such as QFII and RQFII still have a role to play in investors' China toolbox.

However, the number and variation of access schemes is starting to weigh financially and operationally on investors, custodians and regulators. Far from welcoming proposed new schemes, such as the upcoming London-Shanghai Connect, the industry's preference is for some level of harmonisation across existing access channels.

In addition, index inclusion has exposed weaknesses in the current mechanisms; investors have raised concerns about their ability to access liquidity and risk management tools. This in turn is prompting Chinese regulators to act, first to meet the criteria set out by the index providers, and then to ensure markets can operate smoothly at the time of rebalancing. However, the investment industry still has work to do in making sure the whole value chain has the correct systems and procedures in place, in time.

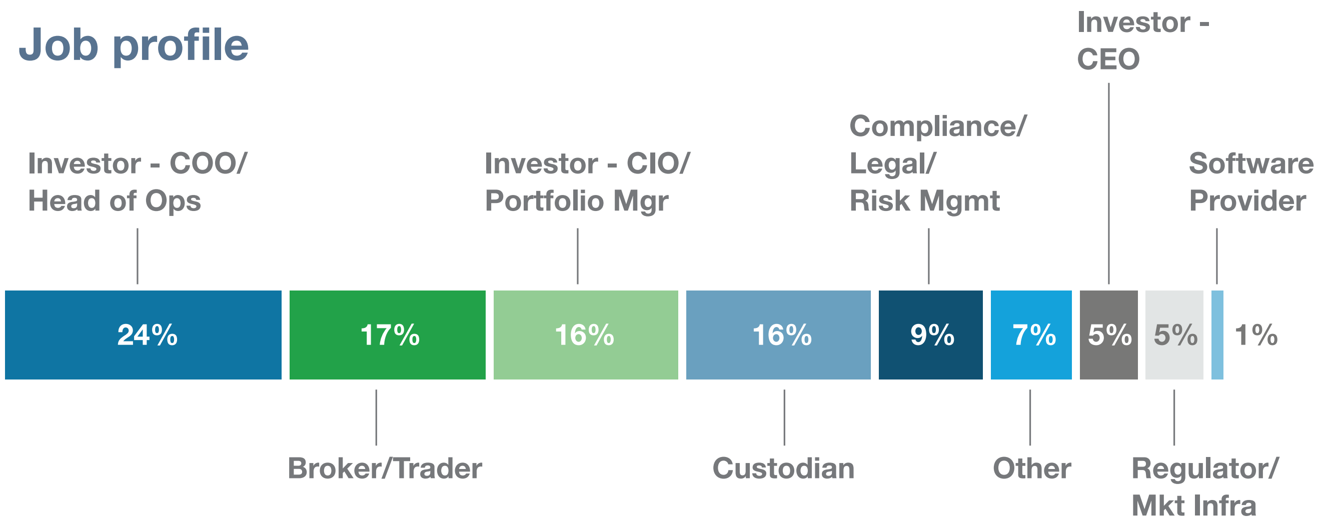
Finally, as China continues the process of opening up its markets, the long-term future of Hong Kong as the primary gateway to onshore markets has become a matter for debate. Competition from Shanghai, as well as financial centres such as London and Frankfurt could lead to a redrawing of the China access landscape.

Mary Huen, CEO of Standard Chartered Bank Hong Kong, giving the welcome remarks at the Standard Chartered MSCI Inclusion celebratory event

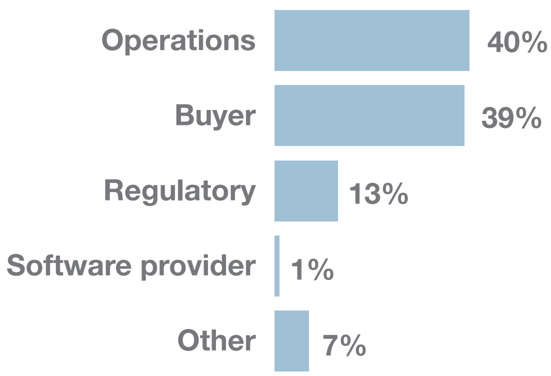
Methodology

- A robust group of Standard Chartered clients were surveyed using an online quantitative survey: 189 responded
- Results are based on a robust base of clients globally, with strong participation from Investors, Custodians, Broker/Traders, and Regulators
- Survey was conducted in March 2018

