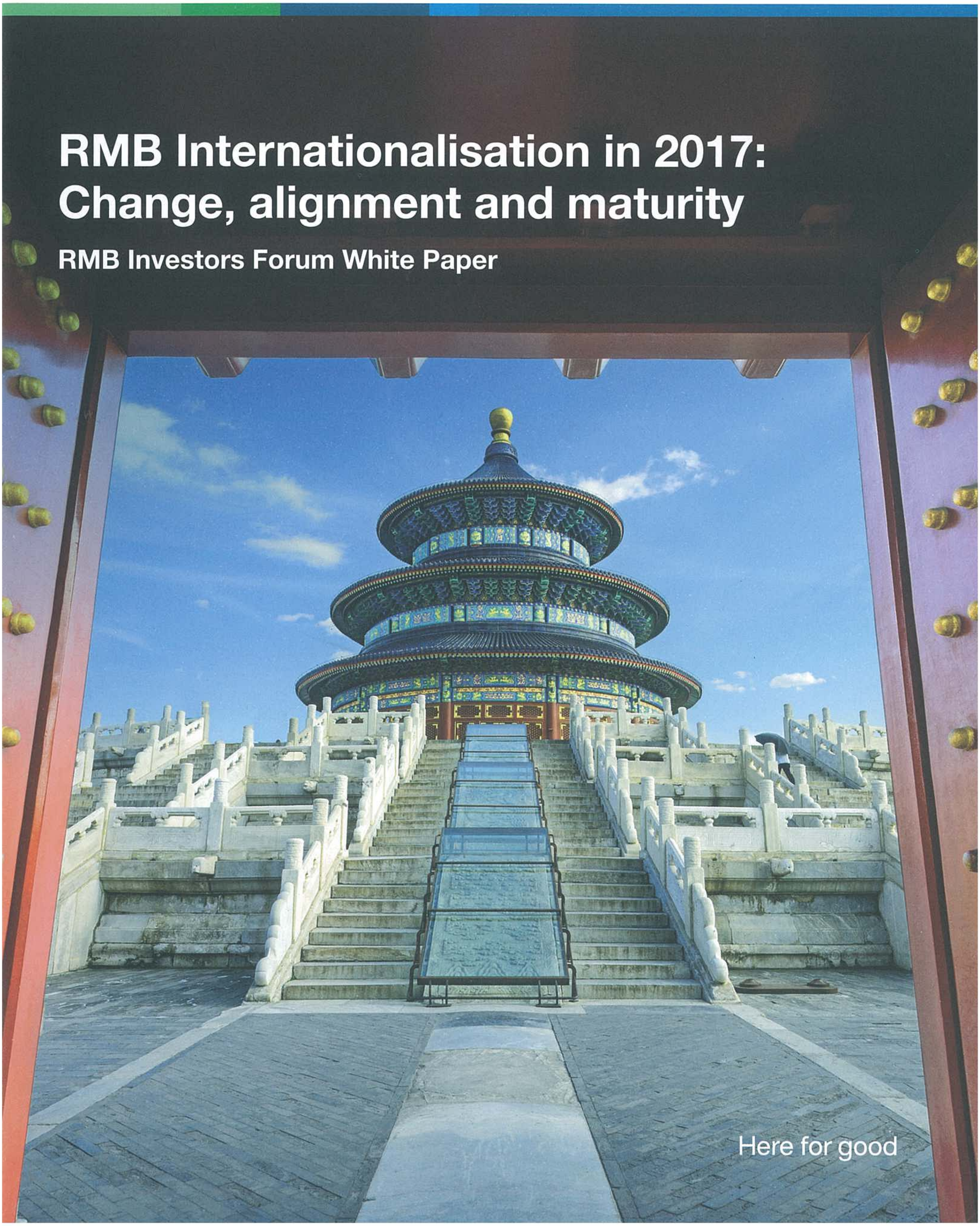
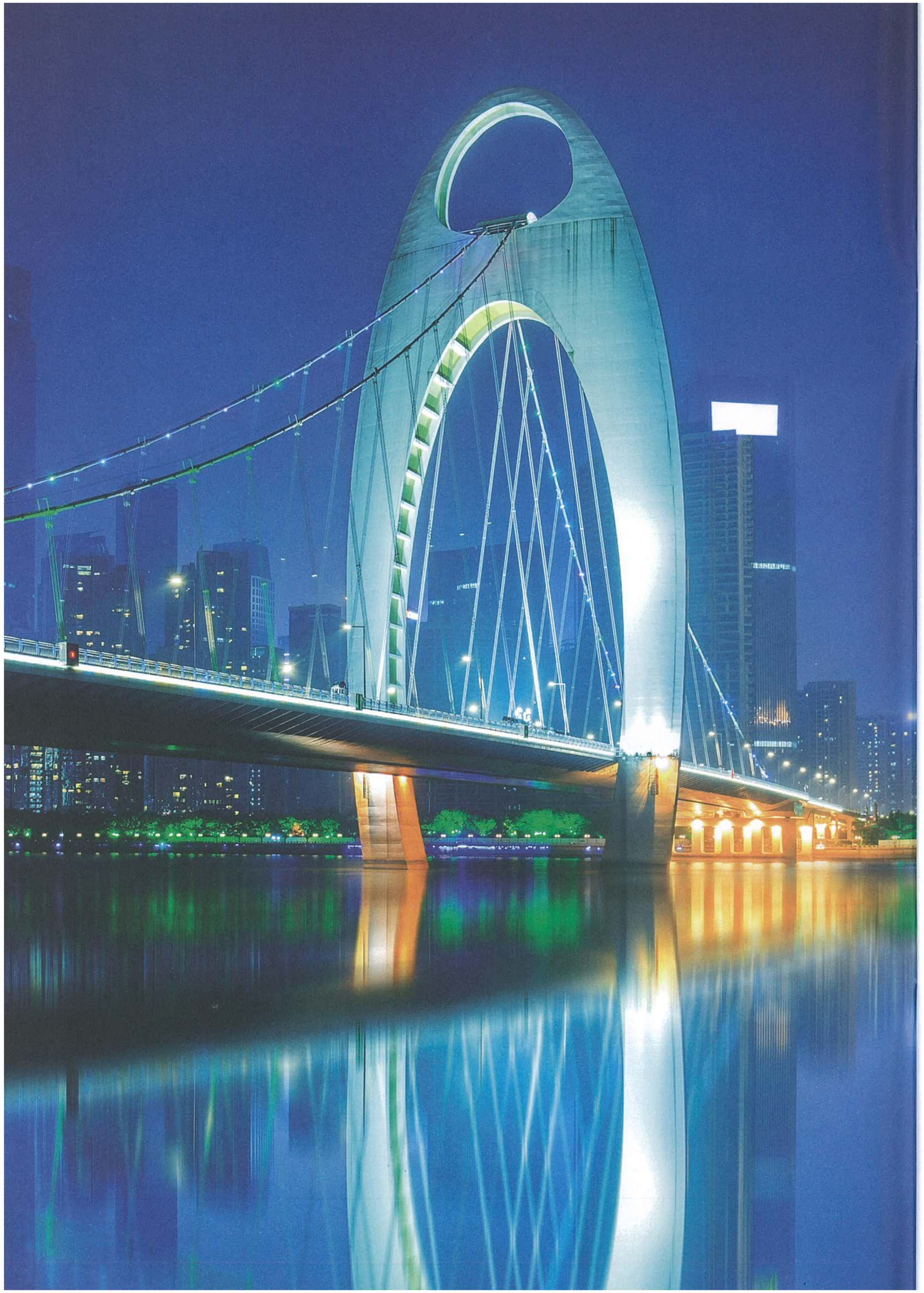
Standard Chartered

RMB Internationalisation in 2017: Change, alignment and maturity

RMB Investors Forum White Paper





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Introduction

The last twelve months have seen continued change and liberalisation in the China market as regulators and market participants have continued to align in shaping the next generation of access mechanisms for the country.

Although no new access mechanisms have been launched since the publication of the 2016 RMB Investors Forum whitepaper, the government has spent the last year working hard to attract international investors to China. The government's recent reform focus has primarily been in the fixed income space, although investors now broadly have free and unrestricted access to China's financial markets through schemes such as CIBM (China Interbank Bond Market) Direct, Stock Connect and soon, Bond Connect.

Investors and index providers are welcoming this progress, and attention is now shifting towards how to manage the largest asset transition in our lifetimes – when China's bonds and equities are included in leading global indices. China has never been more important to international investors with over 60% of respondents in the 2017 Standard Chartered RMB Investors Forum Survey (Survey) describing the country as one of their top three priorities.

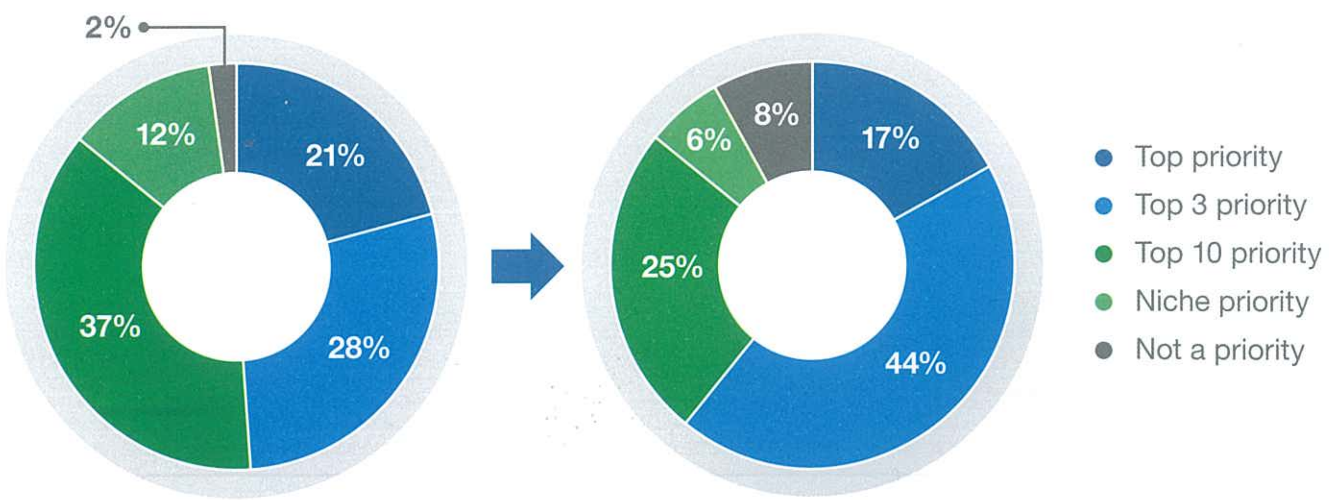
The findings and discussion in this paper are based on the views of Standard Chartered RMB Investors Forum round table participants, quantitative research from a global survey carried out in March and April 2017, Standard Chartered's own research and individual interviews.

The Survey was distributed to more than 900 market participants around the globe. This was supplemented by qualitative research in Hong Kong, South Korea, Taiwan and Singapore that took the form of interviews and roundtable discussions. The aim was to gauge the real sentiment in the market and to contrast views across jurisdictions and throughout the investment cycle.

Participants of the Standard Chartered RMB Investors Forum in Singapore, Taiwan and Hong Kong included professionals from across the investment cycle with long experience in the China market.

China is an increasingly core priority

How important is China to you/your clients' investment strategy?



2016 RMB Forum Survey results

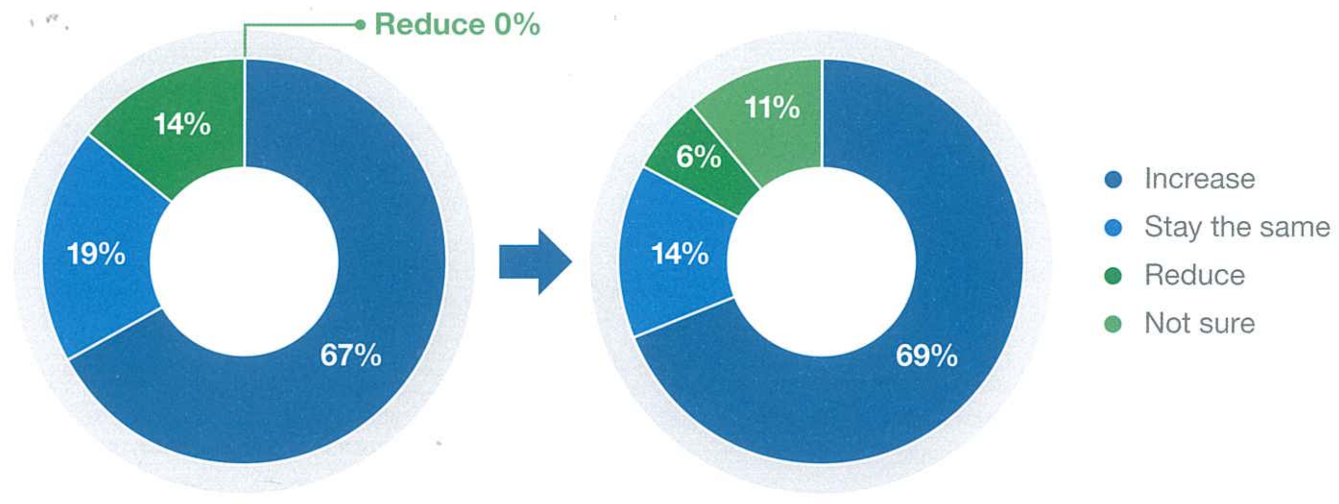
2017 RMB Forum Survey results

Investor appetite and China: Still going strong

Market sentiment has continued to improve following the volatility of August 2015, with investors taking an increasingly bullish view of the near-term outlook.

2017: A strikingly positive outlook

How do you expect your level of investment in China to change in the next 12 months?



2016 RMB Forum Survey results

2017 RMB Forum Survey results

While more than 50% of investors claim to have seen no major change in their investment flows into China in the last 12 months, 69.4% of respondents to the Survey stated they would increase their level of investment in the country, an increase from 67% in 2016.

"Institutional clients are still very much looking at China given its strategic importance. Many global asset managers are adding China into their emerging markets' portfolios because they see the strong economic growth potential of the country," said one industry expert.

The return of confidence

Confidence in the Chinese economy is returning, with 19% of respondents to the Survey stating improved market conditions will be the driver behind their increased investment in the country.

If you expect to grow investments which recent developments would you cite as driving this outlook?

New access channels	25%
Improved client/ investor interest	19%
Improved market conditions	19%
Improvements in existing access channels	18%
Improved regulatory clarity	15%

GDP growth in China increased by 6.9%, marginally beating the 6.8% median estimate.[1] Fixed asset investment activity increased from 8.1% growth last year to 9.2% for the first three months of 2017. This was boosted by a rebound in retail sales; a strengthening of factory output; a resurgent property sector; and solid credit growth.[2]

"Foreign investors are confident that the RMB will stabilise, and this is leading to increased interest in China. In addition, the gap between onshore yields on Chinese government bonds versus the yields available off US or European debt is getting very big, and investors have taken note of this," said Barnaby Nelson, Regional Head of Securities Services, Greater China and North East Asia at Standard Chartered.

Standard Chartered expects the RMB to stabilise around the end of Q3 or Q4 in 2017. This will help drive high hedging costs down, making it easier to generate alpha through the China bond market. This will encourage investors to reallocate outside of their own domestic treasury markets into China.

Low returns in traditional markets

Investors globally are finding it difficult to produce returns in major markets. Interest rates across numerous markets are at record lows, and some are even being held in negative territory. Meanwhile, US economic growth is starting to show signs of weakness. China is, however, showing opportunities for clients with its strong GDP growth and yields on government debt floating around 3.5%.[3]

Investing in China: An answer to many questions

Aside from simply looking to drive returns, international investors have turned to Chinese stocks and bonds in increasing numbers over the last 12 months in order to address a wide range of regulatory and commercial pressures:

Government and sovereign entities have been taking a greater interest in China since the inclusion of the RMB into the Special Drawing Rights (SDR) basket by the International Monetary Fund (IMF) in 2016. "Public sector institutions like foreign Central Banks and Sovereign Wealth Funds (SWFs) are planning to invest in China. The inclusion of the RMB as a reserve currency is a further boost as it will oblige central banks to have RMB holdings for currency management purposes," added the China industry expert.

52.8% of investors maintained their China exposure at existing levels during the preceding 12 months, whereas 36.1% increased their holdings. Just 11.1% said they scaled back on China.

[1,2] "China's Economy Accelerates as Retail, Investment Picks up." *Bloomberg*, 17 April 2017. [Online]

[3] "China's Market News: Government Bond Yields Rise Amid Tightened Liquidity." *Daily FX*, 8 February 2017. [Online]

Standard Chartered research suggests SDR inclusion could lead to cumulative foreign inflows of as much as CNY6.2 trillion by 2020.[4] This interest is already evident in the Survey results, which found 52.8% of investors maintained their China exposure at existing levels during the preceding 12 months, whereas 36.1% increased their holdings. Just 11.1% said they scaled back on China.

Insurers are drawn towards Chinese fixed income by regulatory pressures, as new guidelines force them to lengthen the duration of their bond holdings to match liquidity. Insurers globally are addressing this by identifying instruments that are not only safe, highly liquid, long-dated, but which also produce returns and can be hedged in the same currency. Historically, only US Treasury bills met this requirement but, with the opening of the CIBM Direct mechanism and the introduction of FX hedging, Chinese bonds now provide a massive source of additional supply for global insurers.

There has also been visible activity by **Chinese insurers** setting up Hong Kong asset management subsidiaries, which then reinvest back into China. These firms are doing this as the impressive yields in China can help them build an investment track record before they market their products globally.

"We have seen a large number of mainland retail investors with offshore investments reinvesting their capital onshore. Mainlanders living in Hong Kong are also investing in the onshore market as they believe there are a lot of short-term investment opportunities," said Keith Pogson, senior partner at Ernst & Young (EY) in Hong Kong.

Investment managers are increasingly optimistic about China. This appetite from fund managers is primarily a result of improved market conditions, investor demand for China exposure and simplified access channels into the country's sizeable fixed income and equity markets. More than 75% of fixed income investor respondents to the Survey said volumes would increase in the next 12 months.

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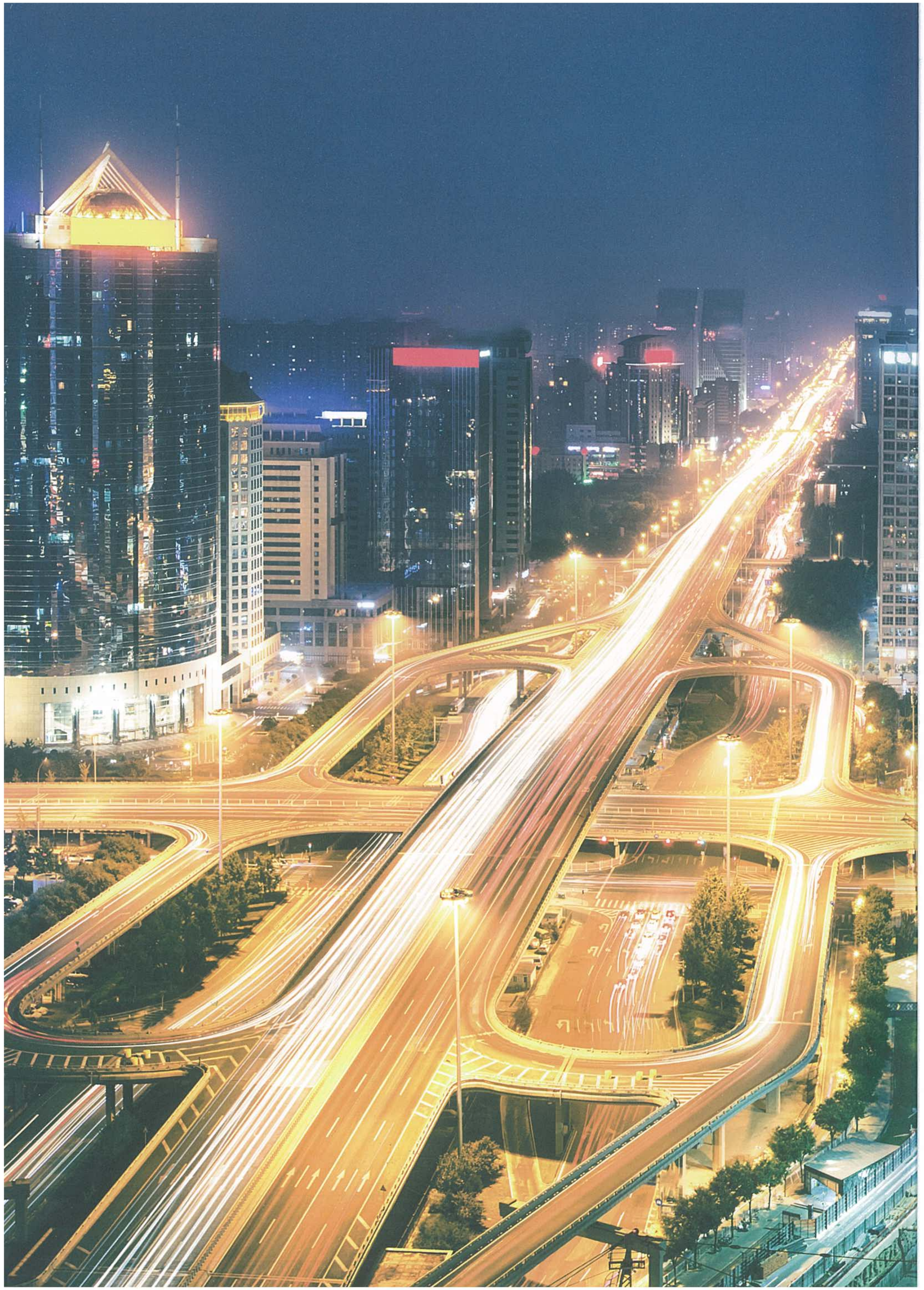
[4] "RMB Investors Forum White Paper: Rise of Next Generation China Access." *Standard Chartered*, May 2016. [Online]