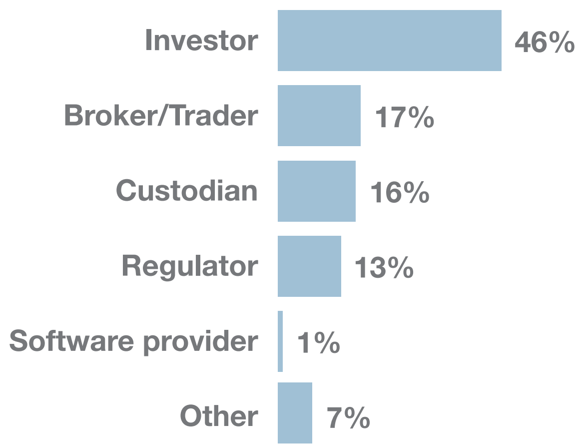
Job profile



Role type*



Company type*



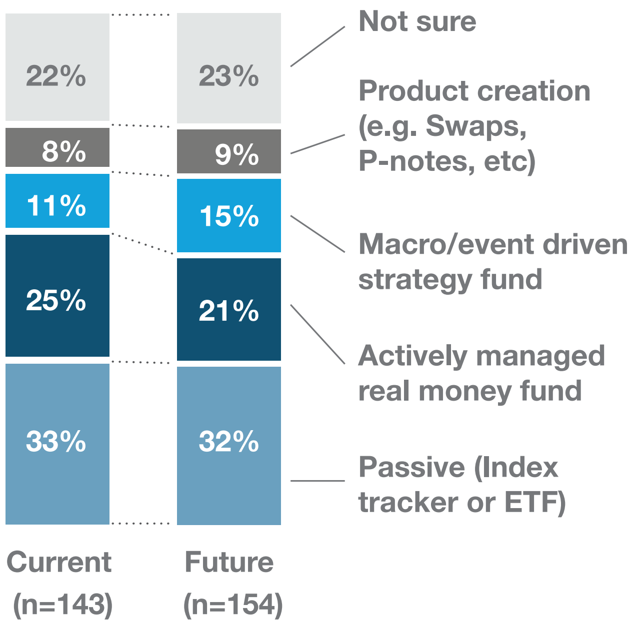
* Ops = Investor COO/Head of Ops + Custodian; Buyers = Investor CEO + Investor CIO/Port Mgr + Broker/Trader; Regulatory = Compl/Leg/Risk mgmt. + Reg/Mkt Infra; Investor = Investor COO/Head of Ops + Investor CEO + Investor CIO/Port Mgr

Market

Hong Kong	41%	78
Taiwan	17%	33
Europe	15%	29
N. America	12%	23
Singapore	6%	11
Japan	4%	8
Korea	2%	4
China	2%	3
TOTAL	99%†	189

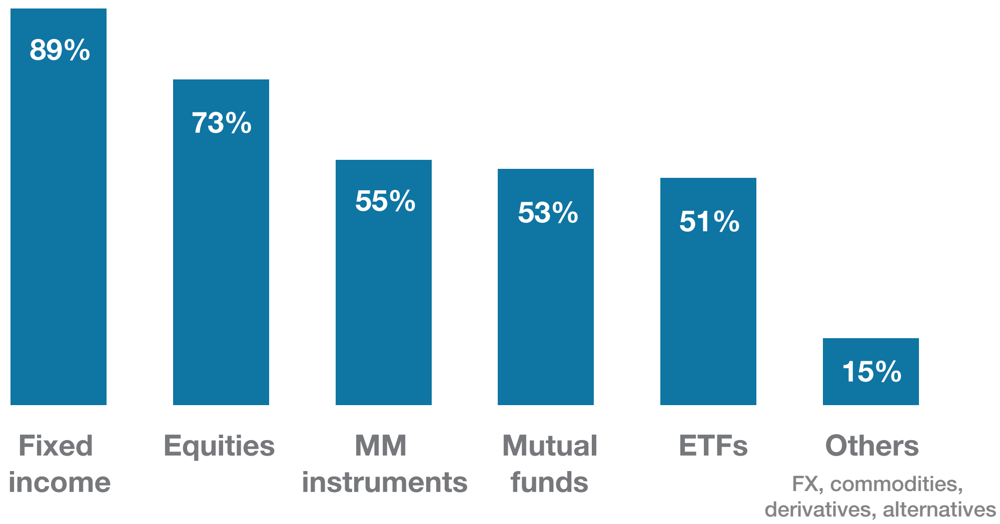
† Doesn't add up to 100% due to rounding

Investment Strategy



Excludes current investors who are not sure of the future

Asset Classes



Standard Chartered