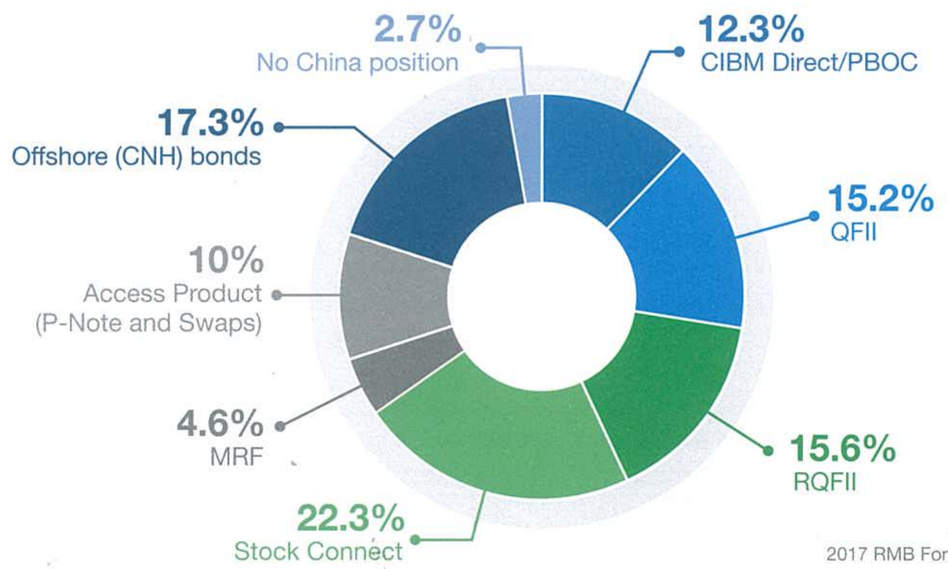


China's many access channels

"China Access is a very complicated process given the plethora of routes by which investors can gain exposure to the domestic equity and fixed income market. Each mechanism has its own unique strengths and challenges," said Nelson.

Accessing China: An art, not a science

Which channels do you currently use and are considering using in the future for investments in China?



2017 RMB Forum Survey results

While complex, the various reforms and routes into China are also spurring greater interest among investors. The Survey found that 25% of investors planning to grow their China exposures were doing so because of the new access channels, while 18% said it was due to improvements to the existing channels.

Stock Connect

In 2016, Standard Chartered predicted that Stock Connect would overtake QFII (Qualified Foreign Institutional Investor) as the most commonly used mechanism for equity managers to access China.[5] "Volumes – in terms of actual turnover – have been low due to the bearish market sentiment, but foreign investors are increasingly opening up accounts to trade A-shares," added Nelson.

Foreign investors can now have exposure to nimbler listings with a greater technology bias on Shenzhen's exchange following its incorporation into Stock Connect. In addition to this, Exchange Traded Funds (ETFs) were designated as eligible securities, which will give foreign asset managers another route through which to sell to mainland investors beyond the Mutual Recognition of Funds (MRF) scheme.

As a result of these changes, 22.3% of respondents who invest in China already identified Stock Connect as their preferred access channel for China investments. This is significant given Stock Connect's relatively recent launch and the many complexities it initially faced. Firms have clearly looked past these early stage challenges, with the Survey stating that 40.4% of firms that expect to grow their investments in China are considering using Stock Connect for access.

[5] "RMB Investors Forum White Paper: Rise of Next Generation China Access." *Standard Chartered*, May 2016. [Online]

Incorporating Shenzhen into Stock Connect in 2016, however, did not make a huge difference as trading volumes have remained stable. 61.1% of respondents to the Survey said trading volumes have stayed the same since Shenzhen was added to Stock Connect, although 38.9% acknowledged it had increased.

CIBM

Chinese bonds remain an untapped market, as evidenced by the fact that just around 2% of investors trading domestic bonds are from overseas. Foreign investors have historically been underweight in Chinese bonds relative to other emerging market debt as they were subject to quotas on inward investments.

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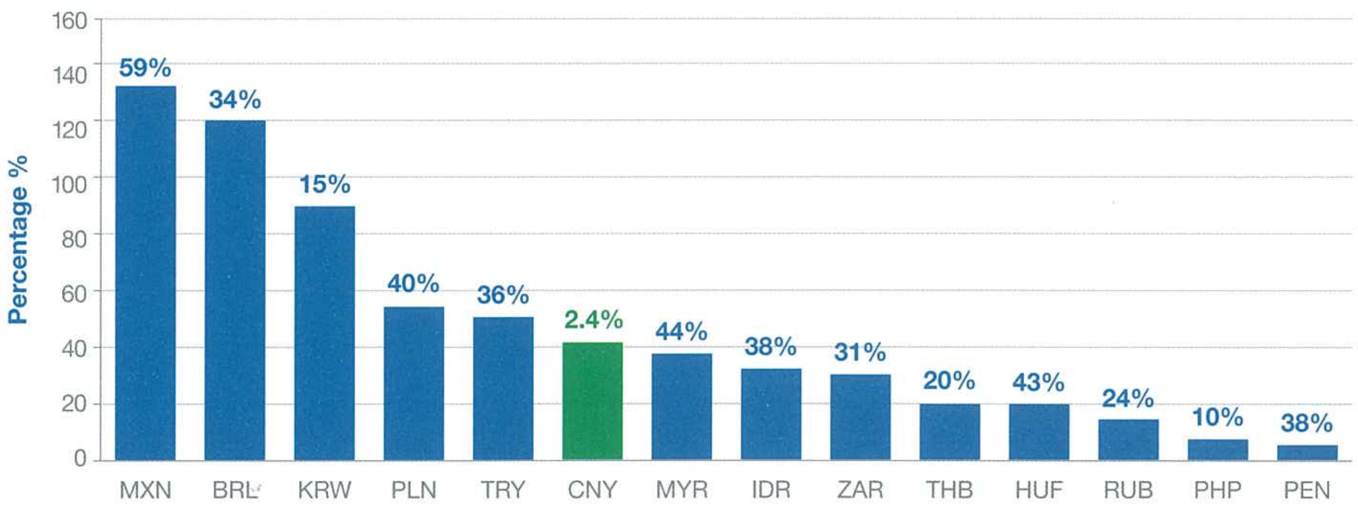
Foreign ownership of EM government bonds

End-2014, USD bn, % of outstanding government bonds



Source: RMB Investors Forum White Paper: Rise of Next Generation China Access

The last 12 months of CIBM reform, however, is likely to change this. 12.3% of respondents told the Survey that the CIBM was their preferred access channel. 32.7% are evaluating CIBM as a channel by which to grow their China investments, it added.

Liberalisation of the CIBM by the People's Bank of China (PBOC) has occurred in waves. In 2015, PBOC confirmed that foreign central banks, international financial institutions and SWFs could trade domestic bonds, engage in repurchase and lending, and transact in bond futures and interest rate swaps free of any quota limits. This was extended to the broader foreign investor community, including banks, securities companies and fund managers in 2016. Long-term investors are favoured by PBOC.

Interest in CIBM may be further accentuated through onshore FX hedging reform in China, which was announced earlier in 2017. The rules enable foreign, public and private sector investors to hedge their onshore bond positions through FX derivatives such as forwards, swaps, cross currency swaps and options with domestic settlement agents.[6]

While FX hedging has been available in Hong Kong's offshore RMB market, there is limited liquidity, making it costly for investors to hedge their positions. Participants at the RMB Investor Forum in Korea said that the opening up of the FX derivatives market would lead to greater appetite for China among foreign investors. Forum delegates in Taiwan and Hong Kong were also bullish about FX hedging reform, with the former anticipating that CIBM will enjoy 50% growth as a result.

"Onshore FX hedging tools are the standard for any liquid bond market," said a regional market expert. Nelson added that he expected insurance companies to be the main users of this new onshore FX hedging tool. "Insurers, for example, are obliged to hedge their positions due to domestic regulations, and these changes will help them tap into an enormously liquid government bond market," commented the expert.

RQFII and QFII

Investors using QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor) as their primary China entry points stood at 15.2% and 15.6% respectively, according to the Survey. RQFII has held strong with 15.4% of respondents stating they would still consider using this channel. These channels remain popular among fixed income managers, although less so among equity managers.

As the pool of foreign investors in China grows, it is likely these newer allocators will increasingly use Stock Connect and CIBM at the expense of QFII and RQFII. Just 1.9% of all respondents confirmed they would look at QFII as an access channel moving forward, highlighting the fact that these mechanisms have now been surpassed in qualitative terms. This is further underlined as QFII and RQFII levels are operating below full capacity, with 50% of quotas on average being used by foreign investors.

"We are seeing greater interest in Stock Connect and CIBM from investors, but these schemes are not actively cannibalising the RQFII and QFII routes, mainly because quotas on the latter have been eased. However, we are seeing newer investors accessing China through Stock Connect and CIBM rather than QFII and RQFII." said Nelson.

[6] "China Opens Currency Derivatives to Lure Overseas Bond Investors." *Bloomberg*, 28 February 2017. [Online]

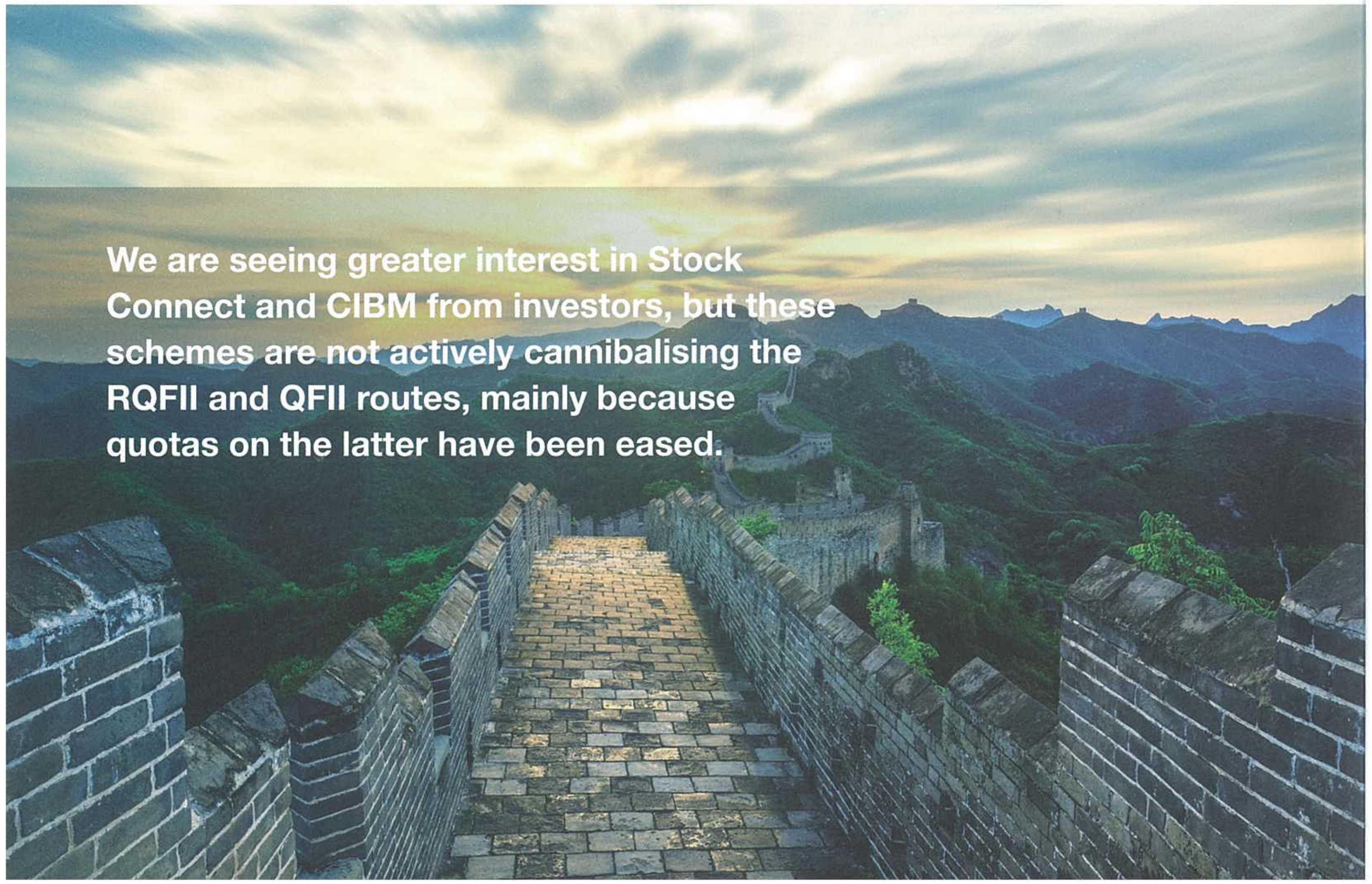
That is not to say, however, that QFII and RQFII remain stagnant. In 2016, management mechanisms for QFII quotas were relaxed and the quota process simplified. In addition, the government has made it easier to repatriate funds by reducing the lock-up period, and lessened the restrictions imposed on inbound and outbound remittances of QFII funds.[7] The biggest development for the RQFII scheme was the decision in June 2016 to allocate a USD38 billion quota to the US, which is now a beneficiary of the second largest quota after Hong Kong. US fund managers are already seeking quotas, with BlackRock becoming the first US asset manager to be granted a license under RQFII.[8]

'Dim sum' and China bonds overseas

In spite of the significant development of these channels, the use of offshore 'dim sum' bonds as a means of gaining Chinese exposure via the security of Hong Kong remains highly popular, with more than 17% of investors opting for this route currently. USD-denominated bonds issued by Chinese companies also present investors with the opportunity to gain exposure to the market without the ongoing FX risks or associated hedging costs. Investors in Korea said this is a particularly appealing channel due to the hedging costs between the Korean Won and RMB.

[7] "China's SAFE relaxes QFII quota and funds flow restrictions." *Linklaters*, 6 February 2016. [Online]

[8] "BlackRock awarded first license under U.S. RQFII scheme." *Reuters*, 15 December 2016. [Online]



How the world views China Access: Our survey results in detail

A regional breakdown of views and approaches

Although investing in China remains something of a niche or "top 10 priority" for investors from the US and Europe, the majority of US and European investors in China have only entered the market during the last one to two years. This is in marked contrast with Hong Kong and Singapore, where China is a top three priority. Newer US and European investors are more likely to use Stock Connect and CIBM to access China, whereas Singapore-based institutions will typically use legacy channels such as RQFII, QFII and CNH bonds. Access channel usage is mixed in Hong Kong with investors using a combination of all of the available mechanisms, namely Stock Connect, CNH Bonds and RQFII. Interestingly, investors in Hong Kong reported the inclusion of Shenzhen in Stock Connect has not impacted volumes.

Investors across all regions want greater regulatory clarity, although respondents in Hong Kong and Singapore said they would like greater asset class coverage and eligibility. Hong Kong investors also said they wanted higher quotas.

On the question of MSCI inclusion, the markets become increasingly bullish as we approach China. Asian investors were more positive about MSCI inclusion, with most Hong Kong respondents earmarking 2017 as the year for Chinese inclusion onto MSCI and various bond indices compared to 2018 among US and European respondents.

An asset class breakdown of views and approaches

The number of equity managers using Stock Connect now exceeds those using QFII. Nonetheless, many still deploy QFII and RQFII with quota consumptions averaging around 50% to 75%. Access through P-Notes (Promissory Notes) is much lower nowadays for equity managers although the market has not disappeared completely. Most fixed income investors continue to gain exposure to China through CNH bonds, followed by QFII and RQFII. Their QFII/RQFII quota consumption stands on average at around 50%. In terms of FX hedging, most of these fixed income investors continue to rely on CNH as opposed to CNY. These investors are broadly bullish on China with most acknowledging that the spate of credit bond defaults is a positive development for the market.

Both equity and fixed income investors urged for more clarity on the rules. Fixed income investors want greater certainty about CIBM, although a number of equity managers said they wanted more asset class coverage, simplification and alignment of QFII/RQFII, and a move away from T+0 for settlement. Both fixed income and equity managers are bullish on MSCI inclusion happening in 2017.

Investor experience

Experienced investors will nearly all view China as a top three priority, and will deploy one of either Stock Connect, CNH Bonds, RQFII or CIBM to obtain access. Those investors who view China as lower priority will typically use either Stock Connect, QFII or RQFII to obtain China exposure and this is fairly evenly balanced. The quota consumptions among experienced investors is below 50% on average, which is lower than investors who do not view China as a top three priority (50%). Standard Chartered believes this anomaly exists because these experienced China investors applied for larger quotas and are using multiple access channels.

Experienced investors are unsurprisingly bullish on China, with 90% stating the wave of credit bond defaults should be seen positively. Those investors who see China as a lower priority held a negative view on the recent series of credit bond defaults. Experienced investors are also highly confident that MSCI and various bond indices will incorporate China into their benchmarks in 2017, although those who said China was a lower priority doubted MSCI inclusion would occur until 2018.

Progress made on investor concerns

Attendees at the 2017 RMB Investor Forum discussions have cited a number of concerns around China Access in 2017, notably high debt levels, capital controls and US trade dispute risk. However, these should not all be viewed negatively, and progress has been made on some of the challenges.

Capital controls

Capital controls have consistently been identified as the primary obstacle to investing in China over the last twelve months. With continuing downward pressure on the RMB, investors have feared a potential closure of investment channels resulting in an inability to access or repatriate funds. This would present a major liquidity issue for global investors. Rumoured introductions of 'window guidelines' in specific areas have done little to help assuage these concerns.

However, foreign investors are gaining confidence from the continued absence of capital control measures imposed on them specifically. Many believe that 'the worst is now behind them'. This was evidenced when capital control restrictions were rescinded in April 2017 when the PBOC notified financial institutions that it was no longer obligatory to match outflows with inflows during the processing of cross-border RMB transactions.

"The government, however, is more concerned with domestic institutions investing abroad or acquiring foreign enterprises than it is about inbound investors taking their money out of the country. The absence of visible restrictions on foreign investors should give them greater security," said a regional market expert.

Credit ratings

Credit bond defaults have been on the rise in China, with a historic number of credit bond defaults in 2016. This should not be viewed negatively by foreign investors though, according to attendees at the RMB Roundtables in Korea and Hong Kong.

The recent defaults are being seen as an encouraging development, with 36.1% of investors telling the Survey that it was a sign of market maturity. Credit bond defaults are viewed as an essential component of a functional bond market and provide the grounds for a differentiated credit curve based on deeply evaluated credit ratings.

In the absence of such a curve today in China (and resulting views of Chinese ratings companies), respondents believe that increasing credit bond defaults will assist foreign institutions in calculating risk more effectively and accurately than ever before. This will help institutional investors in measuring the cost of risk in their investments, enabling them to increase their market exposure further.

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Regulatory clarity and understanding

Improved regulatory transparency was acknowledged by roundtable participants as a major positive development impacting their China allocations. Regulators in China have become more open with market participants, and this is prompting further flows. 16% of Survey respondents said regulatory clarity was a factor behind their decision to increase investments into China, citing the PBOC's recent development of the CIBM as a major contributing factor to positive market growth.

This openness shows that Chinese regulators have a better understanding about how global regulations such as UCITS (Undertakings for the Collective Investment of Transferable Securities), the Securities and Exchange Commission's (SEC) 17f-5 custody requirements, and ERISA (Employee Retirement Income Security Act) work. Chinese regulators have matured in terms of how they engage with institutions subject to these requirements. Equally, foreign investors have gauged where the red lines are when dealing with China's regulators, and have stopped making unrealistic requests for market improvements in areas such as stock borrowing and lending, for example.

"The China Securities Regulatory Commission (CSRC) is interacting much more with the market, providing regular commentary about what it is doing, and outlining its aims and objectives," commented Pogson. Foreign investors are also beginning to understand the nuances and processes of operating in China. "We have learned to play the game," commented one Hong Kong manager at the Standard Chartered RMB Roundtable.

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Accessing China: Key considerations

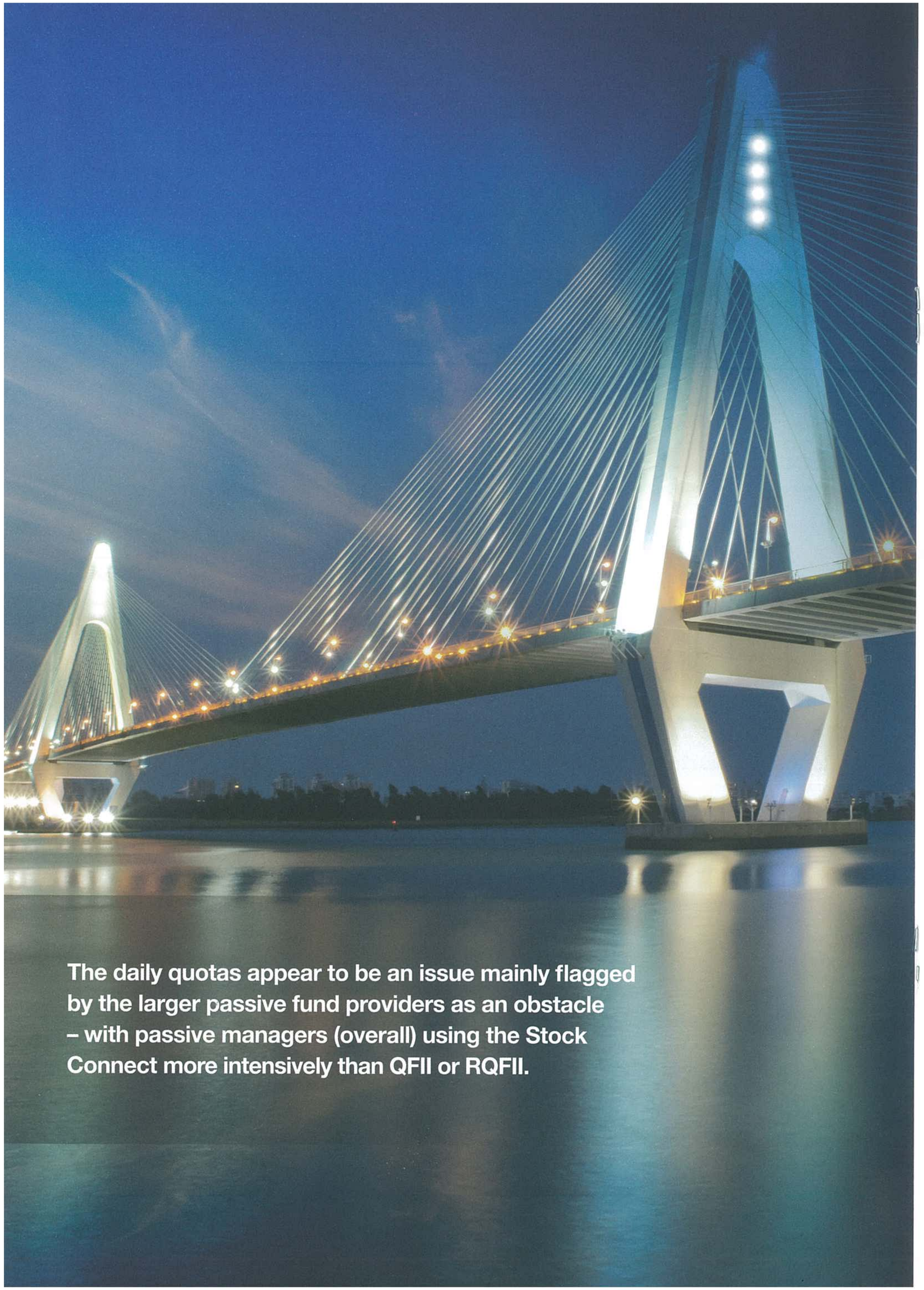
Which of these factors are your top reasons in terms of importance when considering which investment channel to use?

Clarity on rules	29%
Cost	16%
Eligibility requirements	13%
Asset class coverage	13%
Scope of target investment	13%

2016 RMB Forum Survey results

Clarity on rules	16%
Asset class coverage	15%
Cost	14%
Application time	14%
Available quota	13%

2017 RMB Forum Survey results



What is left to address?

While there have been many improvements to Chinese access channels in the last year, there is still much more to be done.

However, our survey this year has begun to highlight a new theme among investors, namely a desire to have finality and certainty in how they can best access China, ideally through a single, coherent framework. Given the current complexities and frictions between channels today, such finality is not an immediate prospect but it presents an interesting opportunity for us in the years ahead.

CIBM

CIBM does bring with it some administrative and KYC (Know Your Customer) obligations. Private sector foreign institutions need to appoint an onshore settlement agent/custodian who will then verify whether an investor is eligible. This will require customer due diligence by the custodian, a process that could potentially take several months, and which could delay CIBM entry.

While little can be done in the short term to address this challenge, a participant at the Taiwan RMB roundtable said these documentation requirements remained friction points with CIBM, and this was discouraging them from switching from QFII.

Another institution at the same roundtable discussion pointed out that redeeming from QFII to reallocate into CIBM remains unviable. Market costs aside, there are strong concerns that this might not be in line with the Chinese government's expectations, since they want fresh capital flowing in, rather than existing investments being redistributed through new channels.

At a more granular level, positive market engagement from the PBOC has led to a firmly positive view that issues around taxation, trading hours and account opening forms will all be resolved shortly to the benefit of global investors.

Stock Connect

Stock Connect is of increasing interest to investors but it still has limitations. First, regulators in China apply a daily ceiling on flows, which is a deterrent to some passive fund managers. At present, there is a daily quota of RMB13 billion on Hong Kong-Shanghai Stock Connect,[9] and the same applies for Shenzhen.

One fund manager at the Standard Chartered RMB Forum in Hong Kong said daily freezes on trading and repatriation risks make it hard for passive funds to enter the market. This is also a problem for UCITS with daily dealing liquidity provisions.

"Stock Connect imposes a daily ceiling on flows. If MSCI upgrades China, there will be a big increase in flows as passive investors try to acquire A-shares through Stock Connect, meaning the aggregate flow ceiling could conceivably be breached quite easily. Investors may simply revert to QFII and RQFII to access A-shares if this happens. In addition, there are other instruments that can be accessed through QFII/RQFII but not (yet) through other programmes," said Mark Shipman, partner at Clifford Chance in Hong Kong.

However, the daily quotas appear to be an issue mainly flagged by the larger passive fund providers as an obstacle – with passive managers overall using the Stock Connect more intensively than QFII or RQFII.

"The risk is a very theoretical one. The bigger and more conservative passive managers take the view that this theoretical risk needs to be accommodated, presumably because their flows alone could trigger the limit if they had a very active day, whereas smaller managers believe this is just a theoretical risk, and not a meaningful one," said Nelson.

9 "Indices: Patience is a virtue." *Funds Global Asia*, 2015. [Online]

Trade settlement processes on Stock Connect is still a challenge, and this has caused ambiguity for market participants and regulators – such as those in Luxembourg and Ireland – over the last few years. Market feedback about Stock Connect's initial settlement model prompted the Hong Kong Exchange to launch a new Special Segregated Account (SPSA) structure in 2015.

The SPSA model allows investors to use up to 20 different brokers for any fund, enabling institutions to demonstrate compliance with best execution regulations globally such as the Markets in Financial Instruments Directive II (MiFID II). This positive step was welcomed by market participants but it has been met since with pointed questions, namely from key UCITS regulators who state the model is not based on true delivery versus payment (DVP).

"In place of real-time DVP, the market creates a 4.5 hour window of potential exposure for investors, which was originally deemed to run counter to the intent and spirit of UCITS V. This made the SPSA model unworkable for European investors. Fortunately, subsequent legal opinions have confirmed this risk to be defined as 'counterparty' risk and not 'custody' risk in UCITS terminology and hence acceptable. But this exercise has created unnecessary confusion among investors around the true value of the SPSA structure for the Stock Connect," said the regional market specialist.

Standard Chartered expects the Hong Kong Exchange to release an innovative new operating model towards the end of 2017, which will incorporate real-time trade settlement. Such a release will address all questions around counterparty risk, making Stock Connect available to investors globally. "Coming immediately prior to any index rebalancing, this development should mark a major milestone in the evolution of the Stock Connect," said Nelson.

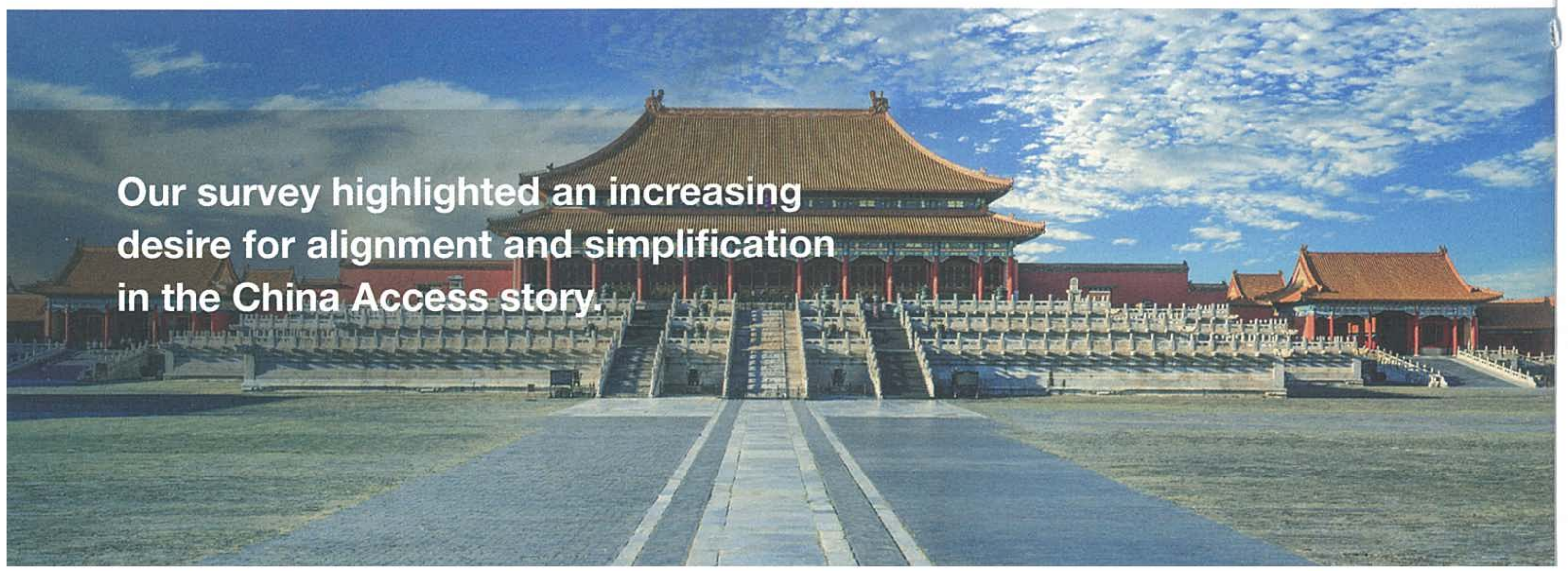
RQFII and QFII

This is not a new issue, but China's taxation policy for QFII and RQFII investors is an area that needs urgent redress.

"The handling of the withholding tax issue for QFII and RQFII managers has been an issue which has only increased in importance since the launch of Stock Connect. Stock Connect is currently temporarily exempted from withholding tax. QFII and RQFII investors are increasingly unsure about whether to continue accruing for withholding tax, or whether they need to prepare for an unwinding of their previous accruals," said Nelson.

Alignment

Perhaps not surprisingly (given the continuing growth in the number and complexity of access mechanisms), our survey highlighted an increasing desire for alignment and simplification in the China Access story. This could take many forms (including merging QFII and RQFII rules entirely; removing legacy mechanisms; or allowing for investments across multiple channels to become fungible) but there is little evidence so far to suggest this is likely to be a focus in 2017/18.



What next for China?

Index inclusion

The last year has seen a significant shift in market expectations away from "will China be included [in global indices]?" towards "how will an index inclusion event be managed?"

Global index providers have spent the last year devising increasingly sophisticated mechanisms to bring Chinese A-shares and bonds close to – but not into – their respective indices. Following FTSE's original example, Bloomberg Barclays confirmed it would establish new benchmarks featuring Chinese bonds, while maintaining its original benchmarks. The Global Aggregate + China Index and the Emerging Market Local Currency Government + China Index will help give investors China portfolio exposure.

Equally, Citi stated in March 2017 that it would incorporate onshore Chinese debt into its bond indices, including the Emerging Market Government Bond Index, Asian Government Bond Index and the Asia-Pacific Government Bond Index.[10] However, Citi did not include Chinese bonds on its dominant World Government Bond Index.[11] Reports also suggest that J.P. Morgan is reviewing the case for incorporating China bonds into its emerging market indices.[12]

MSCI's evolving views on China A-shares are well known but the practicality of index inclusion is not entirely simple. First, the CIBM or A-shares market's sheer size is a key reason why these index providers have been hesitant to add China to their respective indices, as China's weighting would increase to 39% in some instances.[13]

Secondly, huge flows – estimated to be around USD1.5 trillion – of passive funds will enter China's equity market when MSCI follows through with its inclusion of China into its Emerging Market Index. The scale of the transition event presents its own unique challenges.

There is speculation there could be spikes in CNH. The CNH market has seen significant volatility over the last 12 to 18 months, and there is justifiable concern about how the market would react to this massive infusion of liquidity. In addition, investors operating out of markets with a T+2 settlement cycle such as Korea and Taiwan will have to reconcile divergences with China's T+0 equity market settlement cycle. At present, these markets will have to pre-fund A-share purchases up to two days before they have the necessary funding to hand.

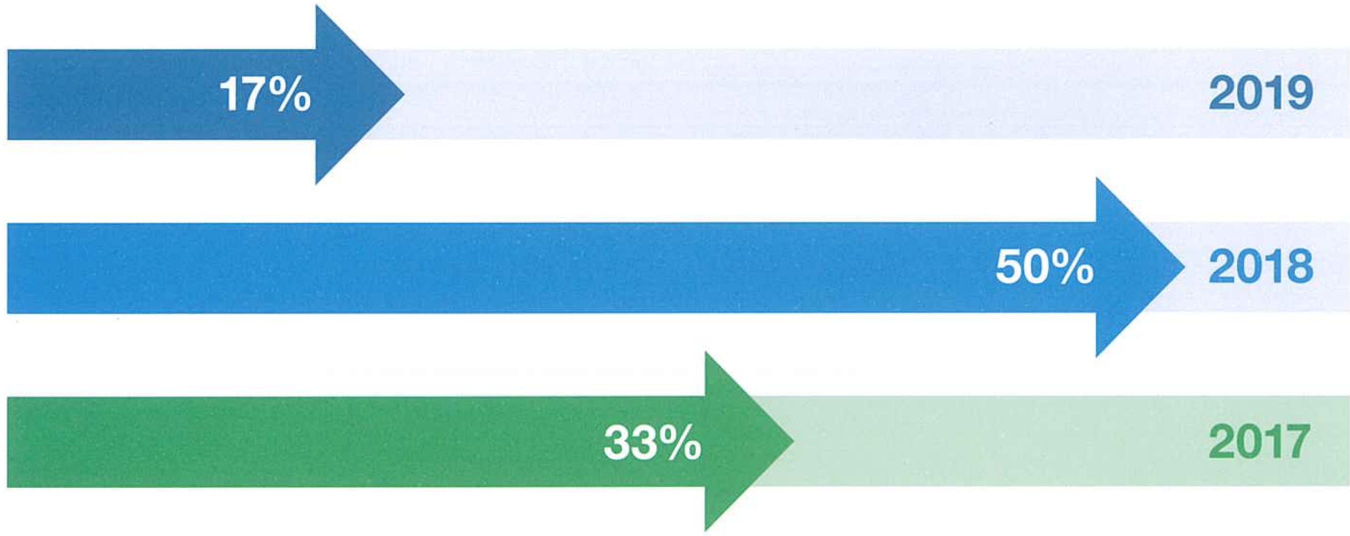
Despite these challenges, sentiment is very positive on the outlook for 2017 and 2018. MSCI inclusion was given a boost when BlackRock said it would support the incorporation of A-shares on global indices, although it did not refer to MSCI by name.[14] This was a milestone as it was the first time BlackRock had publicly supported China's inclusion after having opposed it previously. Having such an influential asset manager coming out in favour of MSCI inclusion will not go unnoticed.

The last year has seen a significant shift in market expectations away from "will China be included [in global indices]?" towards "how will an index inclusion event be managed?"

10 "Citi first to fully include onshore Chinese debt in bond benchmarks." *Financial Times*, 7 March 2017. [Online]
11 Wee, Denise. "UBS Asset 'Doubling Down' on China's $8 Trillion Bond Market." *Bloomberg*, 29 March 2017. [Online]
12 "JPMorgan may add China government bonds to emerging market index." *Bloomberg*, 18 March 2016. [Online]
13 "MSCI and China: A Shares Decision Day." *FTFM*, 14 June 2016. [Online]
14 "BlackRock backs mainland China shares for MSCI benchmarks." *Financial Times*, 20 April 2017. [Online]

Our biggest challenge lies ahead: Index inclusion is coming

When do you expect the leading bond index providers (Bloomberg/Barclays; JPMorgan and Citi) to announce an allocation to China in their main indices?



2017 RMB Forum Survey results

"There has been huge progress made by China in its efforts to obtain MSCI inclusion. The only issues that may hold it back again are the approval requirements for exchange tracking products and possibly the daily quota limits on Stock Connect. Stock freezes appear to be on their way to resolution," said a regional market expert.

The RMB Investors Forum Survey found 50% of respondents expected the leading bond index providers (i.e. Bloomberg Barclays, Citi, J.P. Morgan) to announce an allocation to China on their main indices in 2018. However, one-third of those surveyed were confident an allocation would be granted in 2017, and 16.7% expected it to be in 2019. Similar results were recorded in our 2016 Survey.

Bond Connect

China has built its own capital markets over the past 20 years. With their deep capital, huge market size and late mover advantage, they have learned from the experience and evolution of major international markets and built their market top-down with a very different design. It is a unique market that operates in a distinct way. Meanwhile, international markets have long histories and their own market expectations and practices. Therefore, as China continues to open and integrate with the global community, Hong Kong has a vital role to play to bring these two sides together, helping them connect efficiently and interact in a way in which both sides feel comfortable.

Charles Li
Chief Executive,
Hong Kong Exchanges and Clearing (HKEx)

The prospect of China bonds being included into various global indices has prompted further reform, namely through Bond Connect. Bond Connect, an initiative announced in May 2017 and expected to be due for launch on 3 July 2017,[15] will provide international investors with simplified access to CIBM bonds directly from Hong Kong, removing the need to open custody and bank accounts in China.

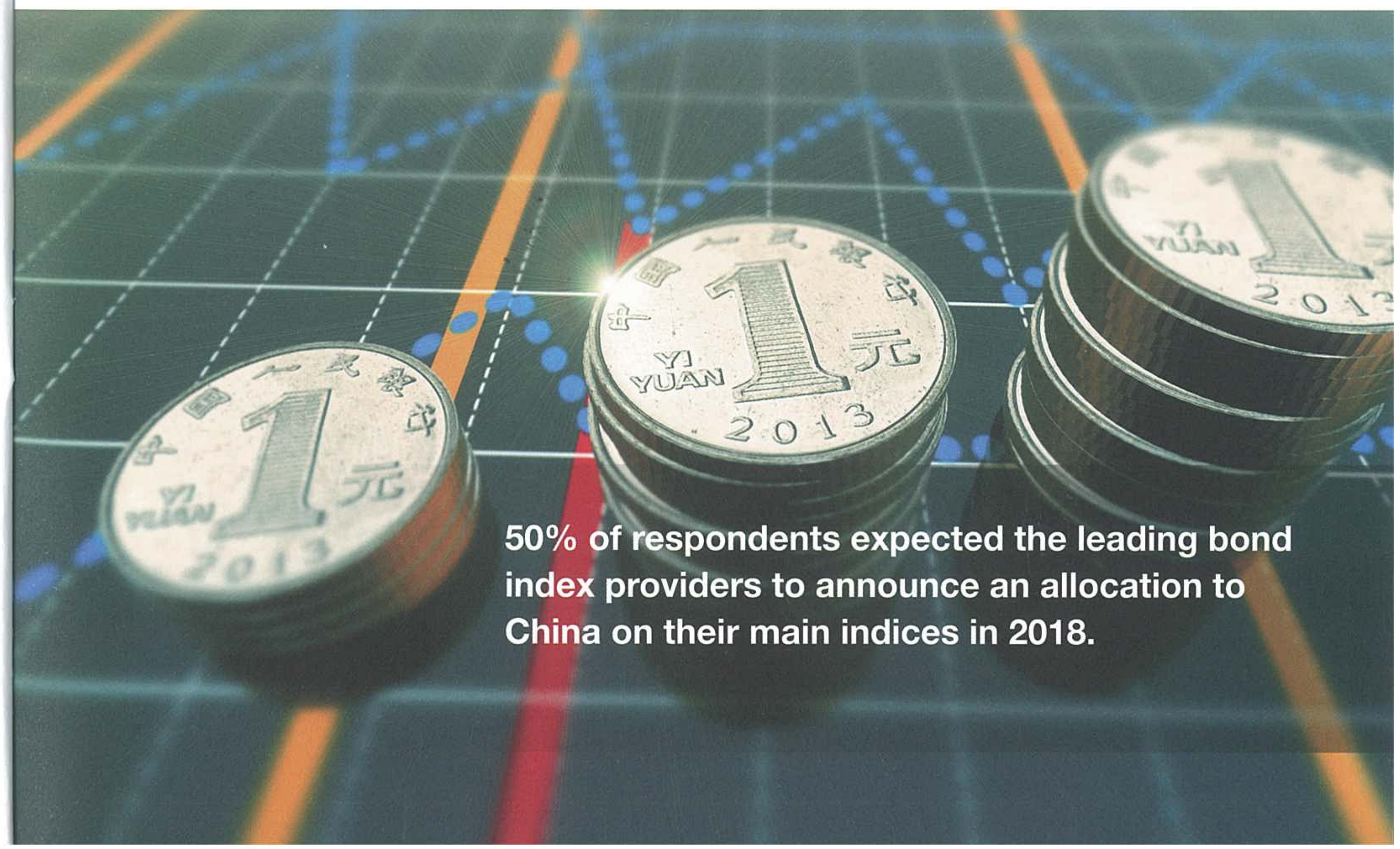
Encouraged by Stock Connect, international investors have immediately begun following the development of the Bond Connect, in the hope that it will prove to be a robust and scalable mechanism for offshore access.

Bond Connect is open to all overseas investors who are eligible to access CIBM under the existing direct scheme (including current CIBM participants) and provides seamless scalability (investors can still use their existing Hong Kong custodians); simple access (a one week application turnaround); and a familiar legal jurisdiction in Hong Kong.

Bond Connect may attract interest from investors who are new to China or are exploring the market, but do not want to commit to the CIBM. Trading on Bond Connect will give them a feel of how the Chinese fixed income market works, with very simple entry requirements.

As with all other mechanisms, it is expected to evolve over time, with future releases likely to include access to onshore FX hedging products as well as connectivity through other leading global trading systems.

[15] The formal date has not been announced by the regulators and may be subject to change.



Bond Connect versus CIBM Direct

	Bond Connect	CIBM Direct
Counterparties	Offshore investor and **designated onshore CFETS market making institutions**	Offshore investor and **onshore CFETS member**
Eligible Investors	Medium-to-long term buy side investors*	Medium-to-long term buyside investors
KYC / Eligibility Checking on Investor	Eligibility checking conducted by **CFETS and/or BCCL**	KYC conducted by **BSA**
Application Process	**Application Form to BCCL and/or CFETS**	PBOC filing
BSA Appointment	**Not required**	Required
Eligible Products	**Cash bonds** for initial stage	**Cash bonds; IRS and bond forwards for hedging; CNY repos****
Quota	No individual/daily/aggregate quota	No individual/daily/aggregate quota
Indication of Intended Investment Amount	**Not required**	Required
Inflow Currency	CNH or other currencies	CNH or other currencies
Currency Conversion	Conversion from foreign currencies to RMB (by tapping onshore CNY rate) by **RMB clearing bank or CFETS licensed banks in Hong Kong (e.g. Standard Chartered Bank (Hong Kong) Limited)**	FX conversion is conducted via **BSA**
Trading Method	**Electronic RFQ**	Primarily **voice/trade capture**
Settlement Cycle	T+0 and T+1 (gross settlement, DVP basis)	T+0 and T+1 (gross settlement, DVP basis)
Settlement	Conducted by **CMU (Central Moneymarkets Unit)**	Conducted by **BSA**
Ownership Structure	**Nominee structure**	**Direct account**

* Investors who currently have access to CIBM via CIBM Direct Scheme are also allowed to trade via Bond Connect.
** Subject to regulatory approvals
BSA Bond Settlement Agent
IRS Interest Rate Swaps
RFQ Request for Quotation
CFETS China Foreign Exchange Trade System
BCCL Bond Connect Company Ltd. (a joint venture between HKEx and CFETS)

The Survey found that 27.4% of respondents were likely to use Bond Connect in the next 12 to 24 months. 70% of the participants at the Taiwan RMB Forum said they were enthusiastic about Bond Connect as it would give them better access to the China market. Nelson said that Bond Connect will help prevent a log-jam of investors rushing into CIBM as and when China is included on the major bond indices.

However, there is still a lot of work to be done in ensuring that Bond Connect can be accessed fully by global investors. As with the launch of the Stock Connect, numerous legal and tax clarifications are required. Outstanding questions about mutual supervision, withholding tax, beneficial ownership and the status of CMU as depositary bank under UCITS V need to be answered. As such, Bond Connect will likely face questions from global regulators, depositary banks and investors.

While this consultation and evolution will ensure a gradual short-term take up of Bond Connect, there is little doubt about its value as an access channel in the context of index inclusion:

"Any inclusion of China into a major bond index will lead to a rush of passive and active investors trying to trade on the CIBM. This will require them to appoint a local settlement agent, which will take time. These investors may use Bond Connect as a tool to get quick entry into the bond market before folding back into CIBM once they have been on-boarded by their custodians." said Nelson.

Conclusions

There is little doubt that 2016/17 has been another transformative year for the China Access story as the country continues to turn “from a teenager to an adult” in financial market terms as one roundtable participant described it.

After a stable year with limited inbound volume growth, the Chinese economy is strong and the country’s fixed income and equity markets offer excellent return prospects for international investors. This makes China increasingly enticing to foreign investors, particularly as returns elsewhere in the world have been constrained.

Investors have more opportunities to enter the Chinese market than ever before, thanks to ongoing reform and new channels. These include the opening up of the CIBM, the inclusion of Shenzhen in Stock Connect, and more generous quota allocations under QFII and RQFII, for example.

Stock Connect and CIBM Direct are winning market share for new inflows at the expense of the older channels because of their greater flexibility and simplicity. Standard Chartered expects this trend to continue with the launch of the Bond Connect.

Older access channels will remain popular among existing investors though, as they have become less restrictive for international clients.

Clarity is still the key consideration for foreign investors – but the last 12 months have seen a significant alignment between regulators and investors, both of whom are working together more effectively than ever before.

Our biggest challenge may still lie ahead in smoothly managing the transfer of over USD500 billion in AUM (assets under management) into China as its equities and bonds are transitioned into the world’s global investment indices.

Standard Chartered China Access credentials

One stop shop approach

As one of Asia's leading trading and asset servicing houses, our leadership in Bond Trading, FX, Asset Servicing and Settlement has provided our clients with unique levels of insight and operational efficiency as they work to meet their investment objectives in China.

Strong connections with global custodians

Standard Chartered has established connectivity with eight of the world's leading global custodians across CIBM Direct, RQFII and the Stock Connect. Seamless connectivity and servicing integration to these custodians means that we are able to provide market leading levels of market access and expertise to our clients.

Standard Chartered China is the ONLY foreign bank that holds all the key licences in the domestic bond market in both primary and secondary markets

This unique combination of licenses gives us unrivalled access to the entire lifecycle of corporate and government debts in China from facilitating bond issuance, to market making and this extends to agency dealing and settlement. No other international bank can offer this extensive level of services in China.

Unique innovation in the market

Standard Chartered has achieved many unique milestones in China Access: thanks to our consistent record of delivering innovation in the market. As the leading bank in the development of the Stock Connect's SPSA model, for example, we have provided global insight to address international regulatory requirements: to the benefit of the entire investment management industry.

Customised services and market-differentiating settlement flexibility

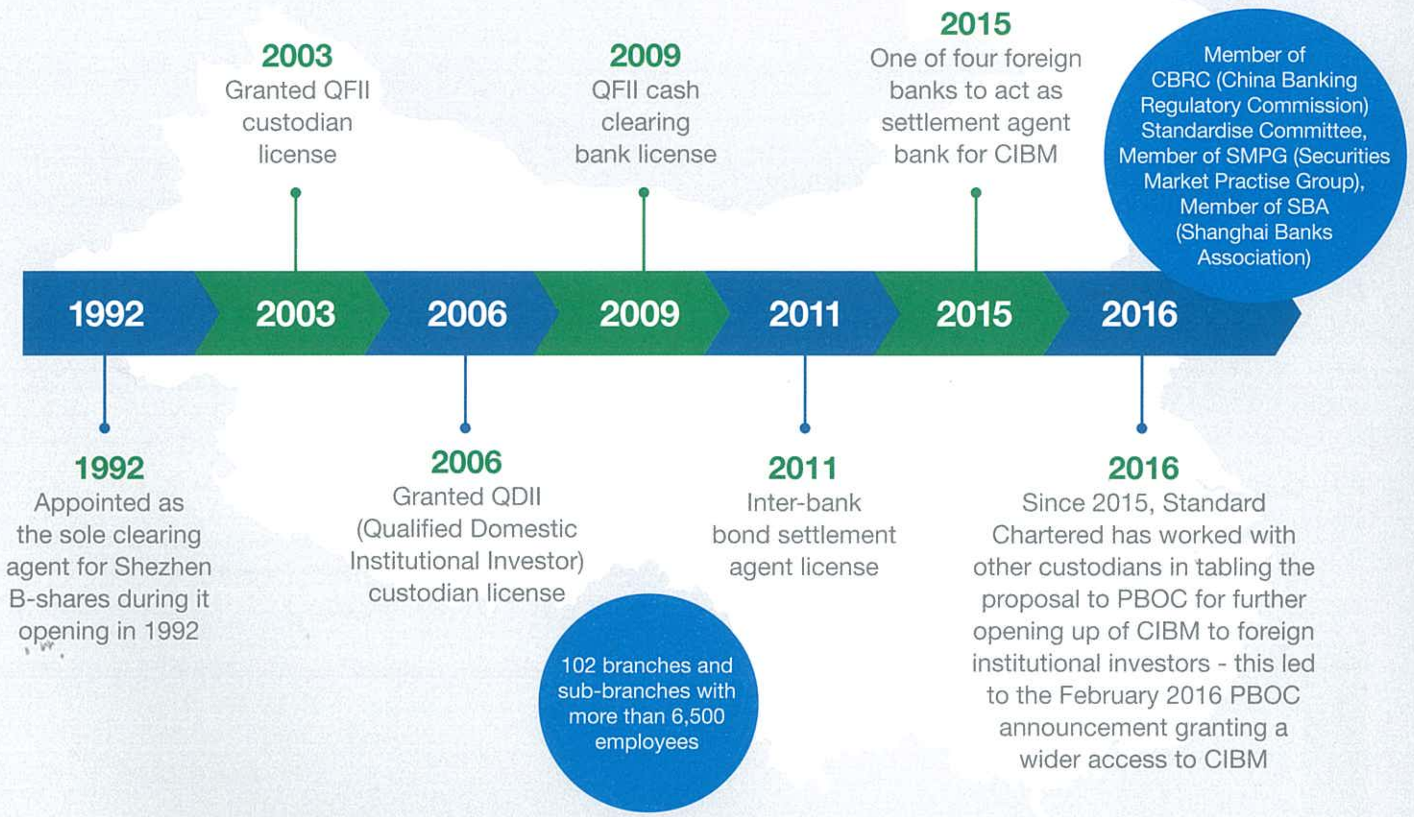
Standard Chartered China is able to tailor end-to-end solutions based on client's specific needs such as master-sub account structures. In addition, Standard Chartered China is able to offer up to T+5 settlement cycle. This unique feature, which only Standard Chartered offers, provides great flexibility to investors' FX strategies and cross-border funding management needs.

Regulator access and market advocacy

Standard Chartered China has direct access to all of the key regulators, including PBOC, SAFE (State Administration of Foreign Exchange), CCDC (China Central Depository & Clearing Co., Ltd.), SHCH (Shanghai Clearing House), CFETS, HKEx, the Hong Kong SFC (Securities and Futures Commission) and the HKMA (Hong Kong Monetary Authority). We are regularly consulted on market best practices and asked to provide feedback on pre-regulatory and market guidance releases.

Unparalleled market research and insight

We provide up-to-date market updates to our China clients, including specific product level information, China macroeconomic news and policy changes. Adding to our market leadership in fixed income research, this insight helps our clients to better understand the China market.



CIBM Bond Trading rankings

#1 Bond Trader by Foreign Banks in CIBM in 2016

Bond trading amount by foreign banks in the CIBM in 2016

Rank	Institution name	Bond trading volume (RMBmn)	Percentage of all foreign banks (%)
1	**Standard Chartered Bank (China) Ltd.**	**2,280,326**	**11.33**
2	Chinese Mercantile Bank	2,224,226	11.05
3	HSBC Bank (China) Ltd.	1,809,580	8.99
4	Mizuho Bank (China) Ltd.	1,684,166	8.37
5	Bank of Tokyo-Mitsubishi UFJ (China) Ltd.	1,638,579	8.14

Source: WIND

Glossary of terms

Stock Connect: The Stock Connect scheme that links the exchanges of Hong Kong and Shanghai, and most recently Shenzhen, was launched in 2014. It enables investors with brokerage accounts in Hong Kong to trade A-shares in Shenzhen and Shanghai, while Chinese investors can buy on-exchange listed securities in Hong Kong. Northbound quotas are fixed at 13 billion RMB.

Key features of the Stock Connect programme

Estimation based on data as of end July 2016

			Shanghai Connect NB Trading	Shenzhen Connect NB Trading
NORTHBOUND	Eligible Stocks	No.	567 (One single board)	~880 (Main: ~270, SME: ~410, ChiNext: ~200)
		Mkt Cap	RMB21.8tn (85%)	~RMB15tn (74%)
		ADT	RMB137bn (68%)	~RMB230bn (68%)
	Quota	Agg Quota	Abolished	None
		Dly. Quota	RMB13bn	RMB13bn
	Investors	Eligibility	None	ChiNext participation limited to institutional professional investors initially

			Shanghai Connect SB Trading	Shenzhen Connect SB Trading
SOUTHBOUND	Eligible Stocks	No.	318 (Hang Seng Composite LargeCap, MidCap & A+H shares not in indices)	~417 (Hang Seng Composite LargeCap, MidCap, SmallCap & A+H shares not in indices)
		Mkt Cap	HKD19.8tn (82%)	~HKD21tn (87%)
		ADT	HKD37bn (85%)	~HKD39bn (92%)
	Quota	Agg Quota	Abolished	None
		Dly. Quota	RMB10.5bn	RMB10.5bn
	Investors	Eligibility	RMB500k	RMB500k

Source: HKEx

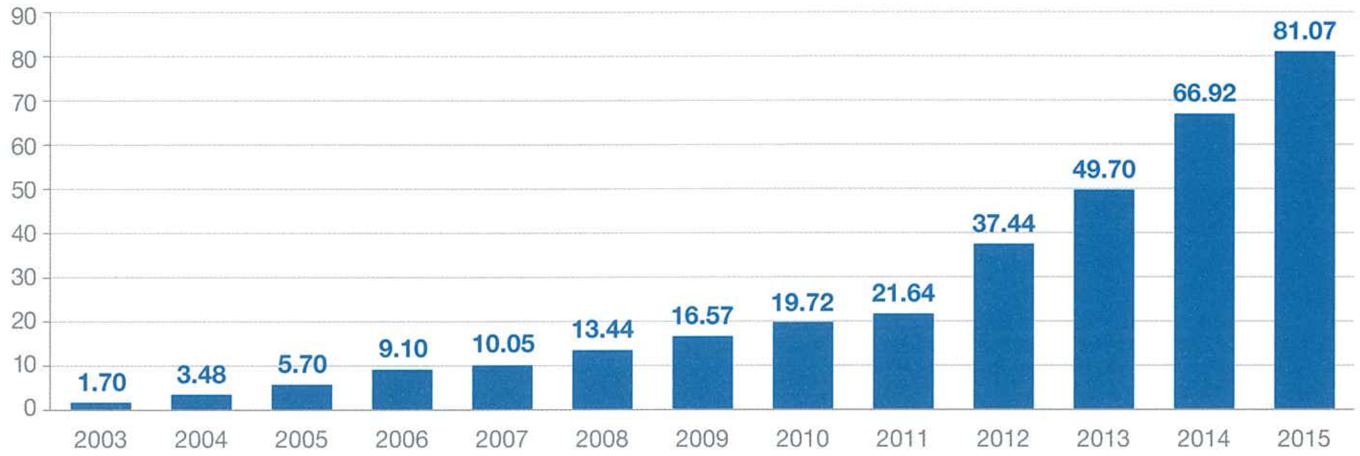
China Interbank Bond Market (CIBM): CIBM is an over-the-counter market for debt instruments comprising government bonds, PBOC bills and corporate debt. It totals around USD7.3 trillion[15] and accounts for 90% of bond trading in China. There are no CIBM quotas.

Market size	Approximately RMB 60.7 trillion as at 23 March 2017 (Source: Wind)
Major types of products traded	China treasury bonds, bonds issued by PBOC, policy bank bonds, financial bonds, enterprise bonds, commercial papers, medium term notes, local government bonds and asset-backed securities
Key market participants	Commercial banks, insurance companies, mutual funds, security companies, foreign investors with RQFII status
Trading hours	9:00 a.m. to 12:00 p.m. and 1:30 p.m. to 4:30 p.m. (Hong Kong time)
Trading and settlement mechanism	Trading mechanism: a quote-driven over-the-counter market between institutional investors Settlement mechanism: primarily delivery versus payment, on either a T+0 or T+1 settlement cycle
Regulator	PBOC
Counterparty with whom investors will trade	The trading counterparty (i.e. the other market participants)
Central clearing	CCDC, Shanghai Clearing House
Liquidity	Total trading volume from October 2013 to September 2014 was approximately RMB34 trillion (Source: CCDC)
Associated risks	Interest rate risk, credit risk, counterparty risk
Minimum rating requirements	No requirement. However, market participants typically require a rating of at least BBB given by a local credit rating agency.
Types of debt instruments commonly seen and the issuers	China treasury bonds: issued by Ministry of Finance Central Bank Bonds: issued by PBOC Policy bank bonds: issued by China policy banks (China Development Bank, Agricultural Development Bank of China and Export-Import Bank of China) Financial bonds: issued by commercial banks and other financial institutions Non-financial credit bonds: issued by state-owned or state-held entities and corporates Local government bonds: issued by local provinces or cities Foreign bonds: issued by foreign entities

Source: CSOP Asset Management

15 RMB Investors Forum White Paper: Rise of Next Generation China Access." *Standard Chartered*, May 2016. [Online]

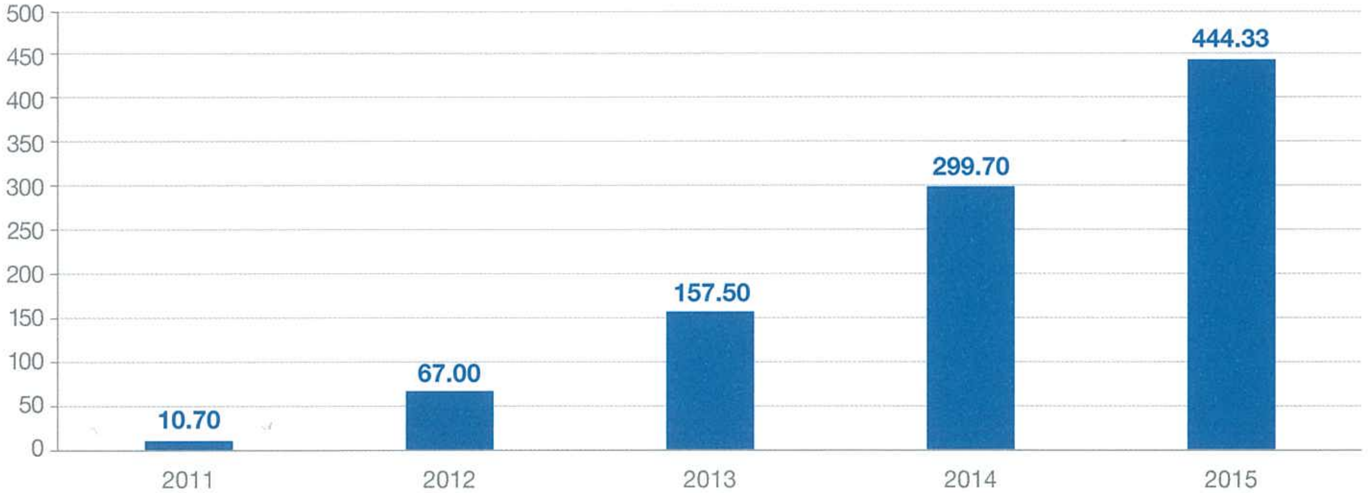
QFII: QFII launched in November 2002. It allows qualified foreign institutional investors to invest in onshore equities and bonds by remitting foreign currency. It has a quota limit but this was recently liberalised, only requiring a filing for basic quota while SAFE approval for additional quota is still required. As of February 2016, 279 foreign institutions have been granted with QFII licenses, and the total quota is USD80.795 billion. 158 foreign institutions have been granted with RQFII licenses, and the total quota is RMB471.425 billion.[16]



QFII Quota Approved since 2003 (USD bn)

Source: Shanghai Stock Exchange

RQFII: RQFII launched in 2011. It allows qualified foreign institutional investors to invest in equities and bonds by remitting funds in RMB. The aim of RQFII is to make it easier to use RMB held outside China to invest in onshore securities.



RQFII Quota Approved since 2011 (RMB bn)

Source: Shanghai Stock Exchange

Bond Connect: An initiative announced in May 2017, which will provide mutual access between the bond markets in Hong Kong and mainland China through a cross-border platform. The scheme will help facilitate trading by international investors in the China bond market. The rules on Bond Connect have yet to be clarified.

[16] "Approved QFII & RQFII List and Quota." Shanghai Stock Exchange. [Online]

[17] "HKMA Welcomes Bond Connect." Hong Kong Monetary Authority, 16 May 2017. [Online